

# Long-term investment returns: Managing outside of the mean

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Welcome to the 2019 Long-term Capital Market Assumptions. So what do we think that the next 10 to 15 years has in store for investors? Well, rather like last year, the secular return outlook is reasonably stable. Risks to growth are quite well balanced. But we are much later in the cycle, and that continues to create pressure on returns.

Now, our outlook here is long term, so we do aim to be cycle independent, but we're certainly not cycle agnostic. Investors should also not be cycle agnostic, because the starting point can have a profound effect on returns over the longer term.

Compared to last year, our growth outlook is quite stable. We've slightly reduced our expectations for US inflation, and this generally comes through in our expectations for equilibrium bond returns. But far the biggest change has actually been cyclical, as US interest rates have risen this year and US bond yields have also risen. Both now sit quite close to our long-term equilibrium expectation. In turn, this makes bond returns rather more attractive this year, than they were last year.

By comparison, equities have had a fairly flat year on a global aggregate level. The US has led, of course, and emerging markets have lagged. But when we look at the global aggregate, return expectations between last year and this year, are little changed. If you look at that on an efficient frontier, we find that a 60/40 stock bond portfolio offers slightly better returns than last year. But it's all driven by improved bond returns, while equity returns are relatively stable.

Now this is for the US. If we look internationally, the picture can be a little different. In Europe, for instance, where policy rates have yet to lift much off of zero, and bond yields have yet to rise, the stock bond frontier is still quite steep. And it's in these differences that investors can find opportunity to generate returns, if they broaden their portfolio out across different markets.

If we return to the US, though, and we use another tool, the Sharpe ratio, it gives us a very interesting picture. The Sharpe ratio, of course, is the amount of return that we earn for unit of risk. And for the first time since the financial crisis, our expected Sharpe ratio for US government bonds now sits above our expected Sharpe ratio for US large cap equities. This is something that could potentially, significantly shift how investors think about their allocation to risk over the longer term.

Of course, the Sharpe ratio doesn't tell us everything. In fact, optically, Sharpe ratios for credit, Sharpe ratios for private equity, and a number of other assets are surprisingly attractive. However, the Sharpe ratio doesn't capture factors like illiquidity risk, something which can manifest itself significantly late in the cycle, and especially during periods of market weakness. Investors who are looking to manage, not only for the long term, but also through the end of this cycle, and to be optimally prepared for the next one, need to factor these in.

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This year's theme is managing outside of the mean. That's not to say we should be discarding our tools, like Sharpe ratios, efficient frontiers, and mean variance, but rather, we should be looking to complement what they tell us with a thorough assessment of the risks we're taking, not only over the long term, but also over the shorter term as we move through this cycle. When we look at the long term for investors, if you are managing for the end of the cycle, we're not suggesting one shouldn't take risks, instead we're suggesting that investors really do need to understand the risks that are being taken.

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