TD Wealth

Half Full

Half Empty

Managing expectations in a post-stimulus environment

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Half full or half empty?

Insights from Brad Simpson, Chief Wealth Strategist, Head of Portfolio Advice & Investment Research, TD Wealth

Equity investors who've gotten used to double-digit returns over the past decade may not be ready for what's coming next. Of course, portfolio managers are quick to remind us that past performance is no guarantee of future results, but looking back to recent years, it's clear that stocks have been propelled by stimulant monetary policy (in the form of ultra-low rates) and stimulant fiscal policy (in the form of tax cuts and deficit spending). It's also clear that some of that stimulus is now being withdrawn.

So what happens to portfolio performance when the euphoria fades and interest rates stop going down, as we've seen over the past couple of years? Are we moving into a period of lower returns? And, if so, how can investors manage their expectations and continue to have faith in their financial plans?

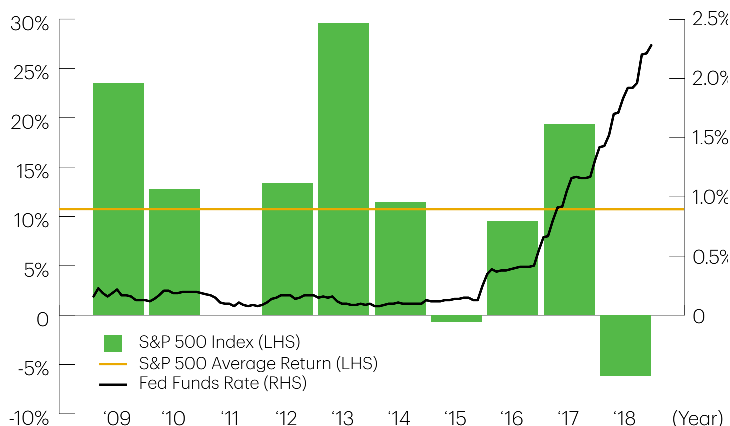
To help sort through these difficult issues, we're talking to Chief Wealth Strategist Brad Simpson, who's written extensively about the once-in-a-generation shift that investors are now seeing as we move into a new ecosystem where global growth is uncertain and central banks are taking a different path in the management of interest-rate policy.

PAIR: Brad, it's a pleasure to chat. Let's talk about managing expectations, and whether our current expectations are reasonable going forward. To begin, can you give us a sense of just how unusual this past decade has been in terms of equity performance?

Brad Simpson: Extremely unusual. Since the market bottomed out near the end of 2008, we've seen one of the longest bull runs in American history. Equity returns over that time have been nothing short of spectacular, particularly in the United States. Over the course of 10 years, the S&P 500 has returned close to 11% a year (see Figure 1). So, it's just been remarkable.

Figure 1: Emergency Measures: 2009 to 2018

S&P 500 Index vs. Fed Funds Rate



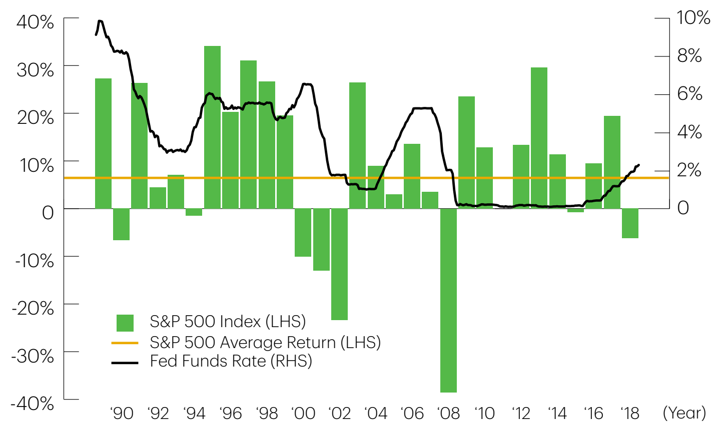
Source: Bloomberg Finance L.P.; Price return, Fed Funds Effective Rate

PAIR: And how does that compare to historical returns?

Simpson: I guess that depends on what you mean by "historical," right? A lot of investors will base their assumptions on 20 or 30 years of performance, and if you're looking back that far, returns for the S&P 500 are close to 8% (see Figure 2). But remember, interest rates in the U.S. topped out a long, long time ago, all the way back in 1981. So, even if you go back 30 years, you're tracking performance in a falling-rate environment, and we're no longer in a falling-rate environment.

Figure 2: Falling Rate Environment: 1989 to 2018

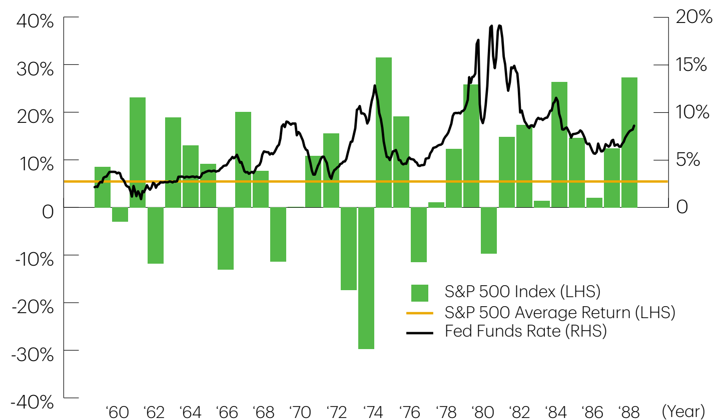
S&P 500 Index vs. Fed Funds Rate



Source: Bloomberg Finance L.P.; Price return, Fed Funds Effective Rate

Figure 3: Rising Rate Environment: 1959 to 1988

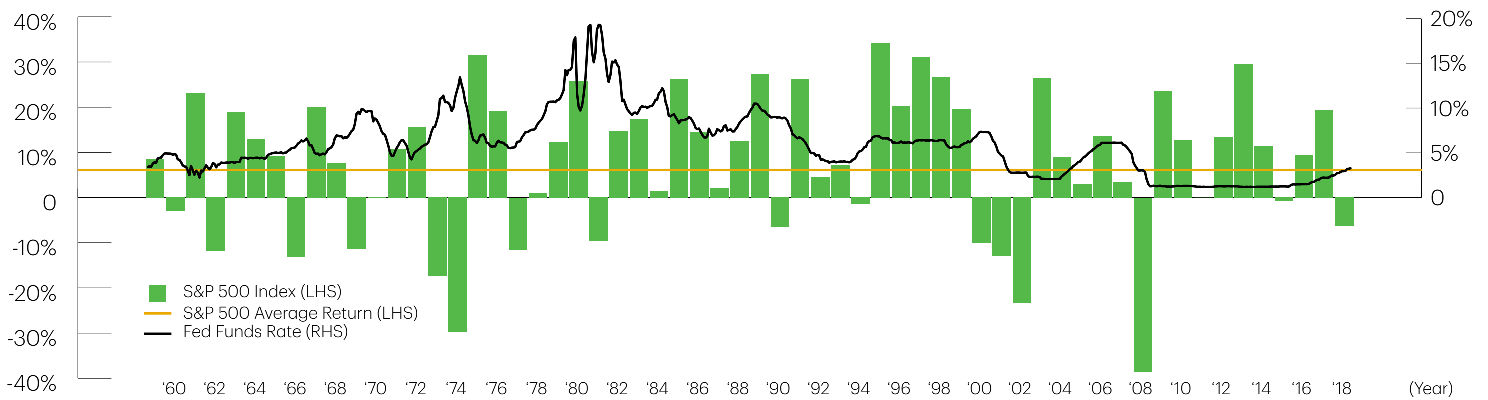
S&P 500 Index vs. Fed Funds Rate



Source: Bloomberg Finance L.P.; Price return, Fed Funds Effective Rate

We have to remember that inflation was rampant in the 1970s, up over 5% annually — almost the opposite kind of situation we have now — so the Fed actually went to war. Interest rates went up all through the 1970s and hit nearly 20% before inflation started to come back down again, and rates continued to fall for over 30 years. It's only recently that they've started to tick back up. So, really, you have to go back to the 1950s to find rates at today's levels.

Figure 4: Annualized Historical Returns I S&P 500 Index vs. Fed Funds Rate



Source: Bloomberg Finance L.P.; Price return, Fed Funds Effective Rate

PAIR: Okay, let's do that. If we go back to the 1950s, what does that look like?

Simpson: Ah, now we're talking! If you go back, say, 60 years, that's a much more representative period. That would take us right through 30 years of rising rates, and then 30 years of falling rates. For the whole 60-year period, annual returns for the S&P 500 were somewhere between 6% and 7% (see Figure 4). That's about half of what we've come to expect in recent years, and it may be the environment we're heading into — a kind of "glass half full" scenario.

PAIR: Six percent is pretty low relative to what we've gotten used to. Some investors might call that a "glass half empty" scenario.

Simpson: It's really not that dire. Rates have hit the floor and bounced, but that doesn't mean they're about to start rising rapidly. One of the guiding themes that we have on the Wealth Asset Allocation Committee is called "lower for longer," which is to say that we expect interest rates to remain low for a significant period of time. Part of the reason for that — and one of the things we learned in 2018 — is that mortgage rates in the U.S. have placed a kind of artificial ceiling on rates. I'm not saying there's a true ceiling, but there's an artificial one there.

Why is that? Because, when the U.S. 10-year Treasury yield gets to around 3.5%, the 30-year fixed-rate mortgage hits 5%. That's a real barrier, both financially and psychologically. And the reality is that a large proportion of the money that flows through the U.S. economy is spent on the construction and purchase of homes. These two things create an enormous amount of jobs, which ultimately provides consumers with the money they need to keep the global economy running.

This goes well beyond construction. It includes industries that produce lumber, concrete, lighting fixtures, heating equipment and all kinds of other products that go into a home or remodeling project. Then you have the jobs that are generated in the process of transporting, storing and selling these products. Still others are generated for professionals who provide services to the builders, buyers and remodellers, such as architects, engineers, real estate agents, lawyers and accountants.

All these employed people spend money, and about 70% of the GDP comes from that consumption, so when homes aren't being purchased and homes aren't being built ... boy, the economy is slow! And that limits what the Fed can do. So, 3.5%, that's probably a ceiling on the 10-year Treasury yield over the short term. That's where you set mortgages. That's where you set GICs.

PAIR: So, if the Fed is limited in how it can hike rates, isn't that going to prop up equities to some extent?

Simpson: It's true. If rates are lower, you're prepared to take on more risk in a stock portfolio, and essentially that's what this whole 10-year period has been. But the equity markets are highly adaptive, almost biological in their complexity. And if we're using that analogy, the Fed's monetary policy over past 10 years has been akin to administering a drug that's never been trialled before.

It reminds me of a show I used to watch when I was a kid. You know, The Six Million Dollar Man, with astronaut Steve Austin who becomes a bionic man? In the opening sequence, the scientists all get together and tell each other, "Gentlemen, we can rebuild him. We have the technology." Better, stronger, faster, right? I think central banks were a little bit like that. The emergency measures they had at their disposal were untested and extreme, but they didn't mind having a bionic market at the time, because the financial crisis was so dire. In a world economy that ultimately depends on people's confidence to go out and buy a home and travel and spend, if you don't have that confidence, you don't do those things. If you feel bionic, you do.

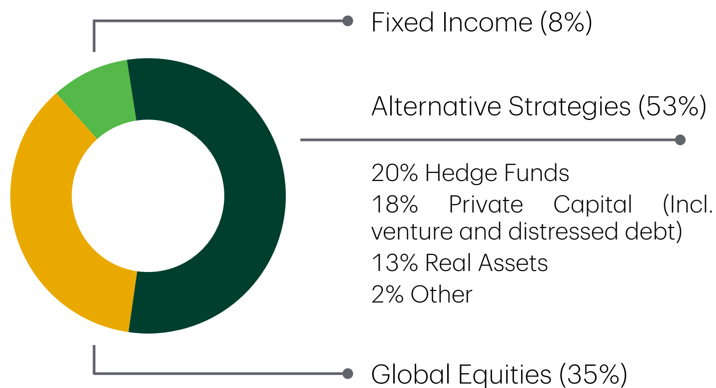
But there is a cost associated with this ultra-accommodative monetary policy. Part of that cost is that we're extracting future returns and bringing those returns to the present. So when we say that returns could be lower for equities, it's partially because of that. Over the past 10 years, we've seen

returns for the S&P 500 at around 10%, but you could make a pretty convincing argument that we've already borrowed three or four percentage points from the next 10 years' worth of returns. So a more reasonable expectation might be closer to the historical average, say 6% or 7%.

PAIR: You seem to be describing a world where equities are running out of steam while, at the same time, fixed-income returns are being held down by the Fed.

Simpson: Right, but we have to remember that there are other options. Far too often, when we think about an investment portfolio, we separate assets into two boxes: fixed income and equity. So the question has always been, what do I think the rate of return will be from my stocks and what do I think the rate of return will be for my bonds? But there aren't just two boxes to invest in. If you look at institutional investors, like pensions and endowments, they're invested in a much broader array of assets.

Figure 5: Allocation on U.S. University Endowments



Source: National Association of College and University Business officers. As at January 31, 2017. 4% held in cash.

I've written in the past quite a bit about using absolute-return strategies, but there are many other options available to us, like private assets, in the form of real estate, infrastructure and commercial mortgages. These investments, which don't trade on an open market, provide four benefits: a reliable income stream; low correlation to equity markets; a hedge against inflation; and an alternative way to pursue capital preservation.

Over the next 30 years, we're going to have to build an awful lot of new infrastructure — that could be bridges, that could be pipelines, that could be real estate — the world is going to be one big construction project, and that includes Canada. Consider commercial real estate. Strong leasing demand for urban office space means there is more demand than supply in Toronto, Vancouver, Montreal and Ottawa. These cities have some of the lowest vacancy rates in North America. Investors spent the past decade chasing returns from technology companies like Facebook, Amazon and Google, whose valuations today make them a very different proposition than they were 10 years ago. The Canadian market for office space is benefiting greatly from rapid growth in the technology sector, and this area now represents the greatest source of demand in our major cities.

What all these private assets have in common is that they provide a distribution of some sort — it could be income from an interest payment or a dividend — as well as capital gains from the growth of the project. There's going to be an extraordinary amount of rebuilding of cities globally, and we have the ability to access these private-oriented markets to help our clients reach their goals. It doesn't just have to be a publicly traded equity portfolio and a publicly traded fixed-income portfolio.

PAIR: Still, even with the addition of so-called "alternative" investments, if performance is muted over the next decade, does that mean investors will have to scale back their ambitions?

Simpson: I think it's important to move away from that kind of thinking and to look at the world a bit more like how a pension looks at the world. Clients need to understand that, as wealth managers, we're just not that short-sighted. We're looking at this the way a pension fund might look at it.

A pension looks at the world in terms of current and future liabilities — like, what am I funding today and what am I funding tomorrow and next week, and on and on like that. You look at what you need to fund and then you figure out what return you need for that, and then you think about how you're going to be able to manage based on that liability.

Individual investors could be doing the same thing. Instead of trying to stay ahead of a falling benchmark, by taking on greater and greater risks, investors should be asking themselves, what are my goals? What do I need to fund? Once you do that, then you back up and ask, how can I accomplish that?

PAIR: You're talking about the importance of financial planning. Do you think investors get fixated on the numbers, even if their goals are still achievable?

Simpson: I think often the public perception is that your advisor is somebody who can somehow divine the future and choose investments better than anybody else. But really, what an advisor or portfolio manager does really well is to build a plan, to keep you on track, and to evolve alongside shifting priorities. I'm not saying the investment part isn't important. It's incredibly important. But I'm suggesting that advisors, by helping their clients build a plan based on reasonable expectations, have a quantifiable rate-of-return impact.

PAIR: Quantifiable? How so?

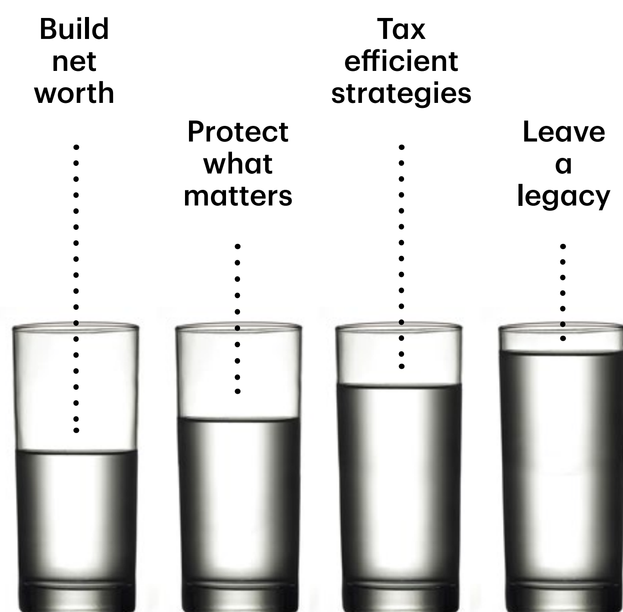
Simpson: Quantifiable. Absolutely! One of the world's largest passive managers, a company by the name of Vanguard, has done studies that try to quantify the impact of having an advisor and a financial plan — where you frame what the client's needs are, what their goals are, what their objectives are.

At TD Wealth, for example, we're guided by four wealth planning pillars. The first is "build net worth," which involves thinking about the risks you're prepared to take, based not only your financial goals but also on your individual personality and blind spots. The second is "protect what matters," which speaks to our understanding of client priorities. The third is "tax-efficient strategies," which means we're going to be careful to structure returns to minimize taxation. And the last one, "leave a legacy," speaks to an understanding of the impact you want to have ultimately with the money that you've made and earned and saved.

And if you look at all these as inputs and build a plan based on them, and then build an investment portfolio based on the plan, and then work with someone who helps keep you on track, you can actually equate a better rate of return at the end of the day. This Vanguard study[1], for example, puts that benefit at "about 3%" in overall annual returns. So, if your expected rate of return is 5% and your advisor can add another three percentage points, that's a big difference.

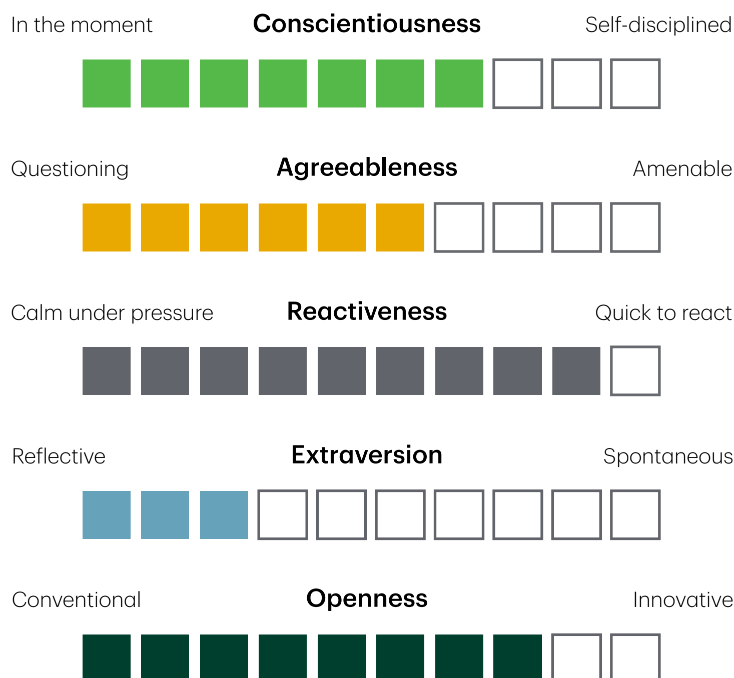
PAIR: So, you're saying that a strong advisory relationship can achieve a better overall return. Let me flip that on its head. Do you think that a strong advisory relationship can also be used to help manage client expectations when returns are expected to be weaker?

Figure 6: Financial Planning Pillars



Simpson: Well, expectations are defined in the space between our ears. They come from our experiences in life but also from our DNA. We're all predisposed to certain behaviours that influence our expectations. Some of us are overconfident, some of us are too nervous to take on any risk at all. We all have blind spots, in other words, and that's when it becomes important to work with an advisor who's trained to identify those blind spots and to compensate.

Figure 7: Five-factor model



Sample results. For illustrative purposes only.

At TD Wealth, we have a discovery tool that relies on a well-established psychological framework for evaluating clients along five dimensions of personality: openness, conscientiousness, extraversion, agreeableness and reactiveness. It's called the "five-factor model," and we're using this approach every day to help guide how we create expectations and help guide our clients' decisions.

Clients who are highly "reactive," for example, are more likely to stress out during times of volatility. Clients who are highly "conscientious," meanwhile, may be really great at saving and planning, but not so great at dealing with the curveballs that life is likely to throw at them, and will require them to adjust their financial plans — like an unexpected job loss or medical condition. So that's one example of how a strong advisory relationship can help with managing expectations.

The bottom line is that we can all be easily led astray by our blind spots, but by using this discovery tool, advisors can help find those blind spots and reduce the impact and the likelihood that clients will make poor decisions.

1. Quantifying Vanguard's Advisor Alpha (Vanguard Group, 2018)

PAIR: Do you think the industry does a good job of explaining that? Or are advisors still trying to portray themselves as investment experts instead of planning experts?

Simpson: I think the industry actually does do a good job of explaining that, but it's harder for clients to get their heads around. A helpful analogy can be found in the world of health care. If you want to live a longer, healthier life, the solution is one of diet, of exercise, of mental health — of a lot of things that, done consistently over a long period of time, leads to a life of greater wellness, right?

The flip side of that is the quick fix, the miracle drug, and every day you can turn on the television and watch commercials about miracle pills — and here it is, and it'll do all the things you ever wanted it to do. It's quick, it's easy, it's understandable. These days, I almost look forward to those drug ads. I ignore the whole ad until the end … and then you get all the disclaimers. Here's a product that's going to do all these things for you. But there are these side effects, all of which are far more dreadful than what you're trying to cure in the first place.

I think that's exactly what happens with investments. A successful wealth-management process is akin to a wellness program. It takes the time to build trust in the program and receive the rewards from it, but the rewards are richer and better because of it, and the accomplishments greater. On the other hand, it's hard to stick to a disciplined plan when you're bombarded by business news feeding you the latest hot stock or sector. It's like the miracle drug that'll cure you in a single dose, but rarely lives up to the hype.

PAIR: So, what's the key then to selling that argument? If you're trying to convince clients that they should be less focused on annual returns and more focused on consistency and goals-based planning?

Simpson: I think that's a fascinating question. And I think the answer is that advisors and their clients need to be committed to the long-term advisory relationship. I go back to this wellness idea. You know, I've had the same doctor for a long time. And when I used to go to my doctor, we would have these brief consults — like, I would say, "I have an ailment," and my doctor would say, "Here's the solution."

Now I have these discussions with my doctor about what's happening in my life, what's happening in my children's lives, what's happening at work. We compare articles and compare notes, and it's far more of a journey, where it used to be a stopping point. What that shows me is that I've evolved as a patient, but so has my doctor.

Wealth management is a lot like that. When I talk to our advisors, many will describe their commitment to clients as constantly evolving. Advisors need to be committed to deepening their relationship with clients and evolving with their clients. □

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Market performance

		(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Canadian Indices ($CA) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
S&P/TSX Composite (TR)	55,186	3.15	6.10	3.15	6.86	10.78	5.48	7.30	10.21	7.37
S&P/TSX Composite (PR)	15,999	2.95	5.27	2.95	3.60	7.55	2.40	4.15	7.01	4.76
S&P/TSX 60 (TR)	2,664	2.84	5.28	2.84	7.78	11.42	6.40	8.03	10.09	7.48
S&P/TSX SmallCap (TR)	948	3.98	7.99	3.98	-1.95	8.86	0.50	2.10	8.64	-
U.S. Indices ($US) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
S&P 500 (TR)	5,556	3.21	1.42	3.21	4.68	15.28	10.67	14.10	16.67	6.15
S&P 500 (PR)	2,784	2.97	0.88	2.97	2.60	12.95	8.41	11.73	14.25	4.13
Dow Jones Industrial (PR)	25,916	3.67	1.48	3.67	3.54	16.20	9.69	11.06	13.88	5.25
NASDAQ Composite (PR)	7,533	3.44	2.76	3.44	3.57	18.23	11.82	15.97	18.52	6.14
Russell 2000 (TR)	7,867	5.20	3.13	5.20	5.58	16.67	7.36	12.63	16.60	8.64
U.S. Indices ($CA) Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
S&P 500 (TR)	7,317	3.40	0.40	3.40	7.62	14.26	14.57	18.29	17.09	5.43
S&P 500 (PR)	3,667	3.16	-0.13	3.16	5.48	11.96	12.23	15.84	14.65	3.43
Dow Jones Industrial (PR)	34,127	3.86	0.46	3.86	6.45	15.18	13.55	15.15	14.29	4.55
NASDAQ Composite (PR)	9,919	3.63	1.73	3.63	6.47	17.19	15.76	20.23	18.94	5.42
Russell 2000 (TR)	10,360	5.39	2.10	5.39	8.54	15.64	11.14	16.77	17.01	7.91
MSCI Indices ($US) Total Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
World	8,635	3.06	2.70	3.06	1.00	13.28	7.13	11.05	13.69	5.50
EAFE (Europe, Australasia, Far East)	7,705	2.56	4.03	2.56	-5.57	9.85	2.54	7.42	10.07	4.56
EM (Emerging Markets)	2,358	0.23	6.20	0.23	-9.54	15.46	4.52	4.78	10.70	9.35
MSCI Indices ($CA) Total Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
World	11,371	3.25	1.68	3.25	3.83	12.28	10.90	15.13	14.10	4.78
EAFE (Europe, Australasia, Far East)	10,146	2.75	2.99	2.75	-2.92	8.88	6.16	11.37	10.46	3.86
EM (Emerging Markets)	3,105	0.42	5.13	0.42	-7.00	14.45	8.20	8.63	11.09	8.62
Currency	**Level**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
Canadian Dollar ($US/$CA)	75.94	-0.18	1.01	-0.18	-2.73	0.89	-3.40	-	-0.36	0.68
Regional Indices (Native Currency) Price Return	**Index**	**1 Month**	**3 Months**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**Since 1/1/2012**	**10 Yrs**	**20 Yrs**
London FTSE 100 (UK)	7,075	1.52	1.35	1.52	-2.17	5.08	0.77	4.73	6.33	0.01
Hang Seng (Hong Kong)	28,633	2.47	8.02	2.47	-7.17	14.43	4.63	8.06	8.37	5.48
Nikkei 225 (Japan)	21,557	3.77	-3.55	3.77	-2.32	10.39	7.75	18.17	11.03	2.05
Benchmark Bond Yields		**3 Month**		**5 Yr**		**10 Yr**		**30 Yr**		
Government of Canada Yields		1.66		1.87		1.96		2.19		
U.S. Treasury Yields		2.39		2.51		2.69		3.03		

Canadian Bond Indices ($CA) Total Return	Index	1 Month	3 Months	YTD	1 Yr	3 Yrs	5 Yrs	Since 1/1/2012	10 Yrs
FTSE TMX Canada Universe Bond Index	1,067	1.52	2.90	1.52	3.63	2.24	3.25	3.01	4.37
FTSE TMX Canadian Short Term Bond Index (1-5 Yrs)	717	0.88	1.76	0.88	2.75	1.22	1.69	1.85	2.56
FTSE TMX Canadian Mid Term Bond Index (5-10 Yrs)	1,159	1.61	3.23	1.61	4.22	1.83	3.28	3.33	4.96
FTSE TMX Long Term Bond Index (10+ Yrs)	1,749	2.34	4.25	2.34	4.36	3.87	5.40	4.33	6.91

Sources: TD Securities Inc., Bloomberg Finance L.P. TR: total return, PR: price return. As at February 28, 2019.