

Investors should brace for lower returns in next decade



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South African investors have enjoyed excellent real returns from all asset classes in the “noughties”; however, they’re in for a tougher time in the “terrible teens”.

Expected slower economic growth and lower returns ahead mean South African investors should be prepared to save more and be flexible in their asset allocation choices to take advantage of any opportunities that arise.

Time magazine called the noughties the “decade from hell”, but not for South Africa. For investors it was a great period, with the best growth since the 1960’s, falling inflation and lower interest rates all leading to excellent asset class returns. For example, the Old Mutual Balanced Fund produced a real return of 8.3% a year above inflation for the decade.

	SA Equity	SA Listed Property	SA Bonds	SA Cash	Offshore Equity
40 Years	7.9	0.8	1.7	1.7	6.1
Seventies	6.5	-6.9	-3.8	-2.3	-1.8
Eighties	10.2	-1.1	-3.7	-0.2	19.7
Nineties	5.0	-5.5	8.2	6.4	13.0
Noughties	9.8	17.7	6.1	2.8	-4.0
2009	26.1	8.0	-7.0	3.1	-1.9
MSI Five-year Outlook	6.5	6.5	3.0	3.0	7.0

Source: MSI

However, these gains are not likely to be repeated in the decade ahead. Although the big theme of China and faster growth from emerging markets is set to continue, to the benefit of South Africa and other commodity producers, its effect is not likely to be so pronounced. Real commodity prices nearly tripled in

the last decade, and we can’t expect a repeat of this phenomenon. Also, we don’t believe South Africa will be able to grow as fast going forward, partly because of slower growth in the developed economies due to deleveraging, as well as local capacity constraints such as electricity and education, among others.

This means SA company earnings growth will also struggle in the next 10 years and result in lower equity returns for investors. After returning a real 9.8% per year over the 10 years of the 2000’s, I expect the FTSE/JSE All Share Index (JSE) to return only around 6.5% per year after inflation over the next five years. This is still beating cash and bonds, but on a risk-adjusted basis I see this as fair value.

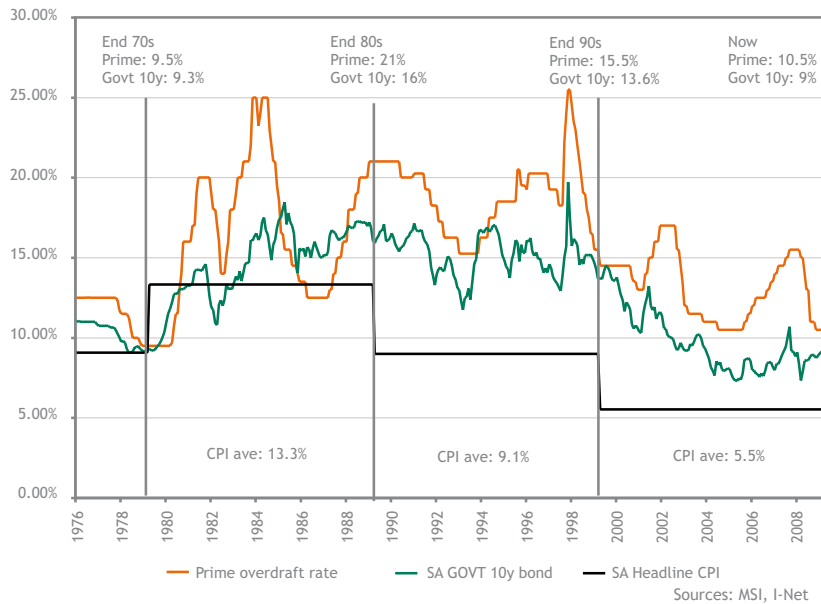
In the short term, it’s important to remember that the local equity market has just enjoyed a 32% gain in share prices in 2009 and its largest-ever annual increase in price-earnings ratios, an astounding 82%. In 2010 the market should benefit from a recovery in company earnings, with at least 25% earnings growth, but this is largely already in the price.

Bond returns to be hit by expected supply overhang

Turning to bonds, the noughties were an excellent decade for government bonds, which posted real returns of 6.1% per year over the decade on the back of substantial falls in inflation and interest rates.

This will not be repeated and, as a result, we expect lower real returns of around 3% per year from bonds over the next five years. Following 2009’s underperformance (when bonds recorded a negative real return of -7.0%), we have upgraded the asset class from underweight to neutral, and would have been more bullish if it weren’t for the coming supply overhang.

Monetary Policy: Falling interest rates and lower inflation



Lower returns = higher savings

What is clear is that it is only offshore equity that is likely to provide a better return in the next decade than the past, with other asset classes offering lower-returns. For investors, this lower return environment means they will have to save more.

And, with most asset classes currently fairly valued relative to each other, there isn't an obvious "big opportunity" for exceptional returns by being overweight in a particular asset class. For investors this also means that as long as they are invested according to the correct risk profile, they shouldn't have to worry about short-term switching or market-watching. Perhaps these "boring" conditions are good, as investors can focus on following their long-term

plans after the roller coaster ride of the last two years.

Looking at cash, real returns over the noughties averaged 2.8% per year, much lower than the 6.4% seen in the 1990s, and I believe the structural reduction in interest rates seen over the past decade is here to stay. The phenomenal cash returns of the 1990s will not be repeated, so investors should expect a real return of around 3.0% per year from cash through 2014. We are forecasting very little movement in interest rates in the next 12 months.

Listed property, meanwhile, enjoyed a strong decade of returns, being the best-performing asset class in SA with a real return of 17.7% year-on-year (y/y) over the period, helped by sharp falls in interest rates. Although I do not expect similar declines in interest rates in the teens, the asset class still offers long-term value, with a projected real return of 6.5% y/y over the next five years.

Offshore equities set to improve

Offshore equities will also offer investors better real returns than other asset classes, forecasting 7.0% y/y after inflation through 2014. International returns will also be boosted by the expected gradual depreciation of the rand.

In the US, equities have just recorded their worst-ever decade of performance, with the S&P 500 posting a negative real return of -3.6% y/y in the past 10 years – worse even than the 1930s. By contrast, US government bonds did better with a 5.1% real return over the period 2000-2009. I expect this performance to reverse in the next 10 years.

A lower-return environment means investors will have to save more

Implications for portfolio management

We will maintain a small positive bias towards equity and property because of their better return prospects. Otherwise we are neutral in other asset classes. But rest assured that in the decade ahead there will be many economic cycles and lots of market volatility that will create opportunities to earn exceptional returns. This is why investors need to be flexible in their asset allocation to benefit from them.

