Strategic Research

The Investor's Challenge: "Runnin' Against the Wind"

Research Note

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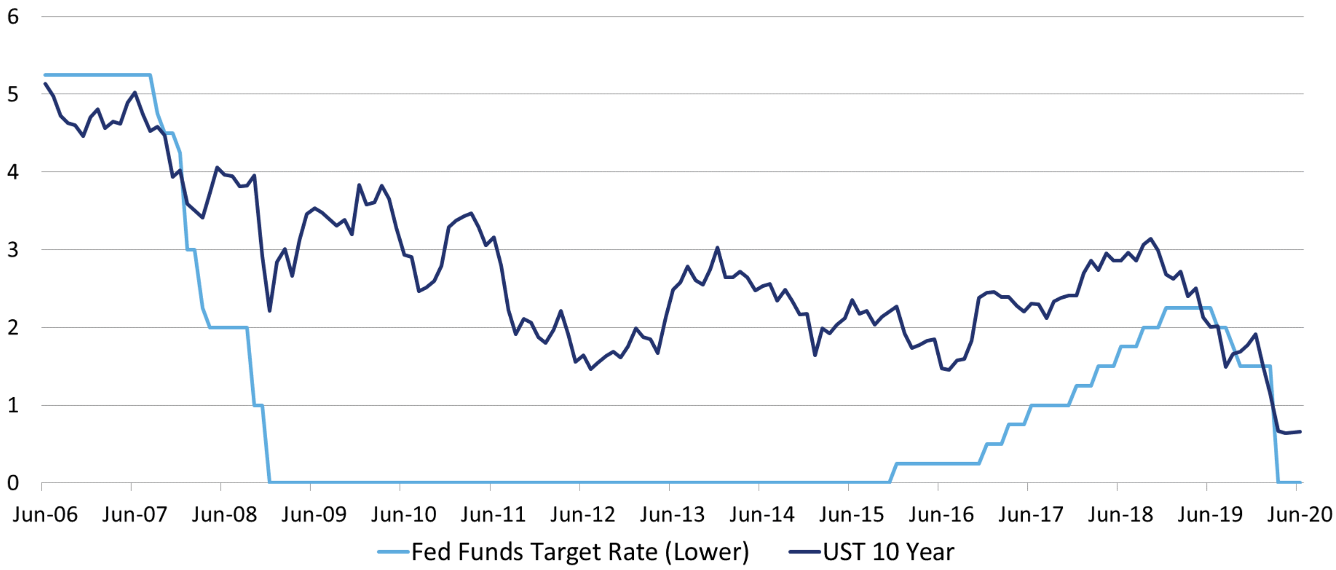
STRATEGIC RESEARCH

The Investor’s Challenge: “Runnin’ Against the Wind”[1]

Labeling market conditions as “The Investor’s Challenge” was a research theme Wilshire first established in an educational webinar series during the post-2008 environment. At its core, the theme discussed the zero/free-cash and low yield challenges facing investors (often referred to as financial repression) and explored portfolio strategies to confront these low-expected-return challenges. In recent annual memos we have chronicled the long journey out of[2] and then abrupt shift back into conditions of financial repression.[3] The 2020 environment, driven by the massive economic impact of the COVID-19 health crisis and unprecedented monetary and fiscal response, has accelerated these conditions to extreme levels. The chart below shows these shifts through the lens of the Fed Funds Target Rate (light blue line), both in absolute terms and relative to the 10-year Treasury yield (dark blue line). Note that while the Fed’s target rate has returned to its post-2008 zero “bound,” longer rates have also fallen more dramatically in the current cycle.

FED FUNDS RATE VS. 10YR TREASURY YIELD



Source: Bloomberg

While the theme of “the investor’s challenge” began with a 0% risk-free cash rate (one that falls below the expected inflation rate), what makes the current environment even more challenging for investors is the anemic – almost non-existent – compensation for taking on interest rate risk (i.e. holding high-quality bonds). As the primary diversifier of equity risk, this has major implications for institutional portfolios and leaves investors “runnin’ against the wind.”[1]

“Wish I didn't know now what I didn't know then”[1]

In moving from the interest rate environment noted above to asset class assumptions, we can observe how current conditions impact future return prospects. We present Wilshire’s June 2020 forecasts in the “building block” framework below to make comparisons to our equilibrium assumptions. The equilibrium assumptions represent theoretical estimates of asset class prospects over an unspecified, ultra-long-term period of time. They can be helpful in serving as a benchmark to understand how current market risk premiums (at least through the prism of Wilshire’s asset class assumptions) compare to

[1] Bob Seger & The Silver Bullet Band, “Against the Wind,” Against the Wind, 1980

[2] Wilshire Associates Incorporated (2019), Yearend Memo: “Halfway to heaven and just a mile outta hell,” Foresti/Junkin

[3] Wilshire Associates Incorporated (2020), Yearend Memo: “Déjà Vu All Over Again,” Foresti

those of "normal" periods (the highlighted circles in the exhibit assist in demonstrating how the return building blocks combine to explain asset class level differences). The panel to the right shows the embedded compensation in moving from inflation to cash to core bonds, etc. Using Wilshire's June 2020 assumptions as an example (the first column in that panel), inflation is assumed to be 1.50%, the real return on cash (i.e. cash minus inflation) represents a -0.75% "building block," the duration and investment-grade credit premium (i.e. core bonds minus cash) is assumed to add 0.50% to cash, etc. The right-most column highlights how the various building blocks within Wilshire's June 2020 assumptions suite compare to our equilibrium forecasts

ASSET CLASS	RETURN ASSUMPTIONS			BUILDING BLOCKS			
	Jun-20	Eqlbrm.	Diff	Jun-20	Eqlbrm.	Diff	
Inflation	1.50	2.50	-1.00	1.50	2.50	-1.00	
Cash	0.75	3.25	-2.50	-0.75	0.75	-1.50	
Core Bond	1.25	5.25	-4.00	0.50	2.00	-1.50	
US Stock	6.00	8.05	-2.05	4.75	2.80	1.95	
Private Markets	8.15	10.85	-2.70	2.15	2.80	-0.65	
60/40 Portfolio	**4.40**	**7.20**	**-2.80**	**3.65**	**3.95**	**-0.30**	← v cash

Source: Wilshire Consulting June 2020 Assumptions

Note the large negative variances between Wilshire's June 2020 assumptions and our equilibrium assumptions (i.e. -2.50% for Cash, -4.00% for Core Bonds, -2.05% for Stocks, etc.). These shortfalls and the modest absolute returns that drive them are just one perspective of the investor's challenge; the 4.40% assumed return for a U.S. 60/40 portfolio (i.e. 60% Stocks /40% Bonds) falls far short of the 7% return targets pursued by many institutional investors. Below, we use the same building block approach to compare Wilshire's June 2020 assumptions to our December 2014 forecasts.[4]

ASSET CLASS	RETURN ASSUMPTIONS			BUILDING BLOCKS			
	Jun-20	Dec-14	Diff	Jun-20	Dec-14	Diff	
Inflation	1.50	1.70	-0.20	1.50	1.70	-0.20	
Cash	0.75	1.45	-0.70	-0.75	-0.25	-0.50	
Core Bond	1.25	3.25	-2.00	0.50	1.80	-1.30	
US Stock	6.00	6.25	-0.25	4.75	3.00	1.75	
Private Markets	8.15	8.80	-0.65	2.15	2.55	-0.40	
60/40 Portfolio	**4.40**	**5.35**	**-0.95**	**3.65**	**3.90**	**-0.25**	← v cash

Source: Wilshire Consulting June 2020 vs. December 2014 Assumptions

A few observations are worth noting:

- As is highlighted via the red circles, the lower level of intermediate and longer-term yields discussed earlier results in today's bond return prospects (1.25%) falling substantially below the 3.25% representative forecast for core bonds during the post-2008 environment (i.e. 2.00% lower with negative contributions from Inflation, Cash v. Inflation and Core Bonds v. Cash).
- As highlighted via the green circle, Wilshire's current equity risk premium (i.e. the spread between our U.S. Stock and Core Bond assumptions) is 1.75% higher than our outlook five years ago, bringing its absolute forecast to just 25 bps short of the earlier assumptions despite losing 2.00% from earlier building block return components. This historically

[4] These assumptions are generally representative of the post-2008 environment; our selection of December 2014 was simply done to line up with Wilshire's "The Investor's Challenge" webinar series noted on page 1.

attractive equity risk premium results in part from the expanded valuation levels low yields (i.e. discount rates) can support as well as from the positive relative relationship between stock dividend yields and bond yields.

- The impact on a 60/40 portfolio from the stock and bond changes above leads to a nearly 1% (i.e. 0.95%) forecast decline when compared to the "low return" environment of the post-2008 period.

"Surrounded by strangers I thought were my friends"[1]

The observations noted above naturally lead to the question, "can we afford to hold high-quality bonds within the current outlook?" Along with the absolute return headwinds described above, there are other growing concerns related to the potential return pattern and diversification properties of high-quality bonds. With bond yields near 0% and approaching their practical floor,[5] it is legitimate to grow concerned regarding the potential asymmetry of future bond returns. Has this anchor asset class that has long been depended upon as a trusted portfolio friend in providing protection against equity selloffs (where falling yields in such recessionary environments propel bond returns higher through their inverse relationship with yield changes) become an unpredictable stranger that can no longer be relied upon for portfolio resilience? Wilshire will expand upon these concerns in future research, including a review of other investment segments that might assist in contributing to the diversification responsibility that has long been shouldered by U.S. nominal bonds.

"What to leave in, what to leave out"[1]

As we noted during our recent quarterly Economic, Market and Outlook webinar, we anticipate many interesting and challenging asset-liability discussions in the coming months and years as we collectively grapple with the current market environment. There will be difficult decisions to make in the variety of paths to consider; from taking on more risk (i.e. concentration risk), to utilizing more complex portfolio construction techniques (perhaps including the modest use of leverage), to staying the course and attempting to ride current portfolio allocations through the environment (i.e. accepting reduced return expectations). What investment segments should be included, what should be left out, and how should portfolios be constructed? While we recognize that there are no "silver bullet" solutions, Wilshire will remain focused on addressing these questions, exploring and identifying institutional quality solutions to manage through these unprecedented times, and will continue "searching for shelter again and again…Against the Wind."[1]

[5] While a discussion of the practical floor on bond yields is beyond the scope of this discussion, a level near -1% seems to be generally representative of such a floor. At lower levels, investors would choose the storage cost of holding cash over the penalty of holding bonds with yields below -1%. Furthermore, the exact level does not materially impact the general point that a floor exists, and it is no longer an exercise in theory that it may someday be reached.

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