Private Capital Advisers

Market Report October 2021

Market returns

Another solid quarter for growth assets even with some weakness in markets towards the end of the quarter. The recovery from the lows of March 2020 have been so strong that over two years – even including the March 2020 downturn – returns from growth assets have been well above average. We have seen much more than just a recovery.

On the defensive side of the portfolio Government bonds are still showing negative returns for the full year. Term deposits and cash have had positive returns, but only just.

Figure 1: Performance for period ending 30 September 2021

	3mo	1 year	2 years
Australian equities[1]	2.7%	31.8%	9.5%
International equities[2]	3.8%	27.6%	15.5%
Listed property[3]	4.2%	29.8%	4.0%
Bonds[4]	0.3%	-1.5%	0.8%
Term deposits[5]	0.3%	1.6%	2.0%
Cash[5]	0.0%	0.1%	0.4%

1.ASX 200 inc Franking, 2.MSCI World Ex Aus Index, 3.ASX A-REIT Index, 4. Aust Comp Bond Index, 5. RBA data

One point that we would like to highlight from these returns is that Government bonds and equities often move in opposite directions.

- For the past twenty years, falling equity markets have generally been accompanied by falling interest rates. Falling interest rates make government bonds rise in value which helps offset the impact of equity falls on the overall value of your portfolio.
- Here we see that the converse is often true as well. Over the past year we have seen spectacular returns from equities and negative returns from government bonds. (Of course the small negative from bonds is more than offset by the gains from growth assets.)
- These returns from growth assets are absolutely unsustainable. There will again come a time that growth assets have significant negative returns. At that time the reason for keeping a portion of your portfolio in defensive assets will become very clear.

The Long-Term Outlook for returns

As we highlighted in our July 2021 quarterly report we expect lower returns going ahead – just how much lower is outlined in the Figure 2 below, which shows our forecasts for the next ten years. These forecasts are built up from assessing what we earn from dividends, how fast we expect company profits and property rents to grow and how much we expect future investors will pay for those profits and rents.

Unfortunately, these forecasts tell us very little about returns over the next one to three years. As we have seen over the past two years short-term returns can fluctuate enormously. However, these forecasts do give us a very good guide to the longer term – and it is quite a sobering picture.

Figure 2 : Ten-Year Forecast Returns

Base case	Australian Equities	International Equities	Listed Property[1]	Hi Yield Debt[2]	TDs or Govt bonds	Cash
Income	4.7%	1.8%	4.1%	5.5%	1.6%	0.9%
Currency impact		0.4%				
Earnings growth	0.7%	3.9%	1.1%	-1.5%		
Valuation change	-0.7%	-2.7%	-0.5%			
Forecast	**4.7%**	**3.3%**	**4.7%**	**4.0%**	**1.6%**	**0.9%**
PE now	18.7	25.8				
PE 2031	17.4	19.6	4.3%			
1. A-REITs; 2. Negative growth is an allowance for credit loss.						
Index Level	7629.7	448.4	1610.7			

Rather than the 10% pa or more we have earned in equities over the past two years, we now expect the next decade's returns on growth assets will be around 3.5 to 4.5% pa. Lower than we would like but still 2.0% to 3.0% better than we expect to get from fixed interest or cash.

This difference is often described as the equity risk premium – the amount of extra return we receive from equities for taking on equity risk. This premium falls when share prices rise, and rises when prices fall. Our assessment of the current risk premium across different markets is shown by the colours in the Tipping Point Tables below.

Figure 3 : The Tipping Point Tables

Australian Equities			US equities			World Ex US			A REITs		
All Ords 7,629.7	10 yr F'cast return	Status	S&P500 4,307.54	10 yr F'cast return	Status	FTSE World Ex US 321.9	10 yr F'cast return	Status	ASX REIT 1610.7	10 yr F'cast return	Status
10000	1.0%	Overpriced	4800	-1.0%	Overpriced	550	-0.1%	Overpriced	2500	-1.0%	Overpriced
9750	1.3%	Overpriced	4600	-0.5%	Overpriced	525	0.4%	Overpriced	2400	-0.6%	Overpriced
9500	1.7%	Fully priced	4400	0.0%	Overpriced	500	0.9%	Overpriced	2300	0.0%	Overpriced
9250	2.0%	Fully priced	4200	0.5%	Overpriced	475	1.5%	Overpriced	2200	0.5%	Overpriced
9000	2.4%	Fully priced	4000	1.0%	Overpriced	450	2.1%	Fully priced	2100	1.1%	Overpriced
8750	2.8%	Fully priced	3800	1.6%	Overpriced	425	2.7%	Fully priced	2000	1.8%	Fully priced
8500	3.2%	Fully priced	3600	2.2%	Fully priced	400	3.4%	Fully priced	1900	2.4%	Fully priced
8250	3.6%	Fully priced	3400	2.9%	Fully priced	375	4.1%	Fully priced	1800	3.2%	Fully priced
8000	4.1%	Fully priced	3200	3.6%	Fully priced	350	5.0%	Fair value	1700	3.9%	Fully priced
7750	4.5%	Fair value	3100	4.0%	Fully priced	340	5.3%	Fair value	1650	4.4%	Fair value
7500	5.0%	Fair value	3000	4.4%	Fair value	330	5.7%	Fair value	1600	4.8%	Fair value
7250	5.5%	Fair value	2900	4.8%	Fair value	320	6.0%	Fair value	1550	5.2%	Fair value
7000	6.0%	Fair value	2800	5.3%	Fair value	310	6.4%	Fair value	1500	5.7%	Fair value
6750	6.6%	Fair value	2700	5.7%	Fair value	300	6.8%	Cheap	1450	6.2%	Fair value
6500	7.2%	Cheap	2600	6.2%	Fair value	290	7.3%	Cheap	1400	6.7%	Cheap
6250	7.8%	Cheap	2500	6.7%	Cheap	280	7.7%	Cheap	1350	7.3%	Cheap
6000	8.4%	Cheap	2400	7.2%	Cheap	270	8.2%	Cheap	1300	7.8%	Cheap

In the Red Zone, expected returns are less than those from fixed interest and it is time to start heading for the exits – only the US sharemarket is in that territory today. In the Yellow Zone, we have a smaller than usual risk premium – and so it is time to be cautious. Today most markets are just in the Fair Value Blue Zone. This is where we expect 2.5% or higher returns than fixed interest. While expected future returns are modest, they are better than TDs and other very secure fixed interest securities.

Portfolio moves

We continue to monitor these valuations closely, in particular Australian equities and Listed Property (A-REITs) which are near the borderline between Fair Value and the cautionary Fully Priced zone. In the event that prices move into that Fully Priced zone we will be considering when it is appropriate to reduce exposures to growth assets in favour of more defensive assets such as high yield debt.

As can be seen in Figure 2, we expect that at current valuations High Yield debt will deliver similar long term returns to equities but with much less risk. (It is not risk free, just less risky than equities.)
As such we consider that it is an ideal asset to hold when growth assets become fully priced.

Points made in earlier quarterly reports that remain valid

- **Diversification remains vital**. The two-year returns show that, among the growth assets where we would expect similar returns in the long-term, we can get large divergences in the shorter term. In particular, Listed Property, with its focus on offices and shopping malls, was deemed by the market to be a long-term casualty of the pandemic and has returned just 4% pa over the past two years while International Equities returned 15.5% pa.
- **Markets over-react**. The property sector which was deemed to be the biggest casualty of COVID, has performed very strongly over the past year. We are often asked why we continue to hold property when the outlook is so bleak? The answer has been that the outlook is not as bleak as the market suggested and this type of rebound is a typical reaction to a market over-reaction.
- **Even secure investments are capable of producing negative returns over shortish time periods**. Government bonds have had a negative return over the past year, however, over longer time frames returns are more reliable. This, of course, is why we always focus on the long-term.
- **These type of equity returns are absolutely unsustainable.** We are delighted when we do earn these sort of returns but also need to recognise that even the seemingly more modest two-year returns are much higher than we are likely to earn in the longer-term.

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