VIEWPOINT

RUSSELL INVESTMENTS RESEARCH

Russell Investments

A case for multi-asset investing: The low return imperative

Rob Balkema, CFA
Senior Portfolio Manager

In recent years, Russell Investments has consistently advocated that investors consider a multi-asset approach to investing for a variety of reasons – one of the primary reasons to consider multi-asset is the "low return imperative."[1] That is, if returns from capital markets are likely to be lower going forward than they have been in the past, it is "imperative" that investors seek additional sources of return to improve the probability of achieving their objectives.

But how big is the gap between what we expect the markets to deliver, and what investors need? We calculate that the required return, or "hurdle rate," for a variety of investor segments is 2% to 4% above what we expect to be delivered by the market alone. A multi-asset approach may be a necessary, indeed an "imperative," ingredient for success.

Capital market assumptions are low, valuations are high

Russell Investments' equilibrium capital market forecasts for major asset classes are materially lower in some cases than they were at the start of the most recent bull market seven years ago, as shown in Exhibit 1.

Our equilibrium capital market forecasts for major asset classes are materially lower in some cases than they were in 2009.

Exhibit 1: Russell Investments capital market assumptions – 10-year arithmetic return forecasts: December 31, 2009 vs December 31, 2016[2]

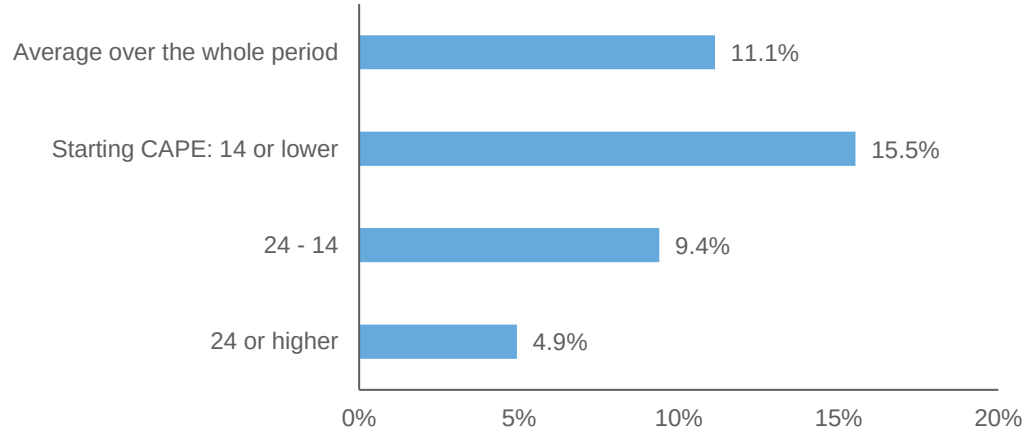
	DECEMBER 31, 2009	DECEMBER 31, 2016
U.S. equity	7.7%	7.0%
Non-U.S. equity	7.8%	8.0%
U.S. aggregate bonds	4.9%	3.1%
Inflation	2.5%	2.1%

According to Russell Investments' assumptions in 2009, a basic 60/40 stock and bond portfolio[3] was expected to return 6.6% per annum (p.a.) over the following 10 years. This same portfolio is expected to return 5.6% over the next 10 years using our December 2016 capital market assumptions, which are around 1% lower than 2009. A survey of professional forecasters conducted by the Federal Reserve Bank of Philadelphia showed that the expected return for a typical 60/40 portfolio over the next 10 years is 3.5 percentage points lower than it was in the early 1990s.[4]

The equilibrium expected returns shown in Exhibit 1 are calculated as the median path of 5,000 different potential paths for returns over the long term (10 years). The actual path of those returns over shorter horizons often depends on where we are in the market/economic cycle, on valuations of various asset classes and on the general sentiment in the marketplace.

Looking at some simple measures of valuation, the measures that often drive where markets might head in the next five to seven years, we see further sobering evidence of lower return expectations going forward. Our colleague Erik Ristuben presented a chart similar to Exhibit 2 at Russell Investments' 2016 institutional client conference. It describes equity returns in the following 10-year period at different valuation levels. The valuation measure is the Cyclically Adjusted Price Earnings (CAPE) ratio, otherwise known as the Shiller P/E,[5] defined as price divided by the average of 10 years of trailing earnings, adjusted for inflation.

Exhibit 2: Simple average of 10-year-forward S&P 500 index return (1/1/36 - 12/31/16)



Index performance is not indicative of the performance of any specific investment. Indexes are not managed and may not be invested in directly.

The key point we are making is that overall expectations for market returns, particularly from traditional asset classes like U.S. equities and bonds, may imply the need to explore other return sources and additional alpha.

Average nominal returns for the S&P 500 Index since 1936 have been 11.1% p.a. However, when looking at rolling 10-year periods, the data show that valuations matter. In particular, when the CAPE was running at 14 times earnings or lower, returns were 15.5% p.a. in the following 10-year period. Conversely, when the CAPE was 24 times earnings or higher, returns only averaged 4.9% p.a. At the time of writing, U.S. equities have a CAPE of 29.3 times earnings,[6] suggesting U.S. equities may be challenged to match the returns they have achieved in recent decades. Our global head of investment strategy, Andrew Pease, calls this "worryingly expensive."[7]

We are not saying that every asset class is expensive by historical standards. For example, at the time of writing the CAPE for EMEA ex-U.K. equities is around 13 times earnings, which suggests potential near term opportunities between equities in different geographies. We are also not saying that desired outcomes are impossible to achieve, particularly when coupled with other methods to improve financial security such as increases in savings rates, increases in contributions or reductions in spending rates. The key point we are making is that overall expectations for *market* returns, particularly from traditional asset classes like U.S. equities and bonds, may imply the need to explore other return sources and additional alpha.

Required “hurdle rates” of return to achieve investment objectives

For most investors, the need for high-single-digit investment returns hasn’t changed. Most commonly, we hear investors say a very general comment like, “I need 7%,” but this doesn’t seem a very precise statement relative to their actual needs. In reality, investors are likely to have a wide variety of return objectives and desired outcomes. Below, we describe our understanding of the desired outcomes for a few different investor types – defined benefit, non-profit and individual/defined contribution. We then translate these outcomes into “hurdle rates” of return to establish whether it is reasonable to expect markets to deliver relative to these goals, or – as we believe – there is a need to explore additional sources of return.

We then translate these outcomes into “hurdle rates” of return to establish whether it is reasonable to expect markets to deliver relative to these goals, or – as we believe – there is a need to explore additional sources of return.

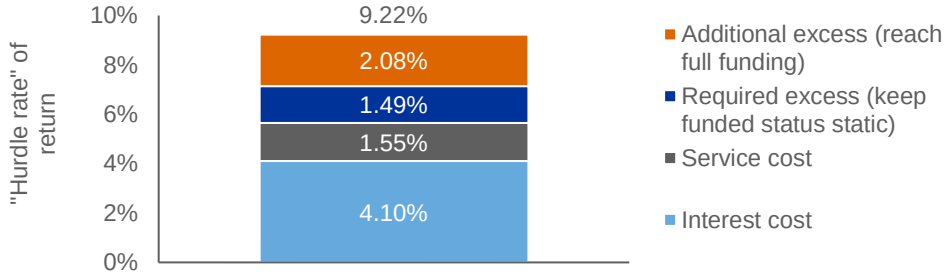
Defined benefit plan required returns

U.S. defined benefit plans have achieved very strong absolute returns over the past eight years, but the average funded status remains below 80%, which means many still have a lot of ground to cover to achieve full funding.[8] For most plans, the three main levers to improve funded status are benefit design changes (e.g., closing or freezing the plan, lump sum offers), contributions and investment returns.

There has been an increasing trend towards closing or freezing defined benefit plans in the United States, but it’s a one-time decision and is sometimes difficult to implement for companies with large union populations. The second option, contributions, is sometimes considered a reasonable use of corporate cash, especially on a net of tax basis (noting that a change to tax laws regarding interest deductibility may change that equation) and increasingly in light of rising PBGC premiums. However, as stated, recent trends suggest many companies are barely contributing enough to keep up with new benefits earned.[9] This means all that is left to improve funded status is investment returns.

A simple way to depict the return required to improve funded status for a U.S. defined benefit plan is shown in Exhibit 3. Here we are using 2016 10-K filings from Russell Investments’ analysis of the largest corporate pension plans in the United States – the $20 billion club – and decomposing key components that form the overall “hurdle rate” required to achieve full funding.[10]

Exhibit 3: Estimated “hurdle rate” of return for a defined benefit plan



U.S. defined benefit plans have achieved very strong absolute returns over the past eight years, but the average funded status remains below 80%, which means many still have a lot of ground to cover to achieve full funding.

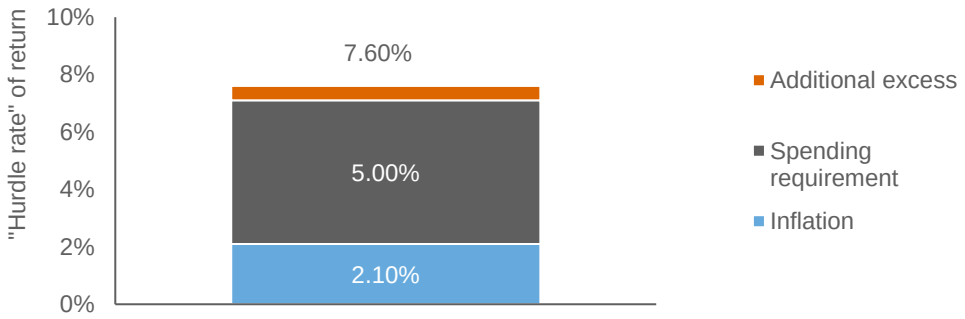
For a typical open or closed corporate pension plan in the United States, obligations increase by interest cost (i.e., increase in liability due to the passage of time) and service cost (i.e., new benefits earned), which amount to 4.10% and 1.55% respectively for the $20 billion club. There is also a “required excess” if the plan is underfunded – for instance, the $20 billon club was 78.5% funded at the end of 2016, so only 78.5 cents of assets are available to earn an investment return per every $1 of liabilities. Thus, the plan needs an additional 1.49% of return from its smaller asset base relative to liabilities, and a total nominal “hurdle rate” of return of 7.14% when including interest cost and service cost, just to keep funded status stable. The “required excess” declines as funded status improves.

The “additional excess” is the additional return required to reach full funding over a certain time horizon, most often happening between seven and 10 years, and including plan expenses like investment manager costs and PBGC premiums. We calculate that the $20 billion club would require an additional 2.08% of returns on top of the aforementioned 7.14% to reach full funding over seven years – a total return goal of 9.22%, which is 362 basis points higher than is expected from a typical 60/40 stock and bond portfolio according to Russell Investments’ December 2016 assumptions.[11]

Non-profit investor required returns

Similar methods in aggregating a “hurdle rate” shown above for DB plans can be applied to non-profit investors. A typical non-profit has a 5% (real) required spending requirement, although certain types of non-profits such as community foundations may not have this required annual payout stream mandated by law, but generally still desire a strong absolute return to fund discretionary spending.

Exhibit 4: Estimated “hurdle rate” of return for a non-profit investor

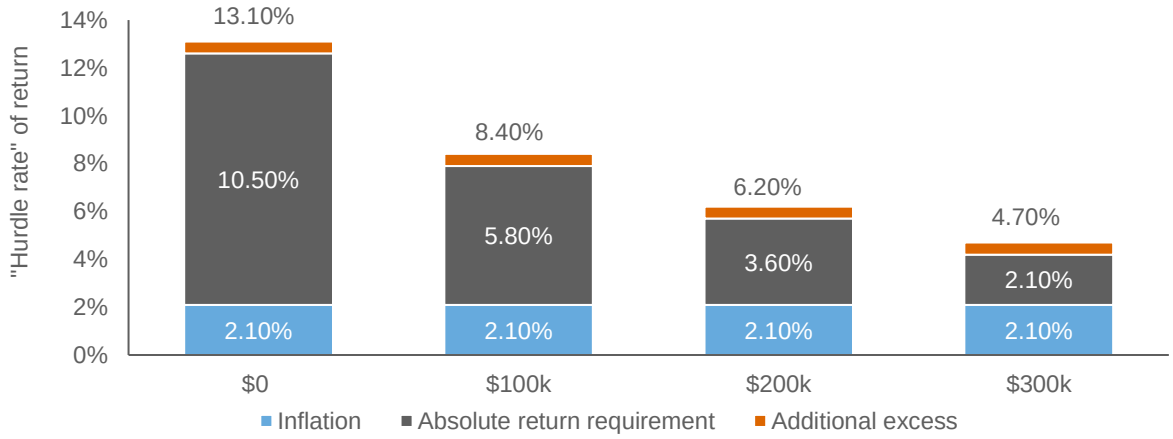


A typical non-profit “hurdle rate” to preserve the real level of capital is shown in Exhibit 4. The calculation is a simple combination of inflation, currently forecast by Russell Investments to be 2.1% p.a. over the next 10 years; the 5% spending requirement and an “additional excess” for investment expenses for a total “hurdle rate” of ~7.6%, which is 200 basis points higher than is expected from a typical 60/40 stock and bond index portfolio according to Russell Investments’ assumptions. If there is a need to spend beyond the required level, the return objective would be higher to preserve the capital base in real terms.[12]

Individual or defined contribution investor required returns

Similar to non-profits, individual investors typically have a component of their objectives tied to the preservation of capital in real terms, although time horizons, risk tolerances and savings rates vary more widely for individuals than for institutions. For an individual invested in a 401(k) plan, it is increasingly common to think of one’s “hurdle rate” as the return required to achieve a certain income replacement percentage[13] at retirement, given a certain savings rate.

Exhibit 5: Estimated “hurdle rate” of return for an individual defined contribution participant at given starting balances



Using an individual defined contribution participant as an example, Exhibit 5 shows the estimated "hurdle rate" of return required for a typical 45-year old, and expects her 401(k) to provide 49% of final income replacement at retirement. Notice that the "hurdle rate" of return required contains an inflation component, but also an absolute return component that declines the higher the starting balance is. Broadly, individuals who are saving less require more return (or need to adjust their expectations for income replacement downwards). Individuals who are saving more don't have as high a return hurdle, but still need to preserve the real value of their portfolios. As with the defined benefit and non-profit examples, there are many cases where the return available from the market does not reach the "hurdle rates" required for individuals.

Overall, required returns are potentially higher than the market alone can deliver going forward

What should be done with the investment portfolio to close this gap?

Looking at each type of investor – defined benefit plans, non-profits and individuals – the "hurdle rates" of return required to achieve desired outcomes are well above Russell Investments' return forecasts for a typical 60/40 portfolio. In many cases 200 to 400 basis points above what might be required, which need to be made up by some combination of investment returns, contributions, increased savings and/or lowering of future expectations! To the extent investors are relying on investment returns, this is the challenge of the "low return imperative." The question, then, is what should be done with the investment portfolio to close this gap?

Multi-asset: a potential solution for a lower return environment

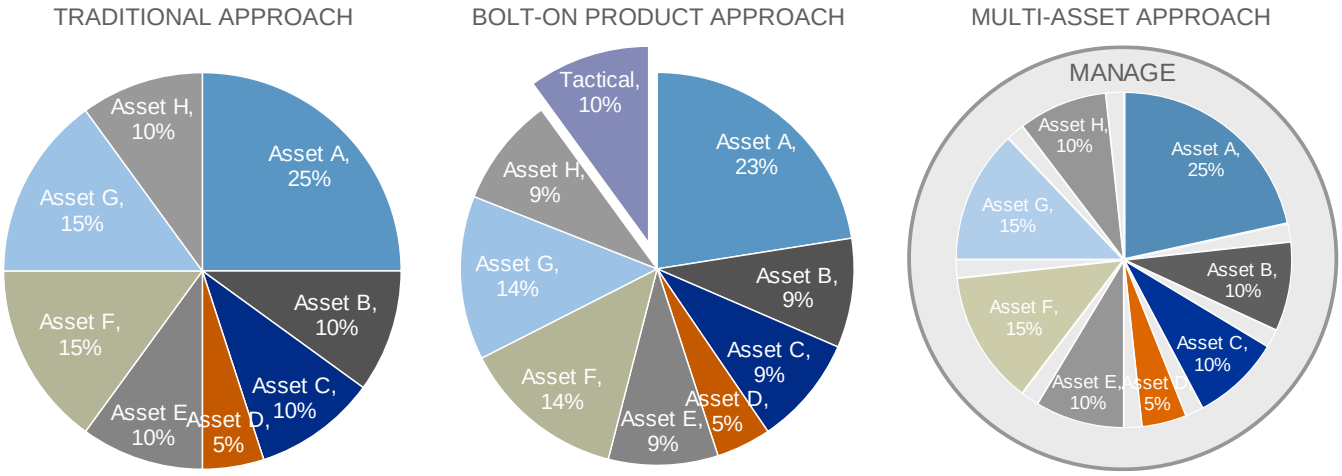
Russell Investments believes there are a variety of ways to solve the problem of the "low return imperative" (or at least lessen its impact). Some of these solutions may involve changes in behavior rather than investment solutions – saving more, contributing more or spending less. Each of these likely involves some painful decision-making, or at least some contrition away from prior habits that resulted in lower funding levels or account balances. Harvesting the illiquidity risk premium through private investments is potentially a powerful tool to help bridge the gap between desired outcomes and market returns. However, for those that have reached the higher end of their illiquidity budget, cannot use leverage and/or have no ability to alter their behavior, we believe most will need more out of their investments going forward. A multi-asset investment solution seeks to maximize the probability of achieving expected outcomes over the long term by accessing return sources and opportunities that may not be available in a traditional asset class "slice" portfolio.

Russell Investments defines multi-asset investing as the process to identify, combine and dynamically manage a globally diverse mix of performance sources to achieve a specific investment outcome.

There are many definitions for multi-asset in the industry. Russell Investments defines multi-asset investing as the process to identify, combine and dynamically manage a globally diverse mix of performance sources to achieve a specific investment outcome. Each multi-asset solution has a customized asset allocation that is **designed** to include both traditional and non-traditional diversifying exposures across a wide variety of styles, geographies, sectors and factors. Multi-asset portfolios are **constructed** through an open architecture framework using a blend of passive positioning strategies to capture strategic beliefs/risk premia and best-in-class concentrated active strategies to capture skill in stock selection, while paying close attention to costs. Multi-asset portfolios are also **managed** dynamically in real time using holdings level risk analysis and precise implementation to efficiently add additional incremental return and/or help manage downside risk.

Exhibit 6 shows how a multi-asset approach contrasts to what we refer to as the "traditional approach" – where the asset allocation is static, where overall portfolio positions are simply an aggregate of underlying manager positions and where the portfolio is not dynamically managed and, thus, is subject to the vagaries of market movements. The exhibit also shows what we call a "bolt-on approach" where the asset allocation is also static, and the tactical element is "bolted on" through a separate investment vehicle. Thus, it arguably isn't as interlinked with underlying exposures as it could be. A multi-asset approach is designed to seamlessly coordinate all phases of a design, construct and manage process in a single vehicle or custom solution.

Exhibit 6: Contrasting a multi-asset approach to investment management, to other investment approaches (illustrative)



Conclusions

In this paper, we have shown that long-term expected returns are lower, and that medium-term valuation measures also support a more sobering outlook for returns from traditional financial assets. Conversely, "hurdle rates" of return have not changed and some investors may not achieve the outcomes they expect unless they find additional sources of return. If institutions or individuals are unwilling or unable to save more, contribute or lower spending rates, the "low return imperative" makes it necessary to explore ways make assets work harder.

Our goal for this paper has been to help investors get a more precise understanding of what their return targets or required "hurdle rates" of return might be. To keep the discussion simple, we focused primarily on returns rather than risks, and did not delve deeply into important implementation issues such as liquidity, fees, investment, regulatory constraints and so on – all of which are important considerations, but are beyond the scope of this paper.

Notwithstanding those caveats, however, we do believe the 200 to 400 basis point delta between required "hurdle rates" and expected returns from the market over the next 10 years make it "imperative" for asset owners and individuals to consider all potential additional sources of return, including those that we believe are only available through a multi-asset approach. This may help avoid the disappointment of not achieving the outcomes we expect going forward.

Our goal for this paper has been to help investors get a more precise understanding of what their return targets or required "hurdle rates" of return might be.

[1] Hussey, J. (2017, February 1). “2017 and the search for returns: the low-return imperative”. *Russell Investments blog post*. http://blog.russellinvestments.com/2017-search-for-returns/

[2] Source: Russell Investments Capital Market Assumptions.

[3] Assuming a 40% U.S. equity, 20% Non-U.S. equity and 40% U.S. aggregate bond portfolio

[4] Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters & Russell Investments. Data as of January, 2017.

[5] Campbell, J., Shiller, R. (1988, July). “Stock Prices, Earnings, and Expected Dividends”. *Journal of Finance*. Vol 43. No.3.; Russell Investments calculations

[6] http://www.econ.yale.edu/~shiller/data.htm

[7] Russell Investments. (2016, October). “2016 Global Market Outlook – Q4 Update” pg. 2. https://russellinvestments.com/us/insights/global-market-outlook

[8] Owens, J. (2016, March). “$20 billion club strategy”. *Russell Investments Research.*; and Collie, B. (2017, March). “Discount rates fall and shortfalls increase for the $20 billion club in 2016”. *Russell Investments Research*.

[9] ibid. In 2015 and 2016, companies in the $20 billion club contributed $31 billion in aggregate, but this barely covered the $30 billion in new benefits earned according to 10-K filings.

[10] ibid.

[11] Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that any stated results will occur.

[12] See endnote 11.

[13] Also called TRI = Target Replacement Income. See Fan, Y., Gardener, D., Greves, J., Murray, S. (2014, September). “Review of Russell Investments’ target date fund methodology”. *Russell Investments Research*.

ADDITIONAL AUTHOR: Marty Jaugietis

ABOUT RUSSELL INVESTMENTS

Russell Investments is a global asset manager and one of only a few firms that offers actively managed multi-asset portfolios and services, which include advice, investments and implementation. Russell Investments stands with institutional investors, financial advisors and individuals working with their advisors—using our core capabilities that extend across capital market insights, manager research, asset allocation, portfolio implementation and factor exposures to help investors achieve their desired investment outcomes.

FOR MORE INFORMATION:

Call Russell Investments at **800-426-8506** or
visit **russellinvestments.com/institutional**

First used: May 2017 AI-25475-05-20