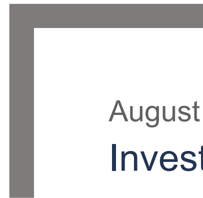

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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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“Cult Figures”

Bill Gross, PIMCO, August 2012

Investors should not extrapolate long-term real equity returns of 6.6% and the generous bond returns over the past 30 years into the future. Equities have grown faster than GDP because employees’ real wages and government corporate tax receipts have both declined as a share of GDP over recent decades. These conditions should reverse, pressuring corporate profits at the same time that GDP growth is slowing due to secular deleveraging. Historically, policymakers have attempted to inflate the economy out of such a predicament. Thus, investors should position themselves for higher inflation in almost all developed economies over the next few years, and possibly decades.

The cult of equity is dying. While several generations grew wealthy during the last secular bull market, more recent returns have been less flattering, to say the least. For instance, Treasuries have outperformed equities over the last ten, 20, and even 30 years. Thus, higher risk is usually, but not always, rewarded with higher return.

A longer time horizon looks more favorable for equities. Indeed, stocks (as measured by the S&P 500 Index) have compounded at a real rate of 6.6% over the last 100 years, outperforming bonds handily. Investors, however, should not extrapolate such generous returns into the future. Over this same period, wealth (or real GDP) compounded at a much slower rate of 3.5%. Thus, stockholders managed to skim an additional 3% annually. Common sense dictates that this cannot continue indefinitely. For instance, should stocks continue to appreciate at a rate of 3% more than GDP, stockholders would command a disproportionate share of wealth, doubling their relative advantage every 24 years.

A primary reason why equities have performed well, compared to GDP, is that the division of GDP among capital, labor, and the state has favored the former for roughly four decades. Real wages have declined steadily since the early 1970s from nearly 54% of GDP to roughly 44%, due in part to globalization (i.e., an abundance of cheap emerging market labor has driven real wages lower in the developed world). In fact, this period coincides with much of the past century’s real return advantage (over GDP) for stocks. Government, meanwhile, has partly conceded to capital as well—effective corporate tax rates are near 30-year lows as a percentage of GDP. As a result, it seems highly unlikely that stocks will generate similar returns going forward, given conditions will not become *more* favorable for stocks. Put differently, labor and government will ultimately demand a higher percentage of the GDP pie. Further, GDP growth itself seems likely to struggle amid a secular deleveraging.

Bonds, meanwhile, are likely to suffer a similar fate of low returns, as bond market returns are highly dependent on initial yields. With the current yield on the Barclays U.S. Aggregate Bond Index at only 1.8%, it is unreasonable to assume bond markets will replicate performance witnessed over the past three decades.

Putting it all together, a 2% return on bonds coupled with a below average nominal return in stocks—perhaps 4%—means a diversified portfolio will struggle to generate returns of more than 3% (and roughly 0% in real terms). Such low prospective returns argue that the global economy will undergo a substantial shift,

as asset inflation is relatively subdued compared to history. For instance, pension funds, government budgets, and household savings balances rely on 7% to 8% compound nominal returns at a minimum. Such return expectations are unreasonable given present conditions. As a result, these programs and their stakeholders will need to make adjustments—i.e., the population will have to work longer, take a haircut on existing assets and entitlements, or some combination of the two.

Historically, policymakers have attempted to generate inflation in the face of such a predicament. Indeed, the simplest way for bonds to return 7% to 8% over the next 30 years is to drive nominal yields to those levels. Clearly, however, current bondholders will suffer large losses in that process. Such an environment also bodes poorly for equities, as they tend to perform poorly amid high inflation. Further, the problem with such a "solution" is that inflation does not create real wealth and its pain is unevenly distributed across various actors in the economy. That said, it remains the most likely outcome and investors should position themselves for an attempted inflationary solution in almost all developed economies over the next few years, and possibly decades.

"Reports of the Death of Equities Have Been Greatly Exaggerated: Explaining Equity Returns"

Ben Inker, GMO, August 2012

Despite the underperformance of U.S. equities over the last decade, investors should feel confident that in the long run, they will in fact realize some equity risk premium. Claims that equities are dead—and unlikely to reproduce the same returns they have over the last few decades—are greatly exaggerated.

Following a 12-year period during which U.S. equity returns have been negative, it is natural to wonder if it still makes sense to own equities "for the long run." Despite this underperformance, an examination of where equity returns come from should leave investors confident that they will realize a long-term equity risk premium. Claims that equities are dead—and unlikely to reproduce the same returns they have over the last few decades—are greatly exaggerated.

The first thing worth pointing out when thinking about the sources of equity returns is that GDP growth and stock market returns do not have an obvious relationship. Just because a country has a high rate of GDP growth does not necessarily mean its equity market returns will also be high. It is true that over time, economy-wide aggregate corporate profits should grow with GDP, and aggregate equity market capitalization should grow with aggregate earnings. However, these relationships have very little to do with the overall compound rate of return realized by equity owners. New companies entering the market, existing companies issuing stock, share buybacks, and merger and acquisition activity all place a wedge between aggregate numbers and per share numbers or compounded returns.

Thse arguments are supported by historical data in the United States. Since 1929, market capitalization has grown at 3.6% real, while corporate profits and GDP have grown around 3.3%. But, there is little connection between this and a real return on U.S. equities of around 5.9% a year. Historical equity returns are better explained by dividend yields (which have averaged around 3.9% since 1929) and real

earnings growth (which has averaged around 1.7%). If equity returns are growing more quickly than market cap, does this mean that investors eventually control a much bigger share of production? No, because investors do not actually compound these returns. Individuals save to fund retirements, pension funds pay out benefits to plan beneficiaries, endowments and foundations support spending to their respective institutions, etc. In other words, rather than always reinvesting, stocks are sold over time to fund some sort of spending.

Why have returns to equity holders been so generous over time, and what should be considered a reasonable return for equity holders? From the issuer's perspective, it should be willing to pay a significant risk premium in exchange for permanent capital. Debt is accompanied by payment obligations, which limit operational flexibility, while equity is permanent capital that offers maximum flexibility in terms of funding long-term projects, etc. From the investor's perspective, the return should be high enough above that of high-quality fixed income to compensate for the inherent uncertainty and volatility of returns. Further, equity should also offer more premium than fixed income because it does not provide the same sort of disaster hedge as high-quality bonds when the economy worsens. Assuming that high-quality bonds provide a real return of around 3% over the long term, the risk premium for equities should be 2.5% to 3% higher.

Having established that GDP growth and equity returns are unrelated, it is worth thinking about what sort of return equity holders should demand or expect going forward. Historically, the S&P 500 Index has delivered around 5.5% to 6% real, but this seems unlikely in the near future. Profit margins are too high, and have been supported by unsustainably large government deficits. Valuations are above historical averages, and the substandard returns of the past 12 years should be viewed in part as the market slowly correcting this imbalance. As deficits come down, margins drop, and valuations normalize, we could see equities sell-off and potentially the S&P 500 return as little as 0% real over the next several years until more normal relationships re-assert themselves. But, there is a difference between the drag on returns resulting from mean reversion to normal valuations and a more sustainable economic environment, and what some suggest is a secular shift toward lower equity returns going forward. ■