tech bites

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(Not So) Great Expectations

AFTER delivering out-sized returns in recent years it is time to recognise that expectations about future global equity market returns need to be pruned – and quite hard. The projected equity returns we see being used look perfectly reasonable in the context of the past but are hard to support based on current valuation.

That is not just our opinion; last October Goldman Sachs launched something of a bombshell when it slashed its baseline assumption for the annualised return from the S&P 500 over the next ten years to 3%. In the accompanying announcement they noted that the spectrum of projections in the market 'averages 6% (range of 4% to 7%)'. The move to 3% represented a massive break with the 'herd' but Goldman was not alone; Research Affiliates's equivalent assumption is now 2.4% and that of AQR is 4.2%. In its capital market assumptions Q1/ 2025, Invesco projects a five year return from US equities of 2.8%. It must be remembered that these projections are gross of all costs. Apart from the normal product costs, there are trading and ownership charges relating to the portfolio within the fund and a loss of return due to non-recoverable dividend withholding taxes.

If Goldman and the others are even close to being right about US equities, the non-US equities in portfolios would need to deliver double digit growth if global equities are to produce the 6% plus that is widely projected. Of course, there are many other firms publishing significantly higher assumptions in respect of long term US equity returns, but this is the first time that we can recall a number of reputable firms issuing projected returns for US Large Cap that are well below the 5% level.

By way of background, equity markets came into 2025 having had a glorious run through 2023 and 2024; the MSCI World index, Total Return, Net, € had grown by 51% in that time. €100 invested in that index on 01/01/20 (which includes a very poor year in 2022), would have become €184 on 31/12/24. The returns of that index over both time periods owed a great deal to those of its very large US component, which in turn were driven by those of a small number of stocks. At the start of 2025 the US represented 74% of the MSCI World index, within which Apple and NVIDIA had a combined weighting of over 10%. The level of concentration within the US market is about as high as it has been in a century.

The stocks which are now such large US and World index constituents have seen explosive price rises and valuation expansion, so it is not surprising that they have had the effect of making the US market valuation looked very stretched by reference to history. Although it should be no surprise that return expectations for the US market and for the global markets it dominates are seeing significant reductions, we see little evidence that this reality has arrived in Ireland. A quick survey of pension calculators being used in Ireland shows a typical investment growth parameter of 4.7%, with one at 6.0%. With the vast majority of savers being in multi-asset funds, and euro bond yields at 3.3% at the time of writing, the equity returns needed to meet a level of 4.7% would be a stretch. We have facilitated a number of manager search exercises in recent months and have seen utterly unrealistic prospective returns being quoted. In one exercise Manager A used an expected return of 6.3% and Manager B used 6.5% in respect of portfolios which would be described as 'Balanced'; both back-pedalled quickly when probed about the basis of their figures!

Given its considerable influence over the behaviour and practices within the life industry the position of the Society of Actuaries in Ireland (SOAI) on the subject is always of keen interest. Illustrative tables published under the Life Assurance (Provision of Information) Regulations, 2001 must be produced in accordance with the advice of the actuary and any guidance notes issued by SOAI; its Actuarial Standard of Practice LA-8 sets out guidance on the maximum levels of returns which can be used and version 1.18, which came into effect at the start of 2025, increased the maximum projected return for equities to 6.65%. A maximum rate of 4.5% had applied since March 2021 and of 5.0% for the prior five years.

It could well be argued that the LA-8 levels which prevailed for most of the previous decade were too conservative (and the actual returns were more than double), but that could most certainly not be said of the current level. The dividend discount model used by Clarus showed projected returns for global equities of under 5% in late 2024 (using a real growth estimate of 1% and a 2% inflation figure) and on that basis we find the move to (the remarkably precise!) 6.65% in Version 1.18 very strange and, frankly, hard to fathom.

The bottom line is that the US (and therefore global) equity market returns of recent years have been supernormal and come at a price: lower future returns.