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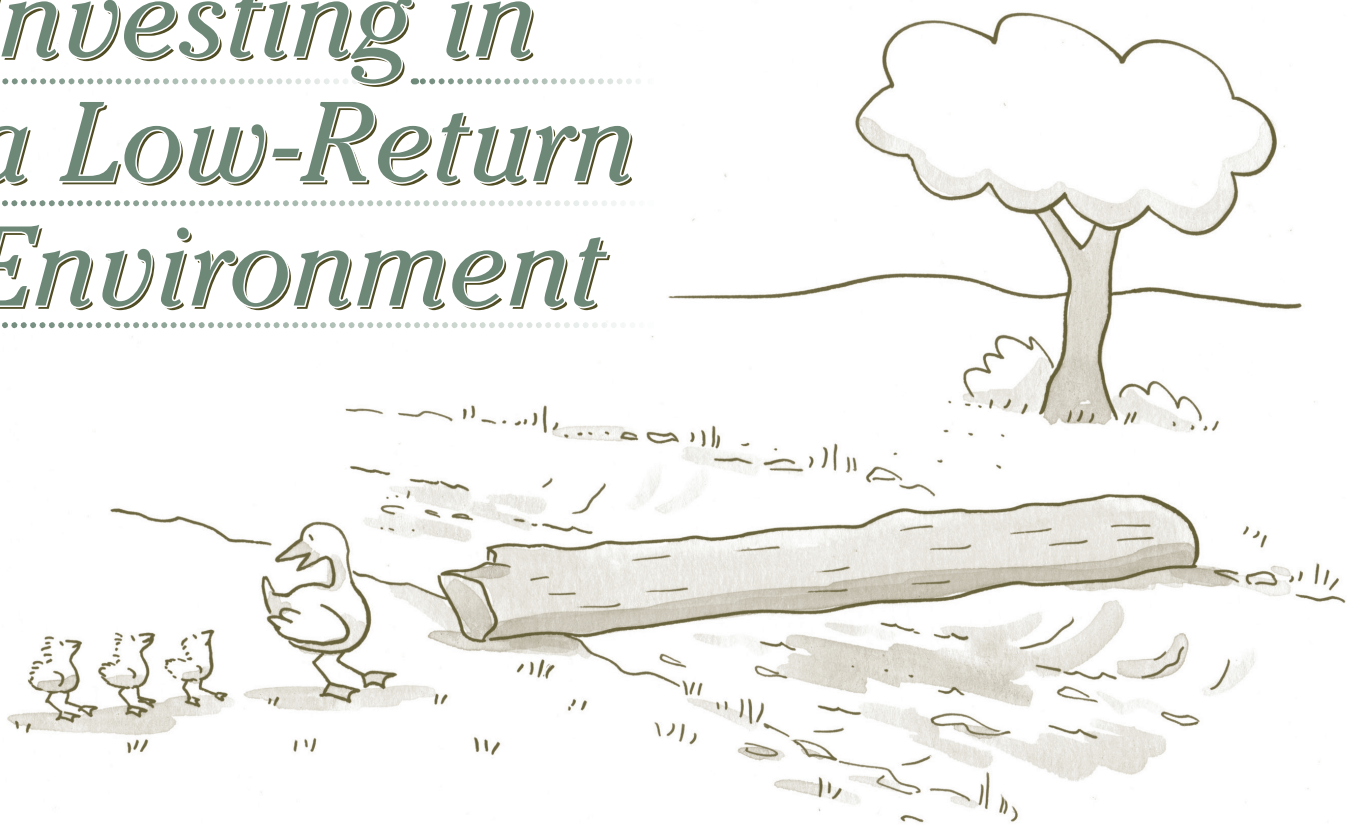
Investing in a Low-Return Environment



"Stay in a row while we cross so you don't fall into the mud!"

Over the last few years, investors' total portfolios have generated below-average returns in the face of many investment challenges, including historically low interest rates and fully priced equity valuations. This low-return environment makes it challenging to meet investment goals. In this article, we will discuss the historical rates of return for stocks and bonds in the United States, describe some reasons why this economic environment is leading to lower return expectations for these asset classes, and highlight ways RMB has been combating this issue for our clients. »

Despite the two bear markets experienced during the 2000s, investors generally fared well in both equity and fixed income markets over the last three decades. According to a study by McKinsey Global Institute,[1] total returns on both U.S. equity and U.S. fixed income from 1985 to 2014 were higher than the long-term average for each asset class. In addition, these asset classes experienced a lower level of volatility as measured by standard deviation over the period (Exhibit 1). The many reasons behind this strong investment period – strong global growth, falling interest rates, positive demographic trends, and corporate profit growth – seem to be reversing and could be considered headwinds in today's economic environment.

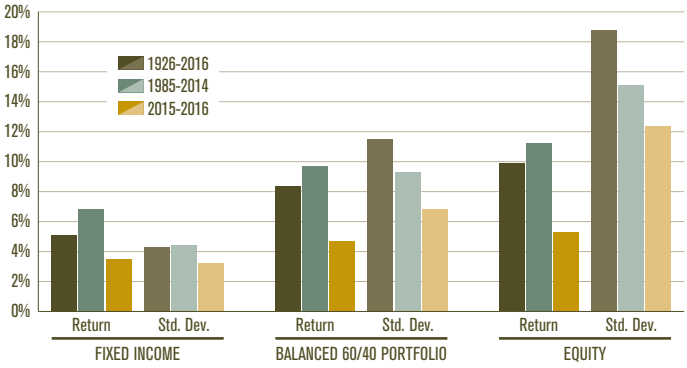
EXHIBIT 1 HISTORICAL RETURNS AND VOLATILITY BY ASSET CLASS

	Long-term Average Jan. 1926 – Sept. 2016		30-year Average Jan. 1985 – Dec. 2014	
Asset Class	Return	Std. Dev.	Return	Std. Dev.
Fixed Income	5.2%	4.4%	6.9%	4.5%
Balanced 60/40 Portfolio	8.5%	11.5%	9.9%	9.3%
Equity	10.0%	18.8%	11.3%	15.2%

Fixed Income measured by Morningstar Ibbotson Intermediate Government Bond Index. Equity measured by S&P 500 Index. Balanced 60/40 Portfolio is a combination of the two above-referenced indices, calculated on a monthly basis.
Sources: RMB Capital, Zephyr StyleAdvisor

Let's compare 2015-2016 investment returns for equity and fixed income to both the long-term average and the prior 30-year average (Exhibit 2). While returns for these past two years have been less volatile, they've also been notably lower. This low-return environment has been a result of slowing global growth, historically low interest rates, extended equity valuations, and falling corporate earnings. Combined with changing demographics, especially in the United States, we have likely entered a period when returns will continue to be below average.

EXHIBIT 2 COMPARISON OF 2015-2016 RETURNS AND VOLATILITY TO HISTORICAL AVERAGES



Fixed Income measured by Morningstar Ibbotson Intermediate Government Bond Index. Equity measured by S&P 500 Index. Balanced 60/40 Portfolio is a combination of the two above-referenced indices, calculated on a monthly basis. 2016 returns through 9/30/16.
Sources: RMB Capital, Zephyr StyleAdvisor

- Global growth has been increasingly sluggish and will likely continue to decline as demographic trends around the world lead to aging populations and productivity gains remain harder to find.

- Demographics in the U.S. have also changed over the last 30 years in ways that negatively affect growth and productivity. Each generation of Americans has longer life expectancies and lower fertility rates than the generation before.[2] At the same time, baby boomers have started retiring; more than 20% of the population will be 65 or older by 2030.[3] As more Americans reach retirement age, the need for fixed income securities will increase, and this increasing demand should help to keep interest rates in check.

- Interest rates on 10-year U.S. Treasury securities have fallen from peak rates of around 15% in the early 1980s to about 2.5% today. This bull market in fixed income is nearing an end as the Federal Reserve began raising interest rates in late 2015 and announced another increase in late 2016. Capital gains, which have been a primary source of fixed income returns over the last 30 years, will be more difficult to achieve in a rising-interest-rate environment.

- Equity valuations around the world appear to be fully valued, with price/earnings (P/E) ratios at or above historical averages. In the U.S., the trailing P/E ratio for the S&P 500 stands at 20.4x as of September 30. This falls in the highest quartile of P/E ratios experienced by the S&P 500; historically, this has been an indicator of lower-than-average returns going forward.

- In addition to above-average equity valuations, corporate profit margins in the U.S. have been declining over the last two years. Despite declining profits and earnings, stock prices have continued to rise. »

- The rising P/E ratio in the U.S. is a direct result of this decoupling between prices and earnings.

At RMB, we have focused on preparing our client portfolios for the current investment environment by supplementing traditional equity and fixed income investments with other opportunities that can offer incremental return without taking on undue excess risk.

- Within our fixed income allocations, we invest in opportunistic fixed income securities, such as floating-rate bonds, that are positioned to perform well in rising-interest-rate environments.

- Absolute return became a larger part of our recommended allocation over the last three years. The primary purpose of the absolute return asset class is to produce returns that are uncorrelated with traditional equity and fixed income investments; returns are typically higher than fixed income but have less volatility than equities. This is an important allocation in the current environment where both equity and fixed income investments are expensive from a valuation standpoint.

- Within our equity allocations, we have focused on areas of the world that are further behind in their economic recoveries and/or have more reasonable valuations. This has resulted in an overweight to developed international with an emphasis on small-cap companies and Japan. Investing in equities outside the U.S. offers diversification benefits due to differing business cycles and currency movements.

In conclusion, we do not believe that the aforementioned macroeconomic headwinds mean an immediate end to the current expansion or that a low-return environment will be the new normal. However, we do believe it's important to position our clients' portfolios to perform well in this type of environment, which brings increased risk of market declines. We have already taken steps to do so and are continuously monitoring the global markets for attractive opportunities. ■

1 *McKinsey Global Institute, "Diminishing Returns: Why Investors May Need to Lower Their Expectations," May 2016.*
2 *Ana Swanson, "There's a devastatingly simple explanation for America's economic mess," The Washington Post, October 7, 2016.*
3 *U.S. Census Bureau, "Projections of the Size and Composition of the U.S. Population: 2014 to 2060," March 2015.*

Index Descriptions

- The S&P 500 index is widely regarded as the best single gauge of the U.S. equity market. It includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 focuses on the large-cap segment of the market and covers approximately 75% of U.S. equities.
- The Morningstar Ibbotson Intermediate Term Bond Index is a one-bond portfolio that measures the total return performance of five-year maturity U.S Treasury bonds.

An investment cannot be made directly into an index. The index data assumes reinvestment of all income and does not account for fees, taxes, or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by your account or private fund.