

OCP CAPITAL REVIEW

100 Park Avenue 28th Floor,
New York, NY, 10017
Phone 646-201-4886
www.ocpcap.com

The Investor's Dilemma in Year Seven of Financial Repression

Laurence B. Siegel

Senior Advisor, OCP Capital, LLC

and the Gary P. Brinson Director of Research, Research Foundation of CFA Institute

lsiegel@ocpcap.com

May 2014

In recent issues of the *OCP Review*, we've focused on monetary policy, interest rates, and the bond market. We've expressed concern that bonds may deliver poor returns for quite some time – that a new secular bond bear market has started.

In an interview with Allianz Global Investors CIO Stephen Sexauer, we also heard the countervailing view that bond yields in excess of nominal GDP growth (say, 4.5% to 5.5%) may be sustainable and attractive.¹ Still, bond returns will be poor on the way to that equilibrium.

Here, we extend our analysis to the equity market and the long-term prospects for investors managing a multi-asset-class portfolio so that they can fund a stream of consumption or pay a liability.

The current condition

Financial repression

Interest rates have remained lower and for longer than anyone expected. This is not a market outcome but an administered price. It is called financial repression because it is a very harsh implicit tax on savers.² In the mordant words of Carmen Reinhart *et al.*, financial repression consists of “measures by which governments channel funds to themselves that, in a deregulated market, would go elsewhere.” Governments typically do this to reduce their own indebtedness.

Financial repression was an element of the successful strategy for paying off U.S. war debts after World War II and it is a key part of the government's strategy for reining

¹ OCP Capital Review, first quarter 2014. Mr. Sexauer is CIO of Allianz Global Investors U.S. Multi-Asset, not of the whole organization.

² The term “financial repression” dates to Shaw (1973) and McKinnon (1973), and was popularized by Reinhart et al. (2011). See also Reinhart and Rogoff (2008).

in debt now. It is working—government debt has started to level off—but the tax on savers has restrained economic growth by lowering real savings balances and forcing savers to reconsider spending plans.

The zero interest rate policy has been reinforced by the neo-Keynesian beliefs of central bankers around the world, who assert that low interest rates are good for growth unless they cause inflation. This linkage has not been borne out empirically—growth rates have been the slowest of any recovery in recent history—but zero rates have been pursued anyway, most likely because they help governments get out of debt.

Why has the recovery been slow? Mostly I blame structural factors, such as changes in technology that tip a large number of workers from positive to negative marginal productivity (thus throwing them out of work more or less forever), and an aging population. Technological unemployment has always been a concern, but unemployment rates have returned to about 4% during vigorous expansions, because (1) new technologies create unforeseen opportunities and (2) the workforce participation rate adjusts.³

Expensive equities

Meanwhile, the bull market that started in early 2009 has progressed to the point where equities are somewhat expensive. At 19 times trailing twelve months' earnings, expected returns on equities are in the range of 6% to 7% per year, as reported in my recent article, "CAPE Crusaders: Shiller-Siegel Shootout at the Q Group Corral."⁴ Thus, expected returns on all assets—stocks, bonds, and cash—are lower than their historical averages. The same is probably also true of real estate and commodities, rounding out the menu of assets available to institutional and high-net-worth investors.

Is patience a virtue?

What should an investor do? Stephen Sexauer, whom we interviewed in the previous OCP Capital Review, wisely counsels patience, but what does that mean? Patience means taking a low-risk position while waiting for higher expected returns.

³ One should remember that, in 1870, agriculture employed about 80% of American workers. We now grow much more food with a tiny fraction of the number of workers; the rest had to find non-agricultural jobs or drop out of the workforce. While this process caused real pain for some individuals, we are much better off because of it. Most of the jobs that were created would have sounded like science fiction to the farmers of 1870. A similar process will cause labor markets to gradually clear as technology causes industrial and service jobs to vanish. Today's long-term unemployed may not return to work, but no one lives forever, and rising generations of workers trained for the jobs of tomorrow will not be unemployed.

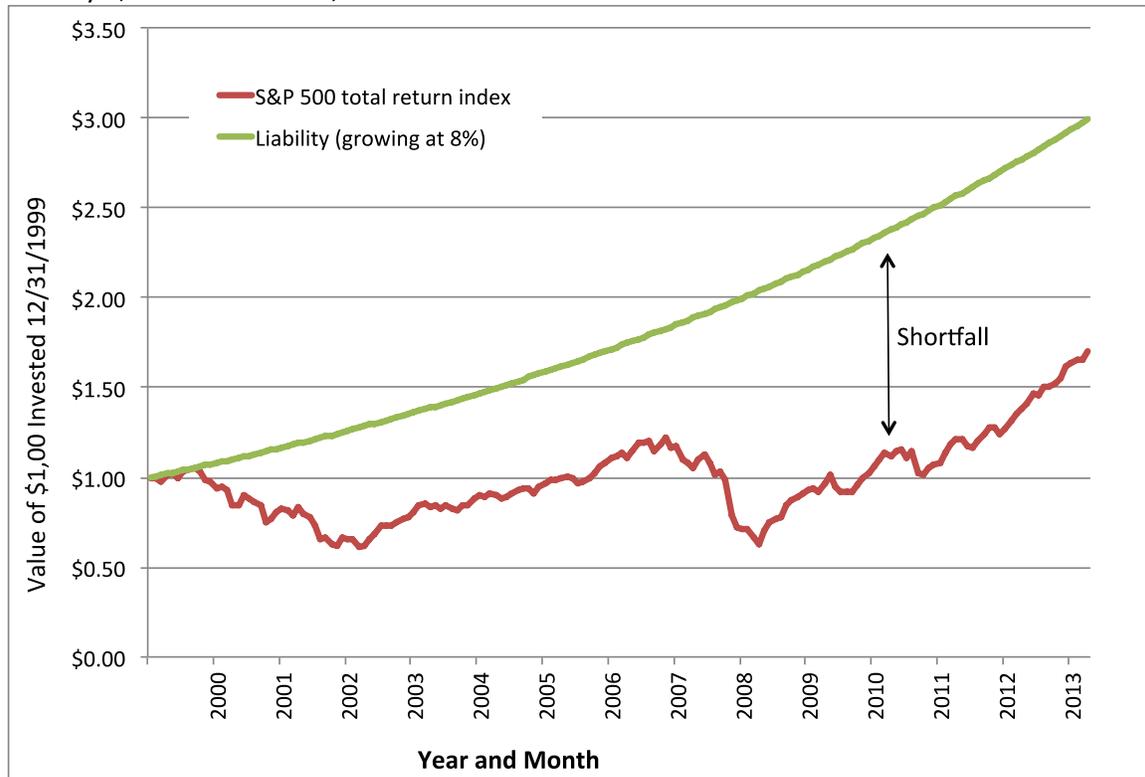
⁴ http://advisorperspectives.com/newsletters14/pdfs/CAPE_Crusaders.pdf. This is the expected nominal total return including dividends, not the real return or the price-only return.

Higher expected returns can come about in one of two ways: lower current prices for assets, or higher expected future cash flows from the assets. We hope for the latter but prepare for the former. A patient approach means taking less than the usual amount of risk because the higher expected returns might be achieved through asset-price declines.

Meanwhile, while we earn low returns, liabilities or spending plans (depending on whether you're an institution or an individual) build and build, and you get further and further behind. Take defined benefit pension plans as an example. In an article in progress, Barton Waring [2014] points out that, if a pension uses an actuarial return assumption of 8% per year, it has to earn that amount in the market to stay fully funded if it starts out fully funded.

Now, let's look at what an all-equity plan would have earned so far in the 21st century. Figure 1 shows the return on the S&P 500 as a slowly rising line with a lot of volatility, and the liability growing at 8% as a faster-rising line. Notice that the spread between the two lines, the pension shortfall, is huge despite the great bull market of 2009-2014.

Figure 1
S&P 500 total return compared to a liability growing at 8%
January 1, 2000—March 28, 2014



Source: Robert Shiller, <http://www.econ.yale.edu/~shiller/data.htm>

The S&P 500 in this century has grown at a stingy nominal rate of 1.65% per year, plus dividends, for a total return of 3.8% per year; an all-equity pension plan with an actuarial return assumption of 8% thus falls 4.2% farther behind each year, for a compounded shortfall, of assets relative to liabilities, of 46% in 14 years. Thus, a plan that was fully funded in December 1999 is now only 54% funded, despite being invested in an asset that has risen in price.

The hypothetical pension plan shown in Figure 1 will never climb out of this hole. Well, it could; an asset return of 20% per year would cause the shortfall to disappear in less than eight years. But the stock market is not going to rise at 20% per year for eight years. It just isn't. If, say, earnings doubled over that period, the market would have to sell at 41 times earnings eight years from now to achieve the needed 20% annual return. You might as well take a ride on a unicorn as follow this strategy for saving your pension plan.

The same principle applies to individuals who have budgeted skinny retirement contributions and are counting on the market to fatten them up. Low returns mean higher plan contributions, more savings, less consumption.

Thinking about the future

What is normalization?

We've heard a lot about normalization in the press, but what is it? Is it a return to more typical interest rates, rates of economic growth, rates of return in the stock market?

It's mostly a return to more normal interest rates, between 0% and 2% above the rate of inflation (so a nominal interest rate of 2% to 5%). We believe that the end of financial repression will also mean a return to more normal rates of economic growth, because financial repression has caused savers to restrain their consumption plans. While some worry about rising interest rates causing an economic slowdown, that does not seem like a realistic concern. Normalization of interest rates paid to savers will lead to further top-line growth (growth in corporate revenues), and potentially further growth in profits (although profit margins, profits as a percentage of revenues, are huge and unlikely to increase further).

Normalization and equities

What we should *not* expect is equity market returns equal to the historical average return around 10% per year. To get "normal" (historical average) returns you have

to start at normal valuations. Current valuations are high enough to depress the equity risk premium to 4% from its historical average around 5.5%.⁵

You also need “normal” (historical average) economic growth. In the twentieth century in the U.S., real economic growth ran at a *per capita* rate of 1.8% plus a “fat” population growth rate of 1.3%. We are conditioned to regard that as normal. While the *per capita* rate could be matched in the remainder of this century if we don’t cook our own goose through poorly conceived policy, the population growth rate will *not* be matched (and a good thing too – the world is getting crowded).

So, top-line growth in corporate revenues will be restrained by slower population growth. Maybe, as almost every observer has suggested, we should get used to a “new normal” of lower, but on average still briskly positive, equity returns. This new normal is much better than the new normal of near-zero growth and depressed stock prices that was widely discussed a few years ago, but it’s lower than the historical average.

Components of growth: Productivity and population

A stock doesn’t know whether an increase in its revenues or earnings comes from population growth or real *per capita* economic growth (also called productivity growth). So, from the point of view of total corporate earnings, a slowdown in population growth is just as bad as a slowdown in *per capita* economic performance.

But equity returns are determined on a per-share basis. If, because of slower population growth, there are fewer claimants (shareholders) than there otherwise would be, share prices will also be higher than they otherwise would be. Under such a circumstance, equity returns could be more a reflection of per-capita growth than of total (per capita plus population) growth. This question has been a real puzzler for quite some time—you can’t just look up the answer. More research needs to be done on it.

What kinds of returns can we expect?

We can put some numbers around these ideas. Yields on Treasury bills (“cash”) can be expected to rise from zero to around 2% over the next couple of years. Ten-year Treasury bond yields, currently 2.75%, will probably rise to the range of 4.5% to 5.5%, producing a large capital loss for existing bondholders but a potentially attractive opportunity for new ones.

I’m less sanguine about these yields being a good long-term opportunity than Mr. Sexauer was in last quarter’s *OCP Capital Review*. I still think that governments

⁵ Equity risk premia cited here are relative to the 10-year Treasury bond yield, as is the custom in the investment business, rather than to relative to cash, which is the way premia are often quoted by academics.

around the world might try to inflate their way out of the entitlements squeeze caused by pensions and health care promised to baby boomers. This is a long-term problem, not an immediate one, but markets incorporate long-term problems as well as immediate ones into returns.

The equity risk premium, around 4%, implies an expected return of 6.75% given current bond yields (see Grinold, Kroner, and Siegel [2011]). If bond yields rise to around 5%, equity expected returns could rise to 9%, preserving the 4% premium, if the rise in bond yields is due to higher inflation that flows through to top-line corporate growth. Of course, the real return on equities is what investors care about, and is hurt by higher inflation.

More likely, a rise in bond yields will reflect increases in both inflation and real rates. A rise in real rates will not help stocks and could cause them to decline.

Alternative investments basically amount to an equity or fixed income position that is hard to access in the public markets, or a set of varying exposures to such positions. Alternatives are not an orthogonal asset class. The expected return on a portfolio of alternatives is the expected return for the underlying mix of betas, plus returns to skill or favorable manager selection, minus fees and costs.

Alternatives carefully selected to have skill at adding value well beyond the cost structure, such as those OCP Capital selectively represents, are a potentially valuable source of alpha for the whole portfolio in exactly the same sense that a winning manager in public equities or public fixed income is a source of alpha.

Conclusion

This long period of low returns will not last forever, but it can feel like forever while liabilities grow and spending plans go unfulfilled. There can be real wealth destruction in an asset-liability context even while markets are slowly rising.

There are only three levers that one can push to bring assets and liabilities back closer together:

1. Spend less
2. Bring new money into the portfolio (save more, tax more, etc.)
3. Earn a higher return than the market (but not everybody can do this).

The investor's dilemma referred to in the title is: Which lever(s) should one push? Each has a downside.

The downside of spending less is obvious: eventual spending is the reason one invests in the first place. No one wants to spend less.

The downside of bringing in new money is that the funder (corporation, government, worker) is likely to object. He or she has other uses for the money, and was counting on investment returns to be better than they are.

The downside of trying to beat the market is that the market might beat you, forcing you into strategy 1 or 2.

Thus, being in control of flows into and out of the portfolio – and being able to make a “fiscal adjustment,” increasing flows into or decreasing flows out of the portfolio if necessary, is the key to success in a market that offers less than spectacular returns looking forward.

REFERENCES

Grinold, Richard C., Kenneth F. Kroner, and Laurence B. Siegel. 2011. “A Supply Model of the Equity Premium,” in Hammond, P. Brett, Martin L. Leibowitz, and Laurence B. Siegel, editors, *Rethinking the Equity Risk Premium*, Charlottesville, VA: CFA Institute Research Foundation, <http://www.cfapubs.org/doi/pdf/10.2470/rf.v2011.n4.6>.

McKinnon, Ronald I. 1973. *Money and Capital in Economic Development*. Washington D.C.: Brookings Institution, 1973.

Reinhart, Carmen M., Jacob F. Kirkegaard, and M. Belen Sbrancia. 2011. “Financial Repression Redux.” *IMF Finance and Development* (June), p. 22-26.

Reinhart, Carmen M., and Kenneth S. Rogoff. 2008. *This Time is Different*. Princeton and Oxford: Princeton University Press.

Shaw, Edward S. 1973. *Financial Deepening in Economic Development*. New York: Oxford University Press.

Waring, M. Barton. 2014. “The Pension Funding Crisis and the Discount Rate for Liabilities.” In progress; available from lbsiegel@uchicago.edu.

Disclaimer

The information contained in this report (including any estimates or projections) have been obtained from sources we believe to be reliable. However, no representation is made that it is accurate or complete. This report is not an offering of any security in any jurisdiction and has been prepared solely for information purposes. Its contents are confidential and may not be reproduced or distributed without prior written consent of the authors.

The information and opinions contained in this report are for background purposes only and do not purport to be full or complete. No representation, warranty, or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this document by the broker dealer or the consultant and no liability is accepted by the broker dealer or the consultant for the accuracy or completeness of any such information or opinions.

The views and information contained in this report are independent of OCP Capital LLC and should not in any way be deemed to be those of its partners or employees.

OCP Capital is an independent broker/dealer registered with the Securities and Exchange Commission (SEC), The Financial Industry Regulatory Authority (FINRA), and the Securities Investor Protection Corporation (SIPC).