



David Stevenson is an experienced investment commentator and writer, writing for a number of leading publications including the Financial Times, Investors Chronicle and Investment Week.

The times they are a-changing...

David Stevenson explains why he thinks ‘the times they are a-changing’, and why it’s important that investors at least consider this, and their investment options.

There’s a fine old Latin phrase ‘Ceteris paribus’, which means ‘all other things being equal’. It’s a useful phrase, which requires us to discount possibilities and uncertainties and instead deal with existing factual circumstances and constants.

If we have this in mind when we think about our investments and portfolios, we can readily assert several factual circumstances and constants.

The first is that interest rates are low. You don’t need me to tell you this, but it’s an important starting point, so bear with me. Rates are at historical lows and despite the likely direction of long-term travel being upwards (if and when they ‘normalise’), in the short term the chatter is increasingly pointing to the possibility of rates being cut. This is being driven by a number of factors, including more concern about long term economic growth and less concern around inflation.

Next up, and linked to the outlook for rates, fixed income/bonds. A 30-year bull market in bonds may have had us all thinking that this asset class offers solid yield, with low risk, but we may all need to ask ourselves if this asset class has morphed into something very different today – i.e. low yield, negative in many instances, with clear risks to capital (not least at the point when expectation around long term interest rates change). In other words, return-free risk, as opposed risk-free return!

What about equities? Well, most equities appear rather expensive currently, especially global large caps and tech (think FANG!). On a long term adjusted basis, using a measure called the price to earnings ratio, many equities are in the top quartile of their historical valuation ranges. We can all hope equity markets remain benign and the easy returns party of the last decade, buoyed by global stimulus measures since 2008, continues... but we should be cognisant of the myriad of risks on the radar screens: everything from trade wars to Brexit, to mention just two headline-grabbers.

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And that brings me to a known unknown... populist governments in situ. Whatever one thinks of Trump, he is a populist. Arguably, Brexit has also been inspired by populists. And, actually, many European countries are now run by populists. Populists vary in their economic policies, and history has taught us that they are not necessarily bad for equity investors, but they bring uncertainty.

So, what are the constants we can take from all of this?

Well, all things being equal, it’s hard to imagine that the next decade will be a repeat of the last decade, in terms of the relatively easy to make good returns. The next decade is likely to be harder.

In a low inflation, low rates world what follows is more than likely low returns. As long as inflation remains low, it’ll likely anchor interest rates lower than historical ‘normal’ levels. And low inflation, accompanied by low interest rates, all other things being equal, probably means growth rates will be subdued, perhaps barely pushing much above 3%, even in good times... which could anchor investment returns. We might be entering a scenario in which real returns of just 2% to 4% become the norm, implying nominal returns of circa 5% p.a.

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And while not wanting to be a harbinger of doom, these lower returns may come with greater uncertainty and volatility. And investors should also understand that business cycles exist... and power booms and busts. We’ve been in one of the longest ever upward business cycles for nine to ten years now, but sooner or later the cycle will turn, perhaps courtesy of a tariff-seeking incumbent populist government.

So, how can investors plan for the decade ahead, given our constants and our ceteris paribus rule?

There are lots of sensible potential portfolio actions but the most important is diversification. Savvy investors should diversify the sources of return and risks in portfolios, considering asset class, geography and the types of investments they hold, by which I mean combine active fund managers, with passive and smart beta managers, and structured product managers. Different types of investment do different things at different times, even when investing in the same asset class... and that’s beneficial, especially in a more challenging investment environment.

Past performance data evidences the highly probable defined returns, with defined risks, proposition of structured products. In fact, to my mind structured products look like they do a better job of delivering quasi absolute return type strategies than absolute return funds do – with the unique benefit of a legal obligation binding the counterparty bank to actually deliver what they stated.

Of course, investors must also focus on the counterparty risk, but all things being equal I would suggest that many investors may benefit from adding or increasing counterparty exposure in their portfolios currently, in order to take some market and fund manager risk out of their portfolios.



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