MULTI ASSET – LONG-TERM RETURN EXPECTATIONS EXERCISE

Investment manager James Squires explains why our Long-Term Return Expectations exercise is fundamental to our investment process, illustrating with a worked example of high yield credit.

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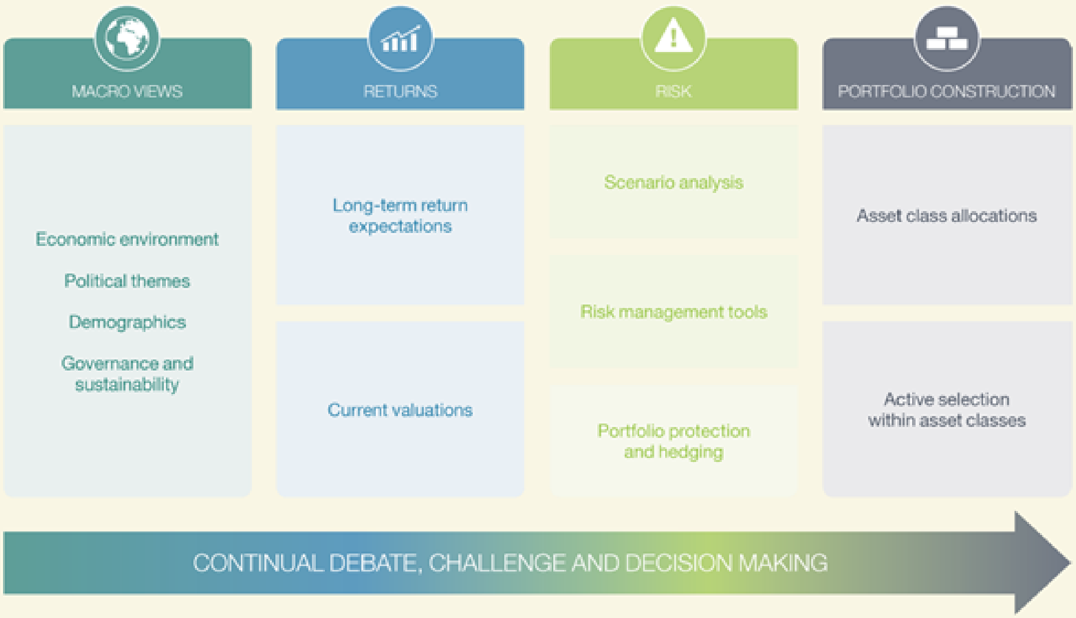
James Squires: Our long-term return expectations exercise is a key part of our investment process. With a broad potential range of asset classes in which we can invest, understanding the fundamentals of each of those is so important to assessing which asset classes will deliver good future returns, and which won't.

In this short webcast then, I will explain why we undertake this exercise, and how we go about it, illustrating with a worked example of high yield credit.



On screen now, you see a high-level diagram of the investment process we follow and you'll see that our long-term return expectations sit squarely in the middle. They're a key part of our investment process, giving us the fundamental lens through which we can view potential returns across all asset classes.

Refreshing those views is something we do every six months and something that requires us to think about the fundamental long-term drivers of the asset classes in which we can invest - to ask ourselves what sorts of returns they have generated in the past and what sort of returns they are likely to generate in the future. We aim to assess those likely returns over cash for each asset class and do so both over the next ten years and in the very long term beyond that.

There are a number of principles we work to as we go about this task:

Principles

Exercise Broad and Long-Term Thinking
Respect the Lessons of History
Maintain an Open Mind

Firstly, we exercise broad and long-term thinking: we will always seek out and use the widest and longest data sets available.

Secondly, we respect the lessons of history. But we don't follow them slavishly. Markets change in many ways from one decade to the next and the asset class we know today may actually bear little resemblance to the one that performed as it did throughout history.

Thirdly, and perhaps most crucially, we maintain an open mind. Just because growth and inflation, or asset class returns, have been around certain levels for a while, we should not assume that they will remain so – so we use multiple sources, challenge preconceptions and think critically to justify any future return expectations we may hold.

So this type of thinking, ultimately a result of debate and discussion amongst my Multi Asset investment team and many of our specialist colleagues, is what allows us to estimate the likely long-run returns for asset classes and to pin down their fair value levels. Once we've done that, we can bring in current valuations and, assuming that these will correct towards fair value over the next decade, we can incorporate this information to give a ten-year estimate for passive asset class returns relative to cash.

Following this process across all asset classes, we can of course compare one to another to see which have the greatest long-term attractions. It's why we are well placed to take judgments on how short-term developments might then pan out.

Now we don't need to reflect the long-term views in our portfolios, but they do provide important context to our investment discussions and our decisions and, over the long run, our portfolio allocations do tend to reflect these fundamental realities.

High Yield Credit

The example of high yield credit is a particularly instructive one.

Now, our starting point for thinking about the long-term returns for high yield bonds is what the fair spread they should pay over government bonds is. Here we use the longest data set for the markets.

High Yield Credit at December 2018

	EUR High Yield	USD High Yield	Weighted Average
Market Value ($)	$310bn	$1,160bn	
Composite Rating	BB-	B+	
Duration	4.1yrs	4.2yrs	
Fair Spread	5.00%	5.00%	
Return from Spread	5.00%	5.00%	
Loss to Default	-3.00%	-3.00%	
Government Bond Return over Cash	0.25%	0.25%	
Long Term Expected Return over Cash	2.25%	2.25%	2.25%

So over 30 years in the US, the long-run median spread has been 5 per cent and we assume that persists. From this 5 per cent we then subtract an estimate of default losses. Over cycles, the high yield bond default rate has averaged 4.5 per cent. One-third of that has typically been recovered by lenders after default so the real loss to default is only around 3 per cent.

Putting these two numbers together, a 5 per cent spread and a 3 per cent default loss, we expect a 2 per cent return over government bonds. And given that we expect government bonds to return one-quarter of a percent over cash, our long-term passive return for high yield is 2.25 per cent over cash.

Things get a little more complex when we move to consider the next ten years.

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Government Bond Return over Cash	0.25%	0.25%	
Long Term Expected Return over Cash	2.25%	2.25%	2.25%
Current Spread	5.06%	5.33%	
Return from Spread	5.05%	5.31%	
Loss to Default	-2.50%	-3.00%	
Government Bond Return over Cash	-0.81%	0.13%	
10 Year Expected Return over Cash	1.75%	2.25%	2.00%

At this time, December 2018, the current spread was different between the two markets, with the spread return being higher in the US than in Europe. However, we were judging that Europe would have a better default experience – with lower losses and that is a direct consequence of that higher credit quality of the European market. Recall that the European market rating is BB versus single B for the US. So we worked with our specialist high yield colleagues to get comfortable with this and then we adapted the history to reflect the present conditions. Doing so would have seen European high yield bonds looking more attractive than dollar bonds. It would have, were it not for our sharply negative view on the likely returns from the underlying European government bonds.

In December 2018, bond yields were exceptionally low. We were expecting them to rise and hence we were expecting bonds to struggle relative to cash. Incorporating this government bond component (and a more sanguine version of treasuries or view of treasuries), saw us ending up with a lower expected return for European bonds, despite their higher credit rating.

Overall, when we combine the two markets, we expected high yield bonds to deliver 2 per cent over cash over the next ten years, just below our very long-term expectation. This understanding that ten-year global high yield credit returns were likely to come in around long-run levels, even if not at a particularly exciting level overall, gave us the confidence to increase our allocation to the asset class at that point in time.

So we go through this Long-Term Return Expectations exercise twice a year, covering all asset classes in similar levels of detail and publishing our key findings in this Long Term Return Expectations paper. The discussions and the conclusions of that paper are a very important component of our investment process and one into which I hope you now have a much greater insight. Thank you for watching.

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