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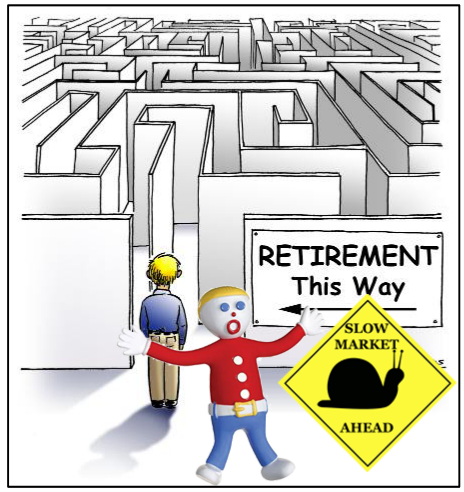
Preparing for a future of low returns

Navigating the Retirement Maze



"The future ain't what it used to be."
– Yogi Berra, baseball player, coach, manager, and author (1925 - 2015)

For as long as most of us have had retirement portfolios, adhering to a handful of dictums was usually sufficient to produce respectable portfolio results: "Save 10% of your income." "Bonds = 100 - your age." "Use index funds." This was generally sound investment advice that would help move you towards your goal of retiring on schedule.

However, dictums work… until they don't. In the past several years, we've entered into economic terra incognita: record low interest rates, slowing global growth, and levels of global debt never before seen. What worked for the past half century may no longer apply, at least for the next decade or two. The risk to those approaching or already in retirement is that the weak return being forecast for typical investment portfolios may not support the retirement lifestyles that they once could. Add to that increasing longevity, and we have what amounts to a potential retirement crisis.

Don't shoot the messengers

Earlier this year, several investment firms issued reports stating that market returns will be much weaker going forward than they have been in the past. The chief global investment strategist for Blackrock, the $4.6 trillion investment behemoth, predicted that the classic 60/40 (stock/bond) portfolio will yield only 3.3% over the next five years before inflation, and less than 3% with only US assets. Grantham Mayo van Otterloo (GMO), a Boston-based investment firm, has an even more dour outlook. Their seven-year forecast shows real returns (after inflation) of *negative* 2.7% for US large cap stocks, and only a paltry 1.4% return for non-US stocks. Real returns on both US and non-US bonds are projected to be negative.

The consulting firm McKinsey & Company also weighed in. In their April 2016 report "Diminishing Returns: Why Investors May Need to Lower Their Expectations," they show that total returns on equities and bonds from 1985 through 2014 were considerably higher than their long-term averages, and during the next 20 years the markets will be making up for this past over-performance with lower returns going forward.

The message here is that if you are planning to simply extrapolate forward past market returns in order to estimate your portfolio's future growth prospects, you're likely to be disappointed.

US stock market: In the doldrums

The low growth rate being forecast for the US stock market is mostly the result of high current valuations, and macroeconomic factors that are constraining corporate growth and profits. When the US stock market began its long climb upwards in 1983, the S&P 500's price/earnings (P/E) ratio – the price you would pay for a dollar's worth of earnings from a stock – was 10.4. Today it is 25. In other words, stocks today cost 2.4 times what they did back then compared to their earnings.

Research Affiliates, an investment firm, released a study this year showing that using six commonly used valuation and forecast methodologies to estimate future market growth, they forecasted a range of real (after inflation) annual returns of between 0.5% and 3.5% for the US market, in contrast to the 100-year average return of 7% per year. The difference between 3% and 7% a year compounded over ten years is gains of 34% and 97%, respectively.

Decent bond yields: RIP

One consistency in all of the reports cited above is that for the foreseeable future, don't expect any reasonable returns from bonds. The world's central banks have been engaging in a game of chicken the past several years, trying to stimulate growth by lowering interest rates, and with little to show for their efforts other than elevated stock markets, as investors have gravitated towards stocks for better yields from dividends. Studies show that long-term bond returns are easy to predict, as they show a high correlation to current interest rates. As of last Friday, 10-year Treasury bonds were yielding 1.6%. So if you buy them today, that will approximate your annual return over the next ten years. Compared to an inflation rate of 2%, you would actually be losing money in real terms.

Yet the US Treasury ranks among the high interest payers in the world right now. $13 trillion of outstanding global debt actually pays negative interest rates. Imagine buying a bond, and when it comes due you actually get less than you paid for the bond, and that's not even factoring in inflation. Bonds have always been seen as the safe investment in retirement portfolios, but today safe also equates to no earning power. Want to stretch a bit and start buying high yield bonds, commonly referred to as "junk bonds"? Then you're no longer talking safe money, but a speculative investment that could plunge during the next recession.

Solution: "Think different"

Unconventional economic times call for rethinking your traditional approach to investments and retirement spending. Here are a few suggestions that can help improve your retirement income prospects.

- Scale back retirement spending – Rather than go with a fixed rate of spending adjusted for inflation, gear your expenditures to your portfolio returns each year. Revisit your spending rate annually.
- Go global – Resist the "home bias" of holding only US stocks and bonds, and increase your international exposure. Emerging markets and China have recently been ignored by most investors, but this is where the future growth is. Consider allocating 20% or more of your portfolio to these markets.
- Alternative investments – I'm not referring to hedge funds, but asset classes that most investors never consider. Real estate investment trusts (REITs), master limited partnerships (MLPs), preferred stocks, and business development companies (BDCs), all of which are publicly traded, typically offer much higher yields than bonds, and help diversify your portfolio into other asset classes. While these can be more volatile than bonds, putting together a mix of them can reduce your risk while increasing your yield.
- Annuities – Low interest rates may make this seem like not the best time for annuities, but they offer special features that bonds don't have: income for life and "mortality credits." The latter effectively give you greater returns on your investment the longer you live. Make sure to check the ratings of your annuity issuer, as they need to survive longer than you do in order to guarantee lifetime payments.

Just because high domestic market growth appears to be behind us doesn't mean that you should settle for mediocre returns going forward. Get creative with your asset allocations for the long term, and you may find that the rewards you reap are greater than the perceived risks. Diversifying your investment portfolio outside of traditional investments may be your ticket to a better retirement.

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