

Don't Expect Big Stock Gains in the Future

Stockholm (HedgeNordic) – What should investors expect their stock holdings to return over the next few decades? Niels Jensen (*pictured second from left*), who founded London-based investment advisory firm Absolute Return Partners 17 years ago, anticipates “no more than 0-3% annual return in equities over the next ten years.” That is certainly a far cry from the returns most equity investors have been accustomed to in the past several decades, but there are obvious factors behind the looming low expected return environment.

“The last 35-40 years have delivered extraordinarily benign conditions for equity investors,” says Jensen. These conditions are mostly attributable to “dramatically falling interest rates, baby boomers moving into their peak spending years and the digitalisation of our societies since the mid-1990s.” The average annual return on global equities has been over 10% since the early 1980s, but are investors right in expecting a similar rate of return going forward?

Because of stagnating or even shrinking labour forces in many of the world's largest economies and subdued productivity growth, Jensen foresees a bleak picture of low structural economic growth. With tempering economic growth usually translating into lower corporate profits, global equities are not expected to provide the returns investors might have been accustomed to in the recent past.

The Productivity Conundrum

To explain his expectations of an imminent low expected return environment, Jensen takes one step back and puts forward one of the most fundamental equations in economic theory:

$$\Delta \text{GDP} = \Delta \text{Workforce} + \Delta \text{Productivity}$$

As Jensen explains, “at the most fundamental level, there are only two drivers of economic growth: workforce growth and productivity growth.” Japan has long been in a demographic decline and Europe is in the early stages of the same, with Jensen arguing that “robust productivity growth is pivotal to economic growth” given that labour force growth will turn negative in many developed countries in the years ahead. Whereas a shrinking labour force in developed economies is no surprise, the question of whether productivity will slow further going forward or accelerate on the back of technological advances remains broadly debatable.

According to Jensen, who just recently released a book titled “The End of Indexing,” productivity growth will slow further as a result of ageing, high levels of debt, and other factors. However, there is “one important reason why productivity growth is so pedestrian, and it is far too much misallocated capital – capital that is deployed unproductively,” argues Jensen. “In a well-functioning economy, almost all capital is deployed in a way that will improve productivity,” he says, listing “a more robust infrastructure” and “a better educational system” as two examples.

“These days, so much capital is deployed unproductively,” cautions the founder of Absolute Return Partners. The servicing of the growing number of elderly people and the production of energy are just two such examples. “On the last example, in the United States (the biggest oil producer in the world), about 32 times more capital is tied up in the oil industry for every barrel of oil produced than was the case in 1980,” Jensen puts forward a specific example of grossly misallocated capital.

Think Outside the Box

On the question of how to earn good returns in a low expected return environment, Jensen

encourages investors to think out-of-the-box. "Don't assume bonds and equities will do the job as they have done since the early 1980s," he says. Jensen reckons investors should maintain low exposure to equity beta, "not at zero, as there are definitely opportunities in the equity arena, but below average." Jensen further adds that he "wouldn't be at all surprised if bond yields 4-5 years from now are even lower than they are today." Nonetheless, the most significant risk he sees ahead relates to "equities and property, the latter of which is even more overvalued than equities."

Jensen considers the alternatives space a good hunting ground for investors, yet not all alternatives are good alternatives. "The classic mistake investors make when investing in alternatives is that almost all of them start with what I call mainstream alternatives," says Jensen, referring to investment strategies such as equity long/short and global macro. "But those sorts of investment strategies are subject to the same low-return environment that equities and bonds are subject to," warns Jensen.

Instead, he encourages investors to search for investment strategies that are not correlated to equities and bonds. "One of our biggest investments at present is music royalties, and the fund we have invested in is closely linked to Sweden," Jensen presents one alternative for investors. "The good news is that royalties are earned whether the economy is firing on all cylinders or not," says Jensen, adding that "the even better news is that the disruption that so many industries have been subjected to in recent years, has been a big plus for the music royalty industry as the introduction of streaming has accelerated growth rates."

Jensen, who started Absolute Return Partners in 2002 after leaving his job as Head of European Wealth Management at Lehman Brothers, says that one important lesson he learned during his long career is that "we all spend far too much time on the short-term." Whereas most market participants attempt to predict next week's inflation numbers or next month's GDP numbers, Absolute Return Partners "zooms in on eight megatrends which will impact pretty much everything in the years to come, and we invest accordingly," concludes Jensen.

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