Laurus
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"For new models of progress to arise, there is a need [for] a responsible reflection on the meaning of the economy and its goals…it is not enough to balance, in the medium term, the protection of nature with financial gain…halfway measures simply delay the inevitable disaster. Put simply, it is a matter of redefining our notion of progress."

- Pope Francis, Laudato Si'

The world is a big and complicated place. If you want to find reasons why it might collapse, they are easy to find. Human beings tilt toward loss aversion after all, and there is always bad news to report. The US could go to war with North Korea (or some other country). The Middle East could explode. We could face a monumental environmental crisis. We could suffer a major terrorist attack. The economy could dramatically underperform or simply run out of steam. We could experience some hitherto unknown problem. And the current market pullback plays to our worry.

However, pretty much the world over, markets and economies are in good shape. The US and Canada are near full employment. In the current earnings season, many companies continue to show profitable growth. And, with benign inflation, there is no obvious impediment to that trend continuing.

Stepping back from the current market climate, we see two major issues facing investors in the coming decade, whether an institution or an individual.

First, from these lofty heights – both from an economic and valuation perspective – caused by an extended period of low yields across most asset classes, it will be difficult for future equity markets to generate returns necessary to meet most liabilities.

Second, assuming you had a long perspective, during the bond and equity bull markets of the past couple of decades the investor couldn't make a mistake with asset allocation. Allocation to passive index products reduced fees and allowed for simple return generation. But as higher yields, inflation, and peak equity multiples come to bear, the next couple of decades will challenge investors to focus on their necessary outcome, rather than buying products that may, or may not, outperform capital market indices.

A long-term flattening of market returns will likely unnerve investors. Like their tilt to loss aversion, human beings are also beset with short term thinking, whether searching for the next big stock "winner", or simply firing an underperforming manager and hiring the next with the most recent healthy track record – only to discover the fired manager outperforms in the next period.

Perhaps our fascination with the need to outperform market indices needs rethinking. If all markets generate low returns and, therefore, all investments are highly correlated, perhaps it's time to consider idiosyncratic methods of achieving better returns.

We suspect that, in a low return / positive correlation environment, current methodologies endorsed by industry experts won't generate the returns necessary to meet investor liability needs. As well, at last estimate five trillion dollars of assets have moved from active to passive management in North America at a time when future market returns are capped.

Paraphrasing from a recent article authored by Bernstein, the shift from active to passive management arose as retail investors discovered they were paying high fees for market-like ("beta") returns. They further contend that, the current framework for asset allocation – starting with some set weight for asset classes and then sub-allocations based on geographical or style bias – seems misplaced.

FCLTGlobal, in their recent article on institutional investment mandates, contend that asset owners (investors) have long term investment goals yet develop mandates with a short-term time horizon. As such, they recommend rethinking policy to avoid time-horizon mismatches.

We were certainly due for the markets to take a breather. That said, we caution that it may be time to rethink your asset allocation, lower expectations, and look towards how one might add value in a low return environment to best meet future liabilities.