Alternative investments key to overcoming the ‘lower for longer’ return challenge

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THE last twelve or so months have been an incredibly testing period for investors. The coronavirus pandemic created an economic collapse and societal crisis the like of which we haven’t seen in a century. Equity markets and other risk assets initially collapsed but were resuscitated thanks to central banks dusting off their Global Financial Crisis (GFC) playbooks and governments deciding that spending was the best way to revive the economy. As the pandemic now slowly disappears in the rear-view mirror, it appears that policymakers made the right calls. Decisive action at the time spared us a long-lasting economic depression and with that a possible repeat of the GFC market turmoil which scarred a generation of investors.

And so, to this year. The big gains across equity, credit and commodity markets so far in 2021 suggest that investors firmly believe that the coronavirus crisis is over. As markets have moved higher though so too have valuations. Sovereign bond yields around the world are near zero while investment grade corporate bond yields (which carry higher risk) are only slightly higher. Whispers of a bubble in global stock markets have grown louder and it’s easy to see why - based on Yale Professor Robert Shiller’s data on equity valuations, US stock market valuations have only ever been more expensive than now on one occasion since 1881, in the run-up to the bursting of the dotcom bubble. Together all of this leaves us with a lingering feeling that rarely has the disclaimer “past performance is no guarantee of future results” been more relevant for investors than now.

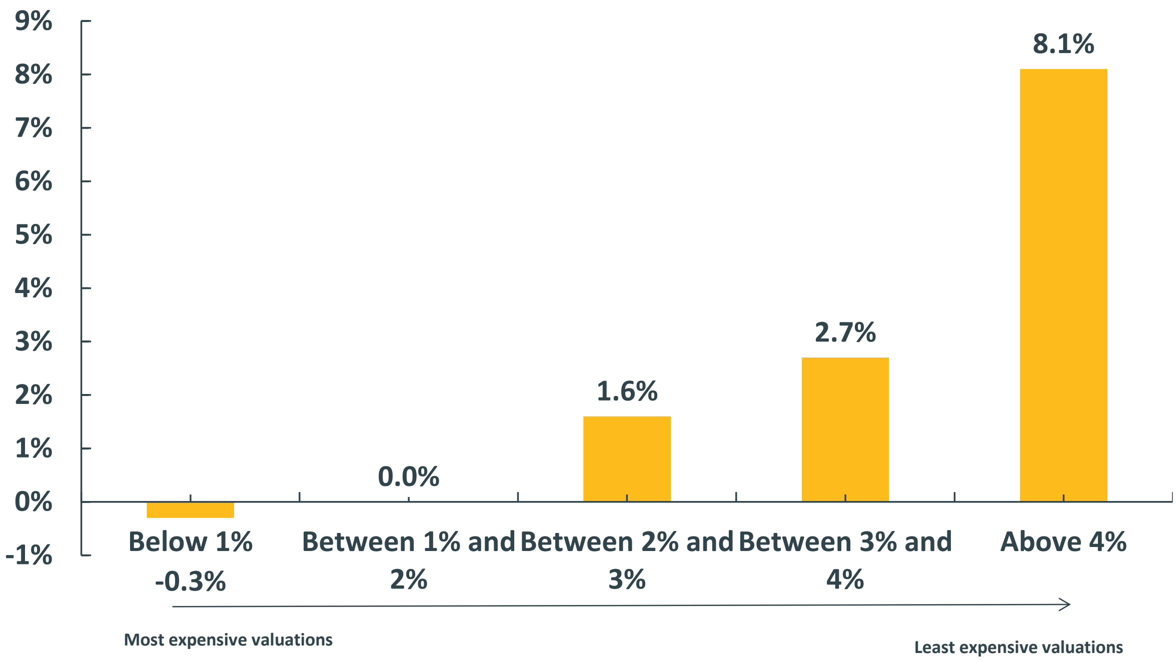
But why exactly should this sharp rise in valuations concern investors? Well, quite simply because valuations tend to be very good predictors of future long-term performance! The chart below courtesy of international research house BCA provides good evidence of this. Essentially the key message in the chart below is this, when you invest at expensive valuations (in this case in government bonds) you tend to earn weaker long-term returns and vice versa. In this chart we can see that when US investors invested in bonds at yields below 1% (coincidentally around where sovereign bond yields are at present) they earned negative returns even before fees over the following five years.

> *Investing is a marathon, not a sprint and the best investors always recognise this.*

In our view most of the conventional asset classes suffer from some degree of overvaluation at present although bonds to our mind are the most extreme example of this. Interestingly, it was recently reported in the media that the Society of Actuaries in Ireland have reduced its return assumptions for all asset classes used in multi-asset funds – a clear recognition across our industry that future portfolio returns are going to be lower (and in some case much lower) than Irish investors have been typically used to.

So, what can investors do to guard against the risk of lower long term returns across the main asset classes? Well in our view diversifying portfolios to include more alternative investments is a good start. Over the past few years at Blackbee we have been very active in

Relationship between bond yields at the time of purchase and future 5 year returns



Source: BCA Research, May 2020. Calculations based on quarterly US data since 1953. Yields are calculated after inflation

Forestry Performance 1990-2020**

	Timberland	Equities	Government Bonds	Gold
Average Annual Return (Per Annum)	8.9%	8.4%	5.5%	5.5%
Annualised Volatility	6.9%	15.7%	5.0%	12.8%
Risk Adjusted Return (Sharpe Ratio*)	0.9	0.4	0.6	0.2

**Defined as Average Annual Return minus Risk Free Rate (2.67%), divided by annualised volatility*

***Analysis based on quarterly returns between 1990 and 2020, risk free rate = avg 3m T-Bill yield 1990-2020*

***Source: NCREIF Timberland Index, S&P 500, FTSE US Treasury Index, Gold Prices*

***Source: Bloomberg, March 2021*

investing in healthcare and social housing, sectors where returns are underpinned by stable medium-term demand which is often led by predictable demographic changes. Forestry is the latest example of an alternative sector we feel could tick a lot of boxes for investors at present, particularly conservative ones who are most likely to be negatively affected by low deposit and bond returns over the medium term.

The asset class boasts a tremendous long-term track record versus all the other main asset classes, particularly when we look at its risk adjusted returns i.e. its Sharpe ratio (see table). In addition, the medium term outlook for Irish timber demand is very strong, driven by strong Irish and European housing demand as well as its use as a source of biomass which has quickly become the largest source of global renewable energy. The sector also benefits from government incentives as Ireland looks to increase its rate of forestry coverage from 11% to 18% by 2050.

However, crucially forestry also tends to be positively correlated to inflation over time - in other words forestry tends to rise in value when prices or broad inflation rates are also rising. From a long-term financial planning perspective this makes forestry an ideal candidate for investment as it helps investors outperform inflation and maintain the purchasing power of their money. But we see this as providing an added benefit for investors in the current climate, as a hedge against the negative impact rising inflation rates could have on global equity and bond markets in the short term.

Over the past few months both consumer and producer price inflation has been rising rapidly. In April alone we saw US consumer prices rising at their fastest pace since 2008 while Chinese producer price inflation (prices at the factory gate) was close to a three-year high. This has rattled equity and bond markets. For those investors that have made strong gains in these markets over the past year, forestry provides welcome and timely diversification, particularly insofar as it protects investors against rising inflation.

From an investor's perspective the coronavirus pandemic is thankfully drawing to a close with something of a happy ending insofar as we have been spared what could have been a repeat of the GFC era. However, investors now face a longer-term challenge, one of lower future long term returns across the main asset classes. In our view diversifying into the alternatives space could help overcome this challenge, particularly for conservative investors. Forestry as an example may not be as sexy as some other investments, but it can play a key role in a long-term investment portfolio. As Nobel Laureate Paul Samuelson famously once said "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas". Investing is a marathon, not a sprint and the best investors always recognise this.