Understanding the High Returns in a Low Return Environment

MARCH 14, 2017

GREG JENSEN
PHIL SALINGER
BILLY PRINCE

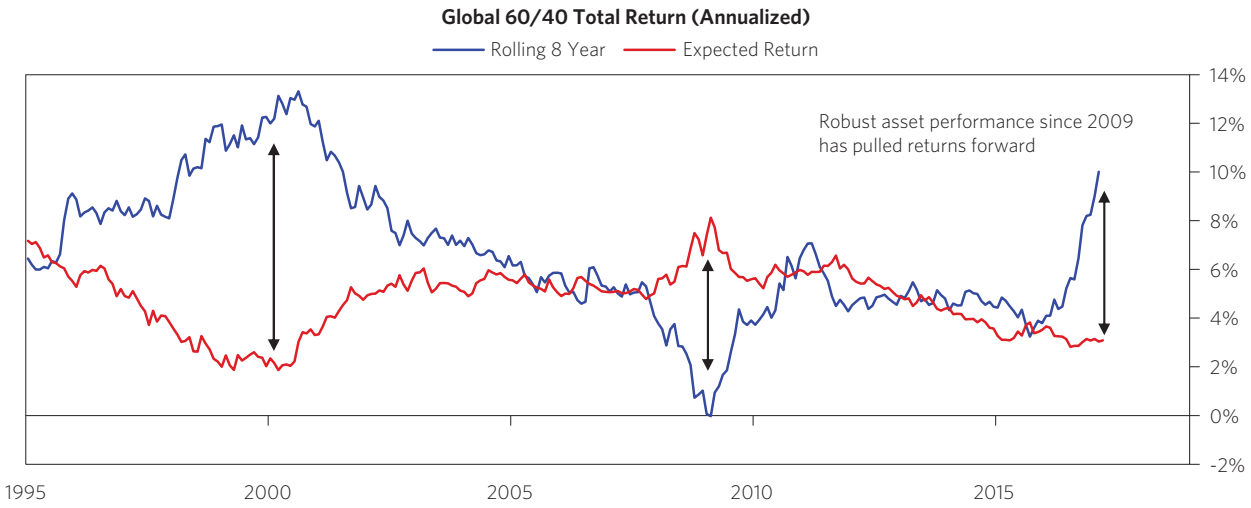
© 2017 Bridgewater Associates, LP

BRIDGEWATER

Since the global financial crisis, most global asset portfolios have performed extremely well, and we are worried that this performance is creating complacency about future returns. Understanding the mechanics of asset pricing can help make clearer what can and cannot be extrapolated. We will go through the mechanics below. First, to cut to the chase, while backward-looking returns of a traditional portfolio are near all-time highs, forward-looking expected returns are near all-time lows. The huge rally in assets has essentially pulled forward much of the next decade's expected returns.

As a reminder, an asset is just the present value of a stream of future cash flows. Over long periods of time, the cash flows of assets are relatively stable and predictable, but their present values (i.e., their prices) change a lot. Looking backward, rising prices produced high returns, but looking forward, higher prices for the same cash flows produce lower future returns. This creates a mechanically inverse relationship between realized and expected returns that has been at work over the past eight years.

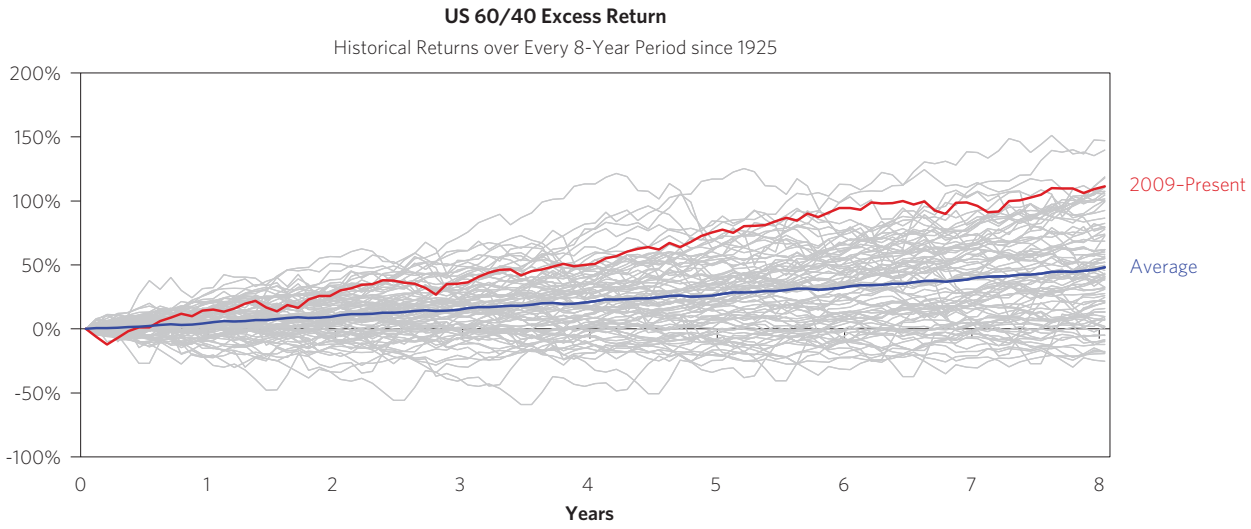
As you can see in the chart below, our rough measure of long-term expected returns has consistently fallen since the financial crisis as the dynamics described above played out. In 2009, the expected return of a global 60/40 portfolio had risen to roughly 8% annually. The subsequent rally in assets over the last eight years pushed more than half of that expected return into today's prices, creating some of the best returns in decades. But that past price appreciation has now squeezed down today's future expected return of the 60/40 portfolio to around 3%.



© 2017 Bridgewater Associates, LP

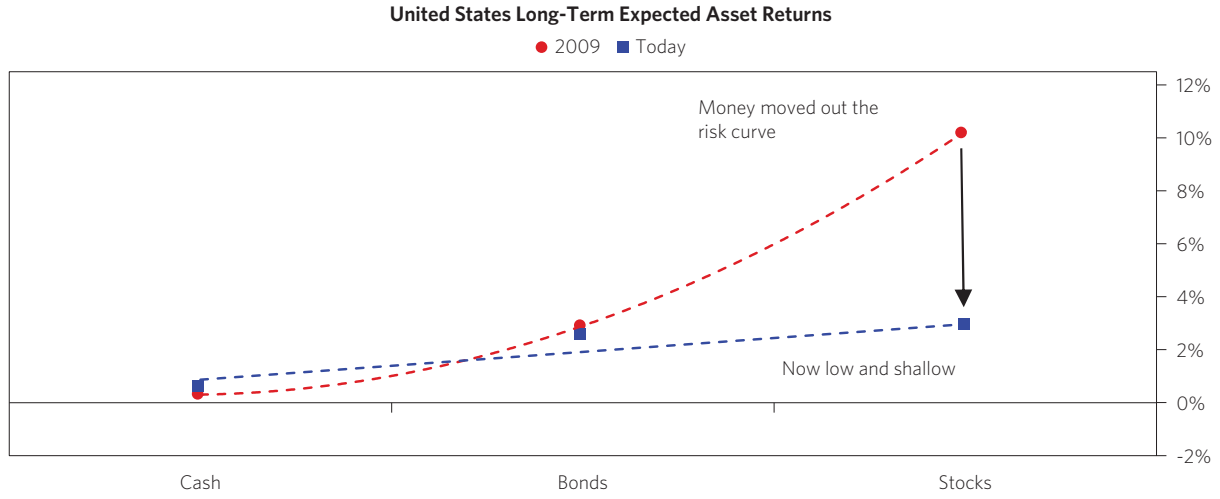
Financial Assets Have Had One of Their Best Runs in History

The recent past is among the best ever for traditional assets. The only periods with higher returns than the present were the years immediately following the Second World War, when easy Fed policy and high nominal growth provided a huge lift to asset returns, and during the 1990s, when the tech bubble pushed stock prices to extremes. The chart below shows the cumulative eight-year excess return of the 60/40 portfolio starting each year since 1925, with the recent post-crisis period highlighted in red.



The Rally Has Been Fueled By a Decline in Interest Rates and Falling Risk Premiums

After the financial crisis, when the Fed aggressively printed money, the money initially remained largely in cash. The yield on cash fell to zero, real yields on cash turned negative, and the risk premiums on other assets relative to cash were high. Over time, risk aversion faded and the higher expected returns of other assets relative to cash motivated money to move out the curve, driving prices higher. The chart below shows the expected returns of US financial assets coming out of the financial crisis versus today. As you can see, the depressed yield on cash has encouraged money to move out the risk curve, driving up prices and depressing forward-looking returns for all risky assets.



© 2017 Bridgewater Associates, LP

As we see it, much of the strong global 60/40 returns since the crisis were driven by unsustainable drivers, and if you remove them from the picture, returns would have been closer to what we expect going forward. Over the past eight years, a 60/40 portfolio has benefited from significant tailwinds including rapidly falling interest rates, sustained margin expansion, and a high degree of financial engineering (i.e., corporate M&A and buybacks). While there have been divergences in earnings growth across countries, the support from falling discount rates has been a significant influence across the board. Going forward, those supports cannot be extrapolated.

Global 60/40 Performance Post-Crisis*

	Dev Wld Avg	US
Equity Excess Returns	10.0%	14.6%
Dividends	3.0%	2.5%
Price	7.4%	12.4%
EPS	5.3%	8.8%
o/w Nominal Growth	2.8%	3.1%
Other (Margins & Fin Engineering)	**2.6%**	**5.7%**
P/E Ratio	2.0%	3.3%
o/w Real Long Rate	**6.7%**	**4.6%**
o/w Implied Earnings Growth**	-4.4%	-1.2%
Less Cash Return	-0.4%	-0.2%
Nominal Bond Excess Returns	4.2%	2.7%
Real Long Rate	3.6%	4.8%
Coupon	0.4%	0.6%
Principal	**3.2%**	**4.1%**
BEI	0.6%	-2.0%
Coupon	1.8%	2.1%
Principal	**-1.2%**	**-4.1%**
Cash Yield	0.4%	0.2%
Global 60/40 Total Return	8.0%	10.1%

*Pieces may not add up due to compounding effects **Includes changes from risk premium

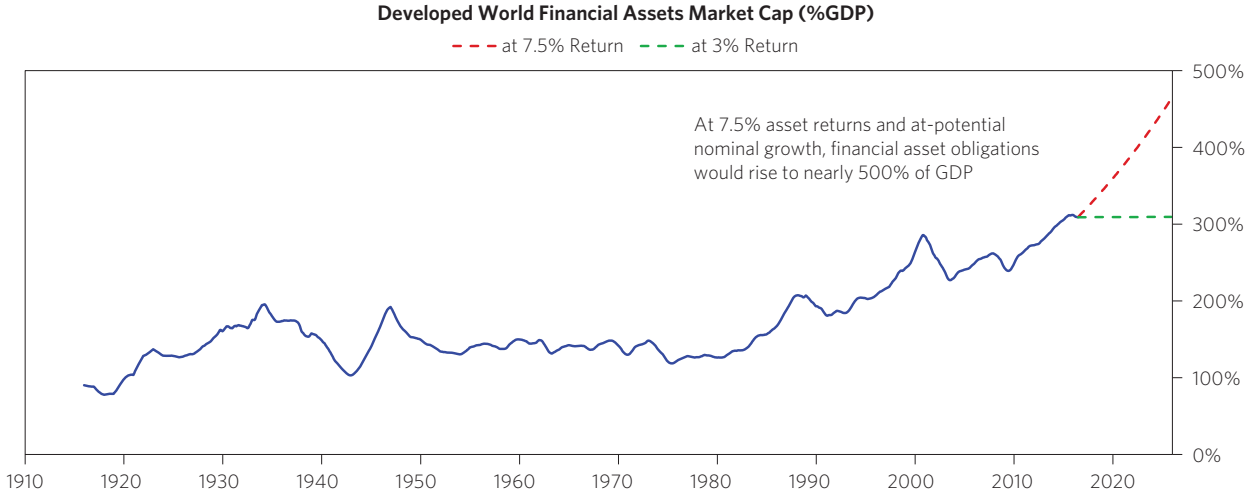
Falling real yields, financial engineering, and margin expansion have all provided a lift to equity returns that likely cannot be sustained

Falling real yields have also provided a likely unsustainable support to bond returns, though offset in the US case by the rise in BEI

© 2017 Bridgewater Associates, LP

Wealth Is Just a Draw on Someone Else's Future Income; So, Wealth Levels Are Bounded by Future Income

Wealth is simply a claim on someone's future income, so wealth growth beyond income growth has its limits. Relative to history, financial wealth is already elevated relative to income. At current rates of expected nominal growth, extrapolating anything close to historic returns would lead to a large rise in wealth relative to the incomes needed to service these claims. Achieving the type of nominal returns many investors are expecting would either require a significant rise in the pace of productivity or inflation.



© 2017 Bridgewater Associates, LP

This research paper is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned.

Bridgewater research utilizes data and information from public, private and internal sources, including data from actual Bridgewater trades. Sources include, the Australian Bureau of Statistics, Asset International, Inc., Barclays Capital Inc., Bloomberg Finance L.P., CBRE, Inc., CEIC Data Company Ltd., Cerulli Associates Inc., Consensus Economics Inc., Credit Market Analysis Ltd., CreditSights, Inc., Corelogic, Inc., Dealogic LLC, Ecoanalitica, Emerging Portfolio Fund Research, Inc., Eurasia Group Ltd., Factset Research Systems, Inc., The Financial Times Limited, Fundata Canada, Inc., GaveKal Research Ltd., Global Financial Data, Inc., Harvard Business Review, Haver Analytics, Inc., The Investment Funds Institute of Canada, Intercontinental Exchange (ICE), Investment Company Institute, International Energy Agency, Investment Management Association, Markit Economics Limited, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, Organisation for Economic Cooperation and Development, Paramita Tecnologia Consultoria Financeira LTDA, Pensions & Investments Research Center, Property and Portfolio Research, Inc., RealtyTrac, Inc., RP Data Ltd, Roubini Global Economics, LLC, Rystad Energy, Inc., S&P Capital IQ LLC, Sentix Gmbh, Shanghai Wind Information Co., Ltd., Spears & Associates, Inc., State Street Bank and Trust Company, Thomson Reuters, Tokyo Stock Exchange, TrimTabs Investment Research, Inc., United Nations, US Department of Commerce, World Bureau of Metal Statistics, World Economic Forum, and Wood Mackenzie Limited. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.

© 2017 Bridgewater Associates, LP