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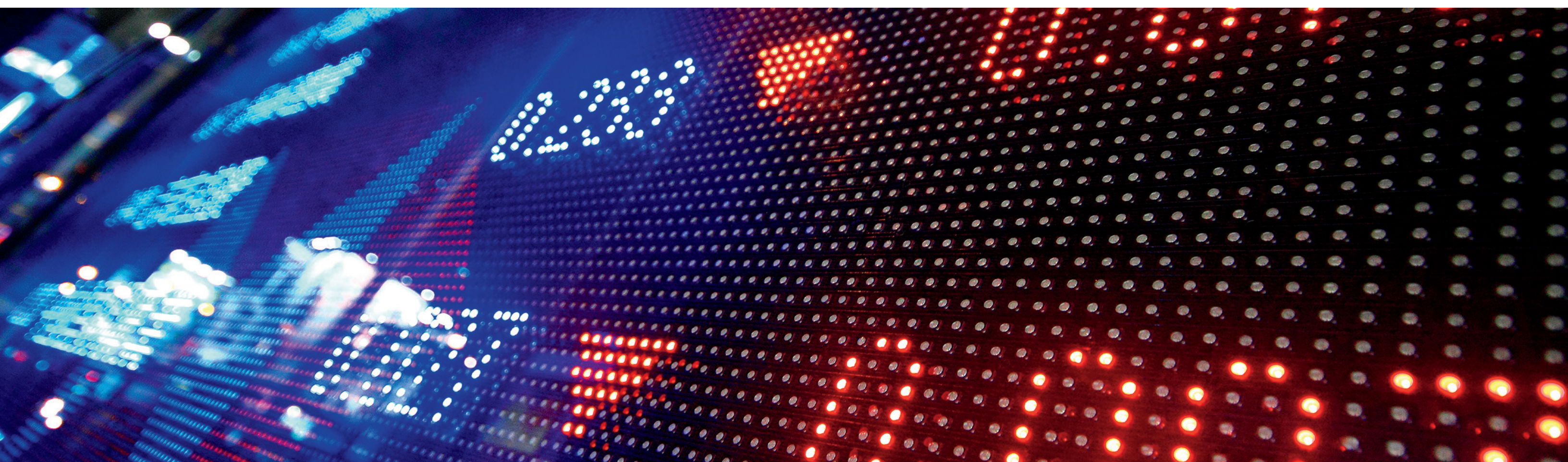

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Corporate Finance

Bracing for a new era of lower investment returns

The conditions that led to three decades of exceptional returns have either weakened or reversed. A wide range of stakeholders will need to adjust their expectations.

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Despite repeated market turbulence, US and Western European stocks and bonds have delivered returns to investors over the past three decades that were considerably higher than long-term averages. From 1985 to 2014, real returns for both US and Western European equities averaged 7.9 percent, compared with the 100-year averages of 6.5 percent and 4.9 percent, respectively. Similarly, real bond returns over the period averaged 5.0 percent in the United States and 5.9 percent in Western Europe, compared with 100-year averages of 1.7 percent and 1.6 percent, respectively.[1]

We believe that this golden age is now over and that investors need to brace for an era of substantially lower investment returns. On both sides of the Atlantic, returns could even be below the longer-term 50- and 100-year averages, especially for fixed-income investors. We project that total real returns in the next 20 years could be between 4.0 and 6.5 percent for US equities and between 4.5 and 6.0 percent for Western European equities. For fixed-income returns the drop could be even bigger, falling to between 0 and 2 percent for both US and Western European bonds. While the high ends of both ranges are comparable to 100-year averages, this assumes a return to normal levels of GDP growth and interest rates—and returns would still be considerably lower than what investors have grown used to over the past three decades.

Our analysis is based on a detailed framework we have constructed that links equities and fixed-income investment returns directly to developments in the real economy. The exceptional returns of the past 30 years were underpinned by a confluence of four highly beneficial economic and business conditions: lower inflation; falling interest rates; strong global GDP growth that was fueled by positive demographics, productivity gains, and rapid growth in China; and above-GDP corporate-profit growth, driven by global expansion, falling interest rates, lower taxes, and cost containment from automation and global supply chains. Publicly listed North American companies increased their post-tax margins to 9.0 percent, from 5.6 percent, over the past three decades.

Each of these four conditions has either weakened or reversed. The steep decline in inflation and interest rates that contributed to capital gains, especially for bondholders, is unlikely to continue. The employment growth that contributed to GDP growth in the past 30 years has waned because of demographic shifts. And after a period of exceptional profit growth, the strongest since the late 1920s, US and Western European corporations face tough new margin pressures from emerging-market competitors, technology firms moving into new sectors, and smaller companies using digital platforms such as Alibaba and Amazon to turn themselves into "micromultinationals."

If we are correct, the implications of this new era of lower returns will prove challenging for a wide range of stakeholders within the investing community but also in society more broadly.

In the United States, about 90 percent of state and local employee retirement funds already struggle with funding gaps, yet for now most of them continue to assume a continuation of the golden age for investors. At their assumed level of future returns of about 8 percent, in nominal terms, on a blended portfolio of equities and bonds, they face a $1.2 trillion funding gap. That gap could increase by an additional $1 trillion to $2 trillion if returns fall to the low end of our projections.

Households will feel the impact directly through their own stock and bond investments and indirectly through pension plans. A two-percentage-point difference in average returns over an extended period would mean that 30-year-olds today would have to work seven years longer or almost double their savings in order to live as well in retirement—and this does not factor in any increase in life expectancy.

A return that's three percentage points lower could mean that US colleges might earn $13 billion a year less from their endowments, requiring cuts to spending, new revenue sources, or fee increases. Asset managers will be directly affected—their fees are likely to come under pressure in a lengthy period of lower returns as investors seek to minimize costs—as will insurers that rely on investment income for earnings.

Falling returns could be addressed in a number of ways, none of them particularly palatable. All investors need to start by having a frank look at the implications of lower returns. Then they need to look at the cost of investing. In a lower-return world, being cost-efficient matters more. In the United Kingdom, 89 local-authority pension funds are merging into 6 so as to be more efficient. Investors can also consider adding to their portfolio longer-dated and less-liquid assets with potentially higher expected returns, such as emerging-market equities, infrastructure investments, commercial real estate, hedge funds, and actively managed funds. However, only a limited number of active managers are able to produce returns that are consistently superior to passively managed funds.

In the end, employers and individuals will also need to increase their pension contributions, change the benefits available in the future, or increase the retirement age. Policy makers need to prepare for a generation of people who will retire later with less income. For the global economy, falling returns could be a drag on consumption if individuals put aside large amounts to save for retirement rather than spend.

"Past performance is not necessarily indicative of future results," reads the standard disclaimer that mutual funds routinely put on all their communications. It is time for investors of all types, individuals as well as institutions, to take that message very seriously by resetting their expectations and taking appropriate steps to avoid being caught short in the event of an extended period of lower returns. ■

[1] Including dividends and capital appreciation.

For more, see the full report from the McKinsey Global Institute, *Why investors may need to lower their sights*, on McKinsey.com.

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