April 15, 2020

RVK

What Lies Ahead?

Return/Risk Tradeoffs and Challenges Beyond COVID-19

Much has been written about the effect of COVID-19 on investment markets and it is likely that there will be considerably more to come. Most of what has been written has focused on immediate and near-term impacts. We would like to turn our focus to potential long-term consequences and share our thoughts regarding "what lies ahead," meaning the potential future considerations for institutional investors once we move beyond the immediate market, economic, and health crises.

Two key questions should be considered by most institutional investors, including defined benefit pension plans, endowments, foundations, sovereign wealth funds, insurance companies, other special purpose funds, and most defined contribution participants:

- "How much risk do I need to take to reach my investment objectives?"
- "What is the potential long-term/strategic payoff for taking that investment risk?"

Our discussion focuses on the second question, including a discussion of challenges all investors may encounter over the next decade based on several trends that have been evolving over the past two decades or longer.

Trend #1: The High Opportunity Cost of Capital Preservation Assets

The ideal environment for many types of investors is when the risks associated with high-return seeking assets (e.g., US and international public equity) can be balanced with diversifying exposures in capital preservation-oriented assets that also offer reasonably attractive expected returns. In the current environment, we believe the prospective returns for capital preservation assets (e.g., Treasurys and other government-related fixed income) are so low that their inclusion can create a meaningful return drag on a diversified portfolio. This return impact is significant enough to cause investors to consider making painful choices between the risk-mitigating benefits of capital preservation assets versus leaning more heavily toward risk asset exposures in order to achieve their portfolio's long-term return objectives.

Exhibit 1 shows a pattern that should concern all investors and highlights a parallel concern about the impacts of monetary policy initiated in the 1990s that continues to this day. With each burst of monetary policy relief (highlighted in blue during the recessionary periods of 2000 – 2002, 2007 – 2009, and 2020), interest rates fell to a new and *lower* plateau leaving investors with an initial capital gain as yields declined, but with a *lower* forward return. This pattern has repeated until today when investors find themselves facing fixed income yields all along the Treasury curve that offer only a tiny fraction of the returns needed to achieve their total portfolio return objectives (see Exhibit 2 on the following page). In short, the return gap between return objectives and current capital preservation asset yields has, in stepwise fashion, become ever more challenging for investors, and the long-term effects of modern monetary policy more concerning.

Exhibit 1:

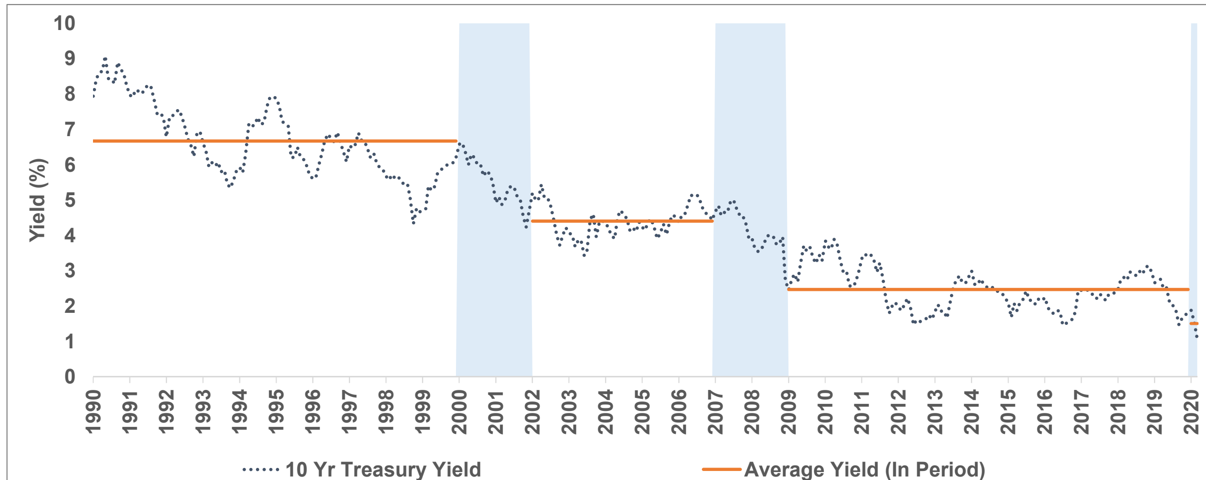
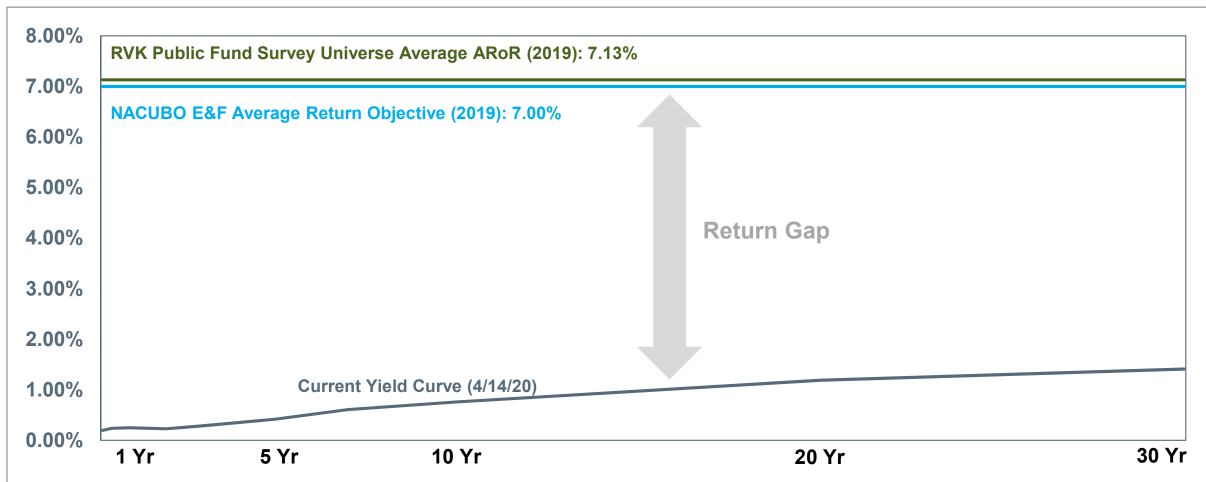


Exhibit 2:



Source: US Treasury

Investors have adapted to this repeated "step down" in expected returns in two ways. First, investors have reduced their exposures to these assets, forgoing some of their risk-mitigating benefits. Second, they have sought allocations to alternative asset classes or strategies in the pursuit of better performance than expected for a mix of traditional investments including capital preservation assets. It is their hope that these asset classes will not only provide better returns than capital preservation investments, but that they will also provide some degree of equity risk diversification, since equity exposures tend to contribute a large portion of return volatility in many long-term investment portfolios. Examples include real estate, private capital, hedge funds, and other multi-asset, inflation related, or absolute return oriented strategies as reflected in allocation trends for public funds and foundations in Exhibit 3.

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Exhibit 3:

Average Allocations to Major Asset Classes - Public Funds	2019	2018	2016	2014	2010	Change (2010 - 2019)
Public Equity	45%	44%	48%	49%	51%	-6%
Public Fixed Income	22%	23%	22%	22%	26%	-4%
Total Alternatives	27%	28%	25%	23%	19%	9%
Cash and Equivalents	3%	3%	4%	3%	2%	1%

Source: June 30, 2019 RVK Public Fund Report

Average Allocations to Major Asset Classes - Foundations	2019	2018	2016	2014	2010	Change (2010 - 2019)
Public Equity	43%	47%	48%	50%	46%	-3%
Public Fixed Income	16%	16%	18%	18%	22%	-6%
Total Alternatives	36%	33%	29%	28%	26%	10%
Cash and Equivalents	4%	4%	4%	4%	5%	-1%

Source: June 30, 2019 NACUBO Study

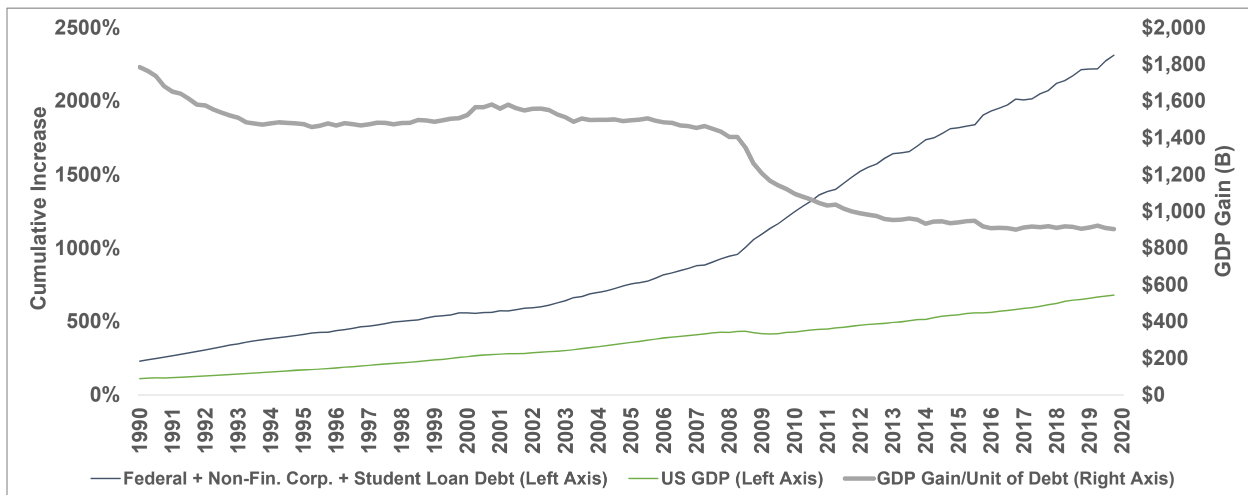
Addressing portfolio risk, return, and diversification challenges are a key focus for RVK's consulting teams. We seek to help our clients identify appropriate portfolio structures through asset/liability and asset allocation modeling, asset class structure studies, and investment manager research. That same focus is mirrored in our consulting teams working with defined contribution plans where the design of investment menus, composition and glide paths of target date funds, structure of multi-manager white label funds, and the selection of capital preservation options receive additional consideration.

Trend #2: Declining Marginal Effectiveness of Debt to Stimulate Growth

We do not believe equity markets track economic growth in lockstep. The value that investors place on stocks in any given time period is influenced by many other factors, among which are current and expected inflation, interest rate environment, profit margins and returns on invested capital, economic and regulatory policies, and conviction in the rule of law. We believe that in the long run, more robust economic growth sets the foundation for higher equity valuations—and the reverse is also likely.

Recent data suggests that as the US economy takes on increasing amounts of government debt, future economic growth may be at risk. The decline in Return on Investment (ROI) for each billion $ of debt incurred across the economy shows no sign of abating and has fallen significantly since 1990 (Exhibit 4). It is one of the many reasons we reduced our forward-looking expected equity returns at the beginning of 2020. The wisdom of policies that emphasize substantial borrowing now in hopes of current economic stabilization and generation of future growth will most certainly be evaluated in the future—with the benefit of hindsight.

Exhibit 4:

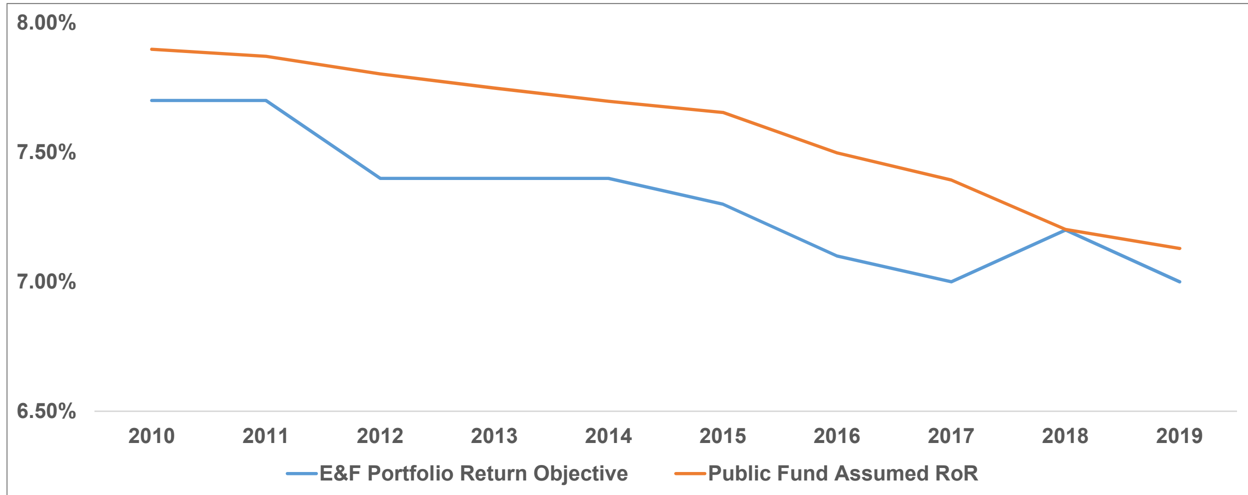


Source: FRED, FactSet

Since the Great Financial Crises (GFC), some of the decline in the underlying foundation for equity valuations has been offset by lower inflation, lower interest rates, and higher corporate profit margins.

These factors appear to have driven Price/Earnings (P/E) ratios higher and contributed to the strong surge in US equity markets through early 2020. As the effects of these positive drivers wane, prospects for underlying economic growth may more strongly influence equity values and investors may reconsider the return goals they believe are reasonable. We believe that process is already underway. For example, endowments and foundations have been re-examining their spending policies, insurance companies are reassessing pricing for annuities and acceptance of long-term liabilities, public and multi-employer pension plans have been steadily reducing their expected long-term returns (Exhibit 5), and defined contribution experts continue to recommend auto-enrollment and auto-escalation features to drive higher savings rates.

Exhibit 5:

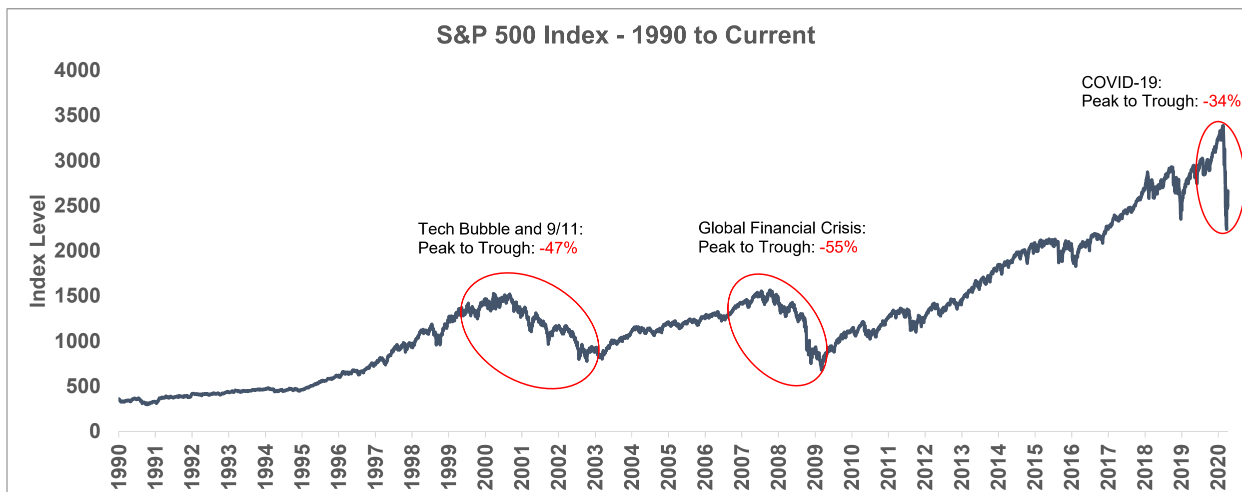


Source: June 30, 2019, NACUBO Study, June 30, 2019, RVK Public Fund Report

Trend #3: More Frequent Major Equity Declines are Sapping Long-Term Compound Returns

Since the 1990s, significant equity market declines have become more frequent than statistically expected provided normal return distributions (Exhibit 6). For this reason, we use “fat” left tail, non-normal distributions in our Monte Carlo analyses for asset classes exhibiting these return patterns in order to understand the stress they can place on portfolios.

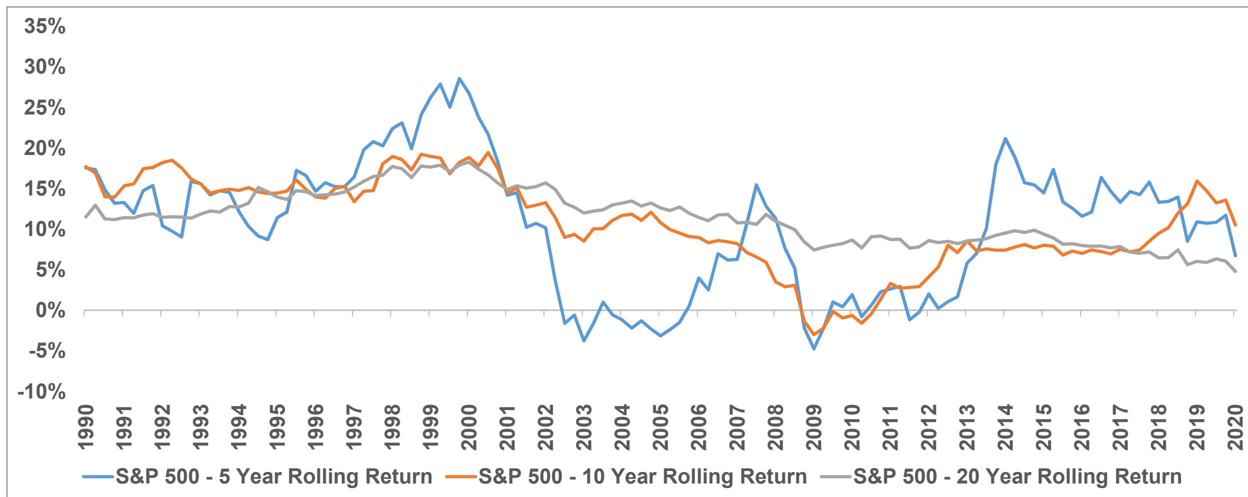
Exhibit 6:



Source: Bloomberg

Since 1990, 10-year S&P 500 rolling returns vary from -3% to 19% (Exhibit 7). Over that same period, the annualized return for the S&P 500 was 9.1%. By comparison, the 20-plus-year compound return for the S&P 500 from January 1, 2000, to March 31, 2020, is much lower at 4.85%.

Exhibit 7:



Source: Bloomberg

The damage done to long-term compound equity returns by these significant market corrections can be problematic for perpetual funds such as open defined benefit plans and most endowments and foundations and even more so for those with deficit spending characteristics. It is also a challenge for individual investors seeking to build retirement savings. We don't know if we will continue along a path of "boom" and "bust" in the equity markets or whether monetary policy, fiscal policy, or some other underlying factor will continue to take a bite out of long-term compound returns. If it does continue, our belief is that trying to tactically time these periods is a chancy endeavor and not one in which many investors have succeeded. We continue to believe that RVK's annual revisions to our strategic capital market assumptions is the most dependable, pragmatic, productive, and least risky means of strategically analyzing and addressing asset allocation decisions through these periods.

Not Pessimistic; Instead Responsible

While we are not pessimistic about the future of the US or global economy, as co-fiduciaries to our clients we also feel a responsibility to map out and monitor as best we can the environment our clients will face as they pursue their investment objectives. By doing so, we hope we can inform and support good investment decision-making as well as the many related decisions they may face regarding contribution and savings levels, benefit and spending policies, asset/liability matching, and more.

With gratitude,

Becky Gratsinger and Your RVK Team

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