

Thirteen years on...

A full 13 years have passed since the *end* of the GFC market upheaval and it's now a distant memory for many. For others, the anxiety felt from equity markets falling for some 21 (odd) months is not easily forgotten - not only due to the steep and protracted falls, but also because it took up to six years for equity markets to recover; and that's assuming you were able to reinvest all your investment income. If you needed the income to support your living requirements, the recovery was even longer.

Behavioural impacts of market conditions

A subtle, yet pervasive effect of experiencing such significant portfolio drawdowns is the tendency among some investors to change their risk profiles at the wrong time. For example, those that capitulated due to anxiety and switched from say a **Balanced** to a **Conservatively** managed portfolio in early 2009 would have missed out on participating in the subsequent market recovery. The opposing FOMO (Fear of Missing Out) tendency applies to those that increase their portfolio risk late in the cycle to chase returns they recently missed out on. Generally, FOMO investors may not fully appreciate the level of risk being assumed when switching to more aggressive portfolios, as can be the case when high returns under stable market conditions have been generated over several years.

The worst outcome for investors occurs when portfolio risk is dialled up, late in the cycle (think late 1999 or 2007) and then substantially de-risked when the anxiety felt from protracted market falls becomes too much to bear (2000-2003; and 2007-2009). The potential cost for investors can be significant, which at times may impair the ability to maintain required living standards.

General market conditions, post GFC

The last 13 years have been highly rewarding to investors. Developed economies have been exposed to disinflationary forces with good levels of GDP, slack labour markets, easy money conditions and falling bond yields. Such economic conditions have supported the long-term performance of both equity and bond markets as highlighted in the chart below:

Exhibit 1

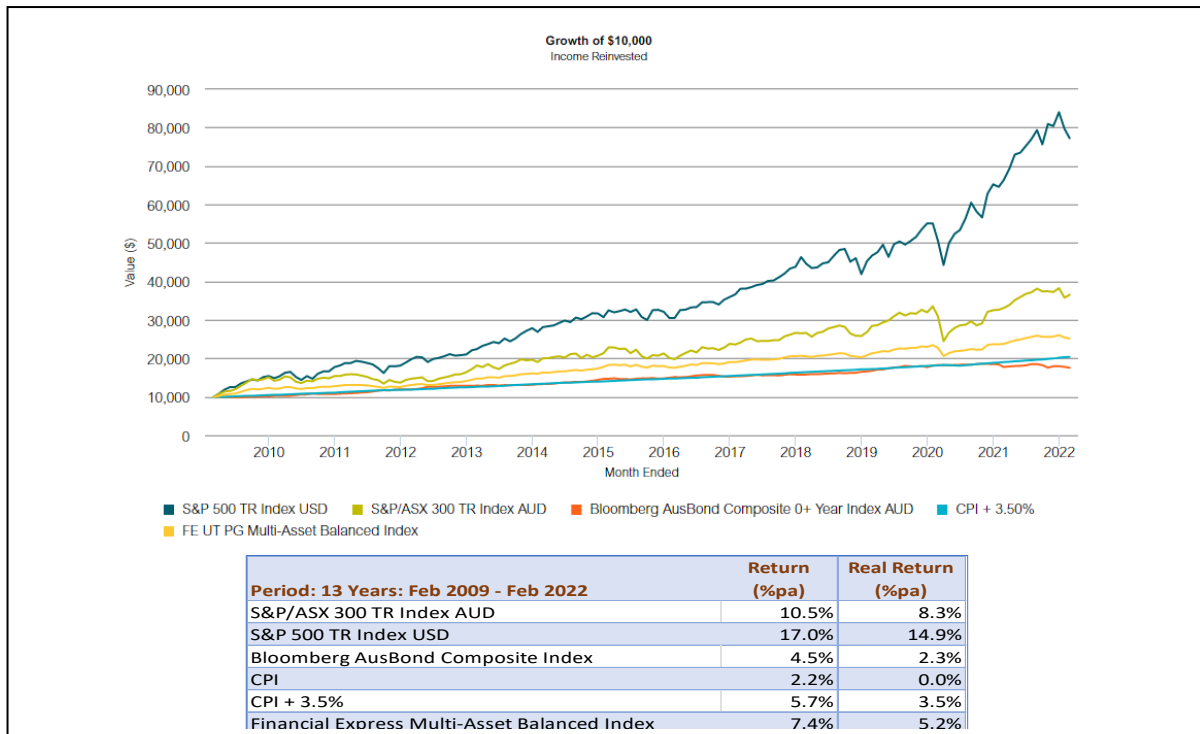


Exhibit 1 plots the accumulated returns *since February 2009* of: (1) the Australian Equity market; (2) the US Equity market; (3) the Australian Bond market; (4) CPI + 3.5%pa; and (5) Financial Express Balanced Index, a proxy for a Balanced Portfolio. We see that each benchmark return significantly exceeded the rate of inflation (2.2%pa), with the US equity market being the star performer, generating a real (after inflation) return of 14.9%pa. Australian equities came in second with a *real* return of 8.3%pa. Australian bonds kept up with CPI+3.5%pa up until 2021; and even though its return lagged thereafter, it still managed to outperform inflation by 2.3%pa. over the 13-year period.

Low point to High point

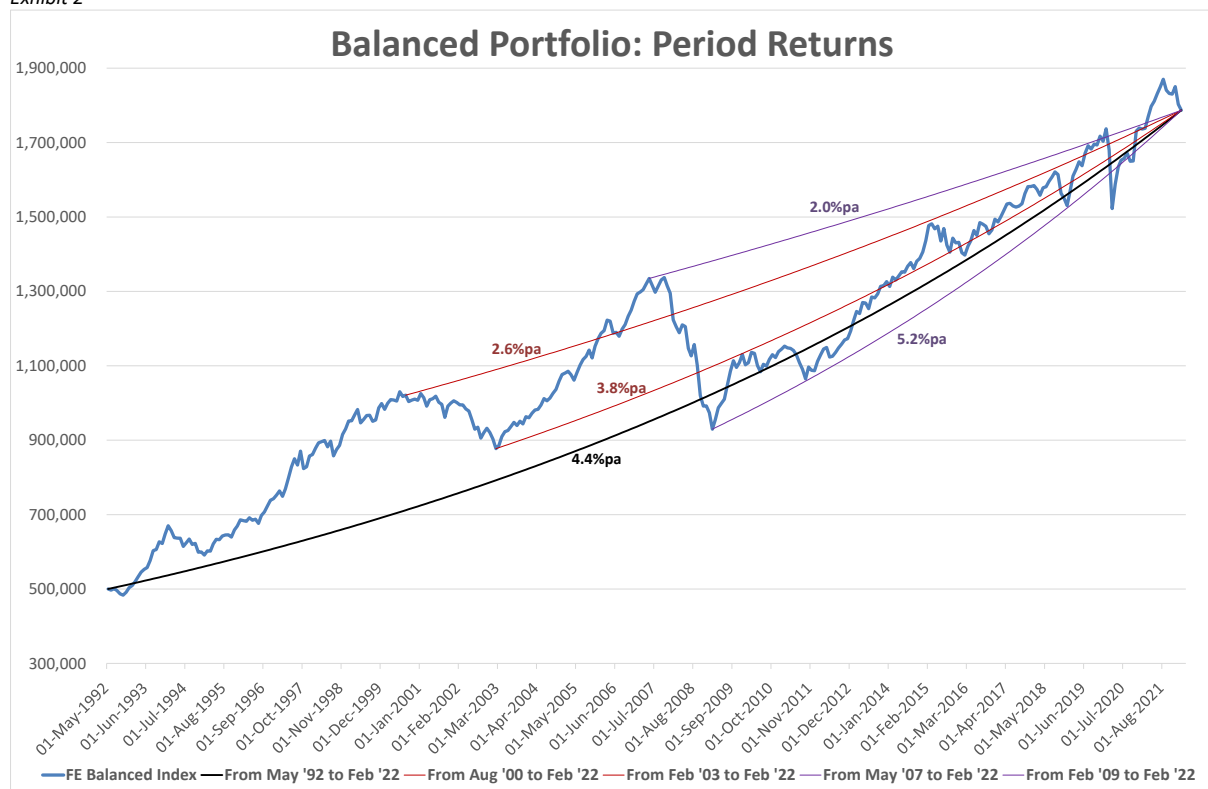
The portfolio entry point has a significant influence on portfolio return outcomes. To emphasise, the above 13-year return summary starts from a low entry point (Feb 2009) for each asset class and ends with elevated current market values. This means that portfolios have not been exposed to a full cycle over the last 13 years, which suggests that future returns are likely to be muted.

How does the performance of the last 13 years compare against longer term returns?

We analyse the returns of the FE-Balanced Index since its inception of May 1992. Exhibit 2 shows that if we look back further than just the last 13 years to take in the last 29½ years, the *real* return for the Balanced Portfolio proxy is pegged back from 5.2%pa to 4.4%pa. We emphasise that May 1992 was another low entry point, with the Australia economy coming out of a recession. Therefore, it does not cover full market cycles; for that, we want a *low-entry low-exit* point scenario. Nonetheless, the longer time frame provides a more robust return framework that incorporates bull-market conditions prior to the GFC together with the Asian currency crisis (1997), the 2000 dot.com crash and the 9/11 market correction.

We can readily deduce the *real* returns generated from prior market high points against current market prices, which shows the extent to which they can fall away based on elevated entry points. To emphasise, when market prices bottomed in March 2009, the Balanced portfolio proxy generated a subsequent 13-year *real* return of 5.2%pa. Conversely, if we take the portfolio entry date during an elevated market period such as August 2000 or May 2007, the subsequent 21½ year and 14¾ year real returns to February 2022 reduce to 2.6%pa and 2.0%pa respectively, as highlighted below.

Exhibit 2



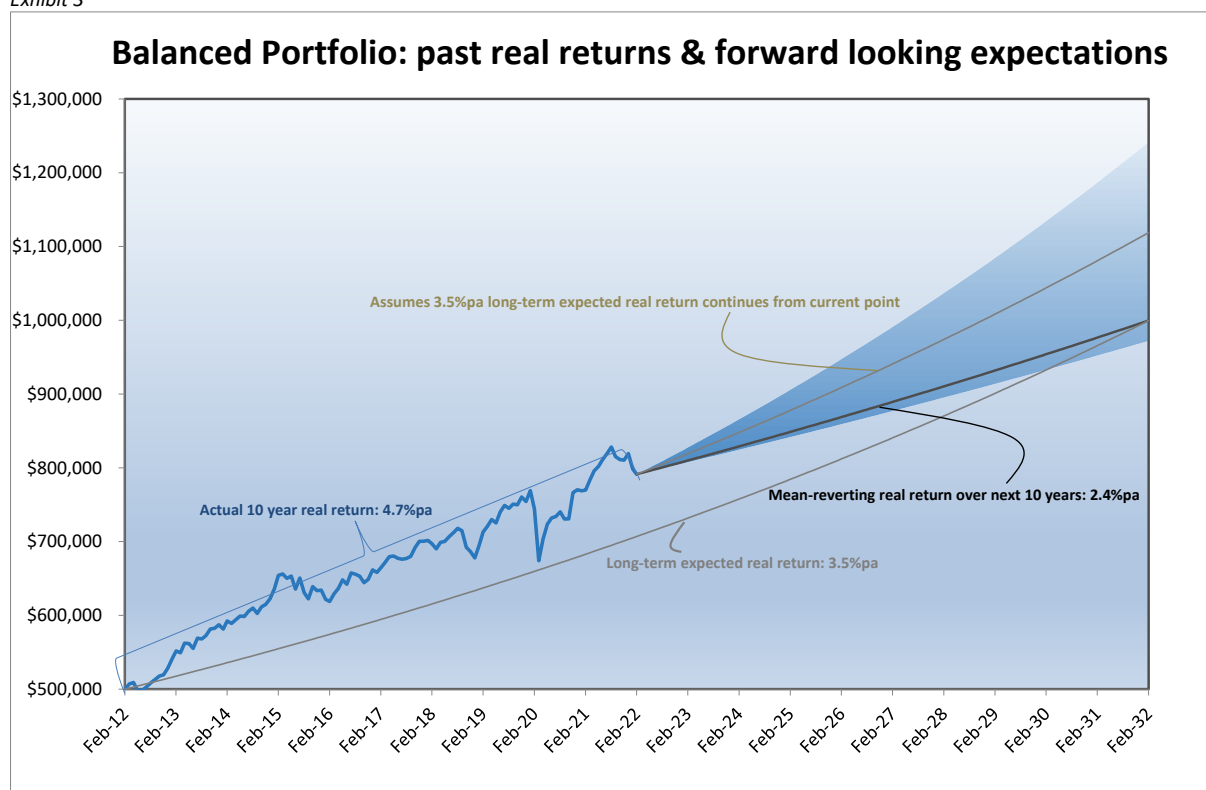
Future returns: what to expect?

In considering future return expectations we first need to derive a long-term expected return, which we estimate by calculating the **real** return on a fixed monthly investment over the last 29¼ years (back to the inception date of the FE Balanced Index). This approach averages out market price fluctuations over a period of 357 months and produces a robust estimate of 3.5%pa as our **real** long-term return expectation.

We next calculate the actual **real** return generated over the last 10-years and use it to derive the prospective 10-year return required to generate a total 20-year **real** return of 3.5%pa (our long-term expectation). This approach is commonly referred to as mean-reverting, which infers that portfolio returns will revert to the long-term average over the long-term.

Exhibit 3 provides a diagram of the analysis. It plots the accumulated growth on an initial investment of \$500,000 exposed to: (a) our expected **real** long-term return of 3.5%pa over the full 20-year period; (b) the actual returns of the FE Balanced Index over the last 10 years and subsequently projected forward a further 10 years with: (bi) a mean reverting **real** return of 2.4%pa; and (bii) the **real** long-term expected return of 3.5%pa.

Exhibit 3



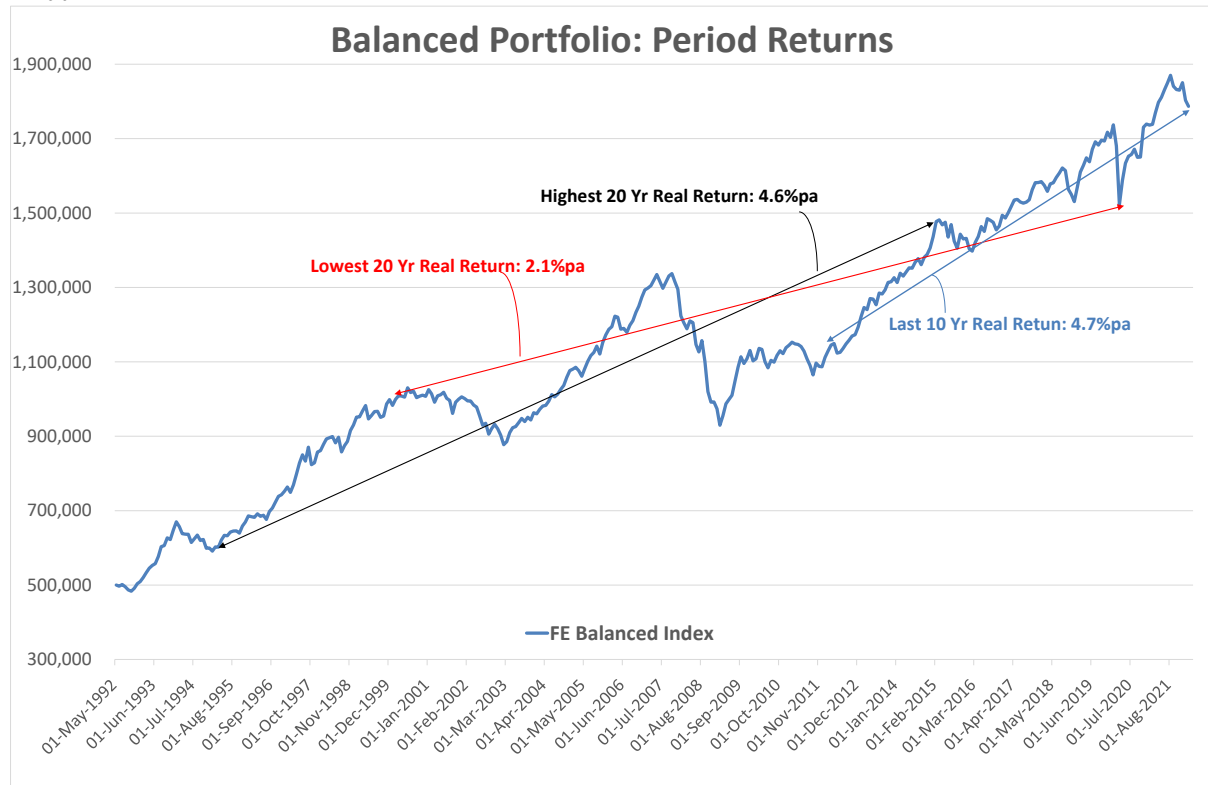
If we combine the actual 10-year **real** return (4.7%pa) with the projected 10-year **real** return (2.4%pa), we generate a total 20-year **real** return of 3.5%pa to match our long-term return expectation. This analysis suggests that the return outlook over the next 10 years is likely to be meaningfully less than that experienced over the last decade.

However, we acknowledge that we live in an uncertain world. Return forecasts that purport to be precise should be taken with a grain of salt. The blue shaded area in the above chart shows a potential range of returns above and below the mean-reversion level. The upper bound denotes an optimistic return outcome based on a prospective 10-year **real** return of 4.6%pa; and the lower bound denotes a pessimistic **real** return outcome of 2.1%pa. The upper and lower bounds represent the highest and lowest 20-year **real** returns experienced by the FE Balanced Index since 1992, for which we have 118 observations. This can make a big difference to the investor's outcomes; the optimistic outcome generates a portfolio worth almost 30% more than the portfolio under the pessimistic outcome.

Take note that the mean-reverting return (2.4%pa) is not much higher than the lower bound (2.1%pa). It highlights our earlier reference to portfolio entry and exit points – strong returns over the last 10 years have elevated market valuations making today a relatively high entry point, which lowers future expectations. The long term expected return (3.5%pa) falls comfortably in the middle of the upper and lower bounds.

The worst 20-year period for the FE Balanced Index was from March 2000 to March 2020, which started at the IT-bubble peak (high entry) and ended with the sharp Covid sell-off (low exit); while the best 20-year period was from March 1995 (low entry) to March 2015 (high exit), as highlighted in the Exhibit 4, below.

Exhibit 4



The astute reader will note that the *real* return achieved over last 10-Years (4.7%pa) is close to the highest 20-year *real* return (4.6%pa), which suggests that the next 10 years could generate around 4.5%pa to match the higher bound. While this falls within the realm of possibilities, we do not assign a high probability to it as we believe the steep upward gradient observed over the last 10 years is unlikely to be sustained. We see strong reversals of the significant tailwinds of the last decade, as noted in Exhibit 5, below:

Exhibit 5

Conditions Since 2012	Current conditions
- <i>Disinflationary / deflationary shocks</i>	- <i>Inflationary pressures</i>
- <i>Slack in labour markets</i>	- <i>Tight labour markets</i>
- <i>Falling bond yields</i>	- <i>Rallying bond yields</i>
- <i>Reducing cash rates</i>	- <i>Bias to increase cash rates</i>
- <i>Low level of volatility</i>	- <i>Higher volatility</i>
- <i>Easy monetary policies (QE)</i>	- <i>Tightening Monetary policy bias</i>
- <i>Significant fiscal stimulus</i>	- <i>Reduced capacity for further fiscal stimulus</i>
- <i>Inexpensive capital markets</i>	- <i>Expensive capital markets</i>
- <i>Lower geopolitical risk</i>	- <i>Higher geopolitical risk</i>

The unknown path of future returns

While returns over the next decade are likely to be meaningfully less than those achieved over the last 10 years, the direction they take over the short to medium term continues to be difficult if not impossible to predict. We have observed three (3) sharp sell-downs over the last decade (2015/2016, 2018, 2020), with equally sharp recoveries aided by massive monetary & fiscal stimulus. It's possible that we are currently experiencing a beginning of the fourth meaningful sell-down in the face of escalating inflation, rising cash rates & bonds yields under a backdrop of heightened geopolitical risk, supply constraints and elevated market prices.

We believe that the potential for returns to eddy towards the lower bound (and potentially breaching it) is greater than the likelihood of them pushing toward and above the upper bound. Markets are prone to overshooting on both sides in the short term. We have seen the Balanced portfolio proxy has substantially exceeded its long-term return expectation over the last decade, just as we observe markets overselling when they correct. For example, the rolling 10-year real return for the Balanced portfolio proxy was less than 2.5%pa from October 2008 to November 2012 (50 months) and from November 2015 to December 2017 (26 months). Our 10-year mean-reverting forecast of 2.4%pa is certainly not without precedent.

Risk tolerance & Investment Preferences

Given the strong returns over the last decade and the muted return outlook, it would be timely to review and assess the extent to which your portfolio remains true to your risk tolerance and investment preferences. This is particularly true for investors that are drawing down on their portfolio to fund lifestyle requirements, given the sensitivity to protracted market corrections and lower returns. Moreover, the low cash and bond yields over the last several years may have enticed some retirees to take on risk beyond their true risk tolerance levels. For much of that time, equity markets were much quieter than they had been during earlier periods, making it easy to overlook any creeping rise in portfolio risk. However, as equity volatility reappears, that can quickly change. Going forward, the list of factors in Exhibit 5 not only give reason to expect that returns will be lower going forward, but also that the higher market volatility we've seen of late is likely to continue. This hurts a portfolio's risk profile from both sides – we may well see lower returns and higher volatility for the foreseeable future.

We re-state our introductory comment:

The worst outcome for investors occurs when portfolio risk is dialled up, late in the cycle and then substantially de-risk when the anxiety felt from protracted market falls becomes too much to bear. The potential cost for investors can be significant, which at times may impair the ability to maintain required living standards.

Investors that are in accumulation mode and regularly contribute to their portfolios will generally have greater tolerance to significant corrections. They are in the reverse situation to investors in draw down – for the latter, market corrections force them to sell off at reduced prices, but for investors making regular contributions, such an event acts as a buying opportunity. Notwithstanding their longer-term investment horizon and ability to assume higher levels of risk, wealth accumulators will want to ensure that their portfolios match their risk profiles.

We further encourage clients to re-visit their personal risk attitudes and investment preferences. In terms of risk attitudes, this broadly refers to your preference of maintaining a '**set and hold**' portfolio irrespective of changing market conditions, or alternatively a '**dynamically managed**' portfolio, which changes the portfolio composition in response to meaningful changes in market conditions.

Investment preferences refer to how your portfolio is implemented. In broad terms, portfolios can be implemented through passive investments that aim to replicate market returns (at a low cost); or active investments that seek to outperform market returns (at a higher cost); or a combination of both. There are compelling but nuanced arguments for and against each implementation.

It's certainly a good time to speak to your adviser.

Disclaimer

This DFSPS document is a general guide publication and does not constitute and is not intended to be a substitute for professional financial advice. In preparing this document, we did not take into account the investment objectives, financial situation and particular needs ("financial circumstances") of any particular person. You should not rely nor act on any information contained in this article without seeking professional financial advice. Past performance should not be taken as a guarantee for future performance.

Use of Material and Information:

The information and material provided in relation to the DFS Investment Methodology (Information) is proprietary to DFS. Unless expressly stated otherwise, DFS claims copyright ownership of all Information in respect of its Investment Methodology. The Information may be used for the purposes of private study, research, criticism, or review, as permitted under the Copyright Act 1968. You are not permitted to re-transmit, distribute, or commercialise the information or material without seeking prior written approval from DFS. Where permission is obtained, the Information must be reproduced in its unaltered form and must acknowledge DFS as the source. DFS reserves the right to revoke such permission at any time.