Future Return Expectations — December 2020

OVERVIEW

- **Current low interest rates, tight credit spreads and high equity valuations point to lower future returns.**
- **A 60/40 portfolio has historically produced solid returns, but that can vary widely based on an investor's starting point.**
- **Non-traditional assets can be an effective way to enhance returns in a low return environment.**

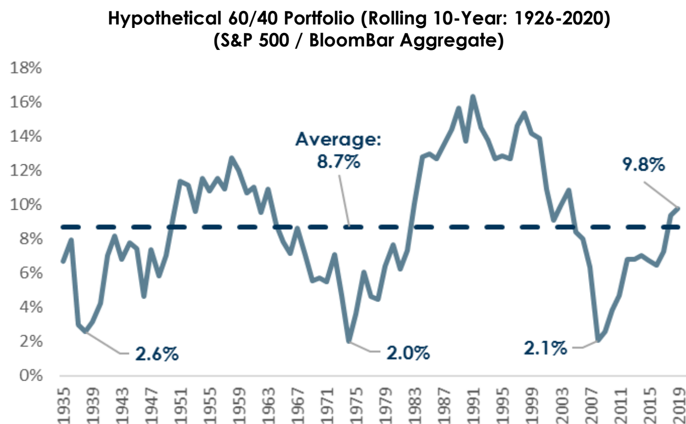
Overview

The pandemic-induced downward spiral in the credit and equity markets which began in February was halted largely on the strength of historic actions by the Fed and Treasury. By Mid-March they had announced rescue programs including bond buying, interest rates at zero, loan programs, stimulus checks, and enhanced unemployment benefits. The subsequent recovery has been remarkable, with the S&P 500 returning ~60% since the market low. Fed guidance has suggested rates will remain low for the foreseeable future and further stimulus appears likely. An accommodative Fed and Treasury is encouragement for investors to be less risk averse, helping sustain the recovery in equities.

It is truly an unprecedented market environment, making forecasting as challenging as ever. However, some broad conclusions may be drawn. As various prognosticators release updated forward return assumptions, the common theme is lower return expectations across asset classes. This is largely based upon two key metrics: high equity multiples (P/E ratios) and low interest rates. Both valuations are near historic extremes, and a move back towards historic averages is likely to result in below average returns for fixed income and equity.

Review of Long-Term Historic Returns

From 1926 to November 2020, the average 10-year rolling return for a hypothetical portfolio of 60% Stocks and 40% Bonds (60/40) was around 8.7%. As such, an investor might expect that a return target of 8% annualized over the next 10-years is reasonable. As of the most recent year-end, the 10-year performance of a 60/40 portfolio stands at an above average 9.8%.



Source: Ibbotson, ACG Research, history prior to BloomBar Agg filled with LT US Gov't

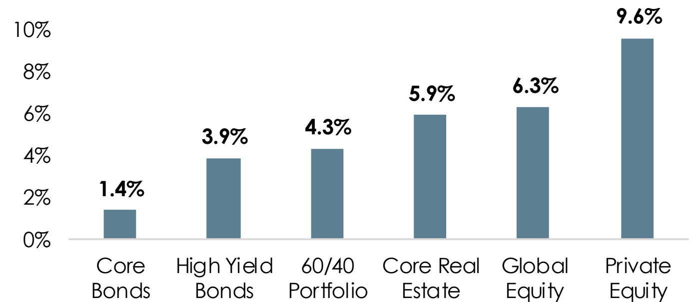
While returns for the last 10 years might be considered robust, having exceeded the long-term average of 8.7%, the outcome was heavily dependent on maintaining a 60/40 asset allocation throughout the period. Returns for the same portfolio at prior year-end periods can paint a very different picture. For a period beginning just prior to the GFC (as of 12/31/16) the 10-year annualized return was 6.4% and as of 12/31/08 the 10-year annualized return was only 2.1%. The starting point for this latter period coincided with the peak of the infamous "Tech Bubble." Clearly, having a 10-year investment horizon does not necessarily mean an investor can achieve the historical "long-term" average return.

Future Return Expectations

Equity P/E ratios and interest rates provide a useful gauge as to where we might be in the current cycle. With those as a guide, the current entry point into the market might not seem particularly compelling. This does not imply however, that one should remain in cash or wait for a better time to invest (time the market), but rather that returns over the next decade are likely to be lower than the long-term average (8.7%).

Cash currently yields around 0.1% and the BloomBar US Aggregate is yielding below 1.2%, both under inflation. So provided an investor has at least a 10-year time horizon, achieving even the lowest historical 10-year return for a 60/40 portfolio (2.0% - 2.6%) would exceed current rates for cash or core bonds. However, if the current equity/economic cycle is extended, a 60/40 portfolio should offer more upside vs. cash/bonds.

A Challenging Return Environment:
ACG 2021 Intermediate-Term Capital Market Assumptions



Source: ACG Research, Arithmetic Returns, 60/40 = 60% Global Equity/40% Core Bonds

Such a subdued outlook may inspire investors to reach for returns. Trying to "beat the market" with frequent, short-term tactical trades is a very difficult undertaking. A more prudent approach is to augment a portfolio with non-traditional assets such as Private Equity, Private Debt, Long/Short Equity, and Real Estate. These asset classes carry their own risk and liquidity considerations but can be sources of enhanced returns.

ACG Position

Investors should expect that current market dynamics will pose a challenge to achieving even historical average returns. We believe strategic allocation across equities, fixed income and real estate remains the most prudent approach. Depending on each investor's unique risk and liquidity preferences, however, utilizing non-traditional assets can enhance returns over a more traditional portfolio.

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231 South Bemiston Avenue ♦ 14th Floor ♦ Saint Louis, Missouri 63105 ♦ 314-862-4848 (ph) ♦ www.acgnet.com