CIO BLOG

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ONE FOR THE AGES

"Maternity wards are already shutting down in Italy. Ghost cities are appearing in northeastern China. Universities in South Korea can't find enough students, and in Germany, hundreds of thousands of properties have been razed, with the land turned into parks."

Long Slide Looms for World Population with Sweeping Ramifications, May 23, 2021, The New York Times

It takes a fertility rate of 2.1 to replace the existing population. Here is a brief list of fertility rates in selected countries: US, 1.7; China, 1.7; UK, 1.6; Germany, 1.5, Japan, 1.4; Italy, 1.3; Spain 1.2; South Korea, 0.9. The countries in this narrow list constitute half the global economy and 80% of the world equity market.

The consequences are not immediate. Even as fertility rates fall below 2.1, total populations can continue to grow for long periods – decades even – as fewer babies are born, but still outpace deaths on the other end as parents, grandparents and great-grandparents continue to live longer. Nonetheless, eventually, fewer births inevitably lead to shrinking populations.

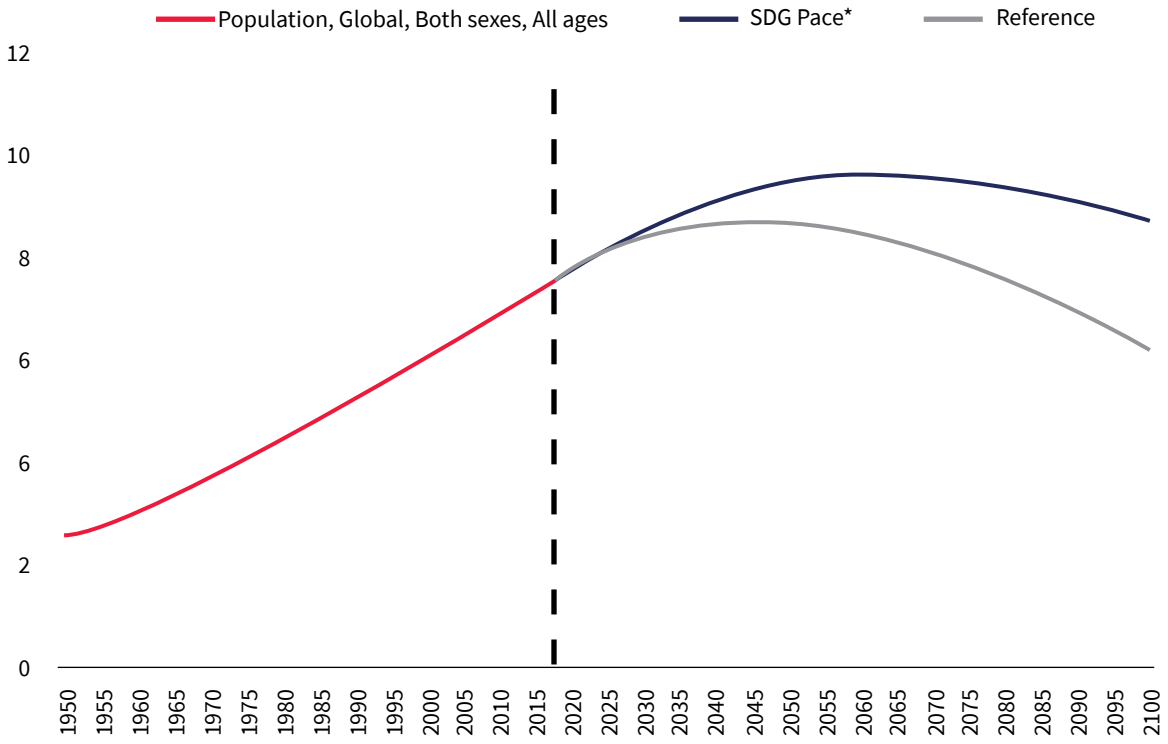
Why this is happening is beyond the scope of this essay, but rests on a complex confluence of multi-generational shifts in societal mores regarding work, contraception and the real and perceived costs of children.

This wasn't always the case. Indeed, it's a startlingly new paradigm. In 1900, the global population stood at 1.6 billion. In 1950, it reached 2.6 billion. This represents an increase of about 60%. By the turn of the century, it had crossed 6.2 billion – a staggering fifty-year surge of nearly 140%! Again, the reasons why are beyond the scope of this essay but includes an interplay of expansive post-WW2 government policies, booming economic growth and geopolitical stability[1].

With fertility rates nearly everywhere on an irreversible decline – policies to raise them have largely fallen flat – base case estimates suggest the global population will peak in 2060 at about 10 billion. Should the UN Sustainable Development Goals for female educational attainment and "contraceptives met need" be reached, the peak will be under 9 billion as soon as 2045[2]. For high-income countries as a bloc, populations will peak in less than two decades at 1.1 billion. It has already begun in some such as Japan and Germany.

GLOBAL POPULATION GROWTH (BILLIONS OF PEOPLE)

1950 - 2100



Source: Vizhub Health Data – population forecast. To the left of the black dotted line is historical data and to the right is forecasts
**SDG Pace denotes level to meet UN Sustainable Development Goals*
Reference Rate from recent trends in female educational attainment and contraception met need

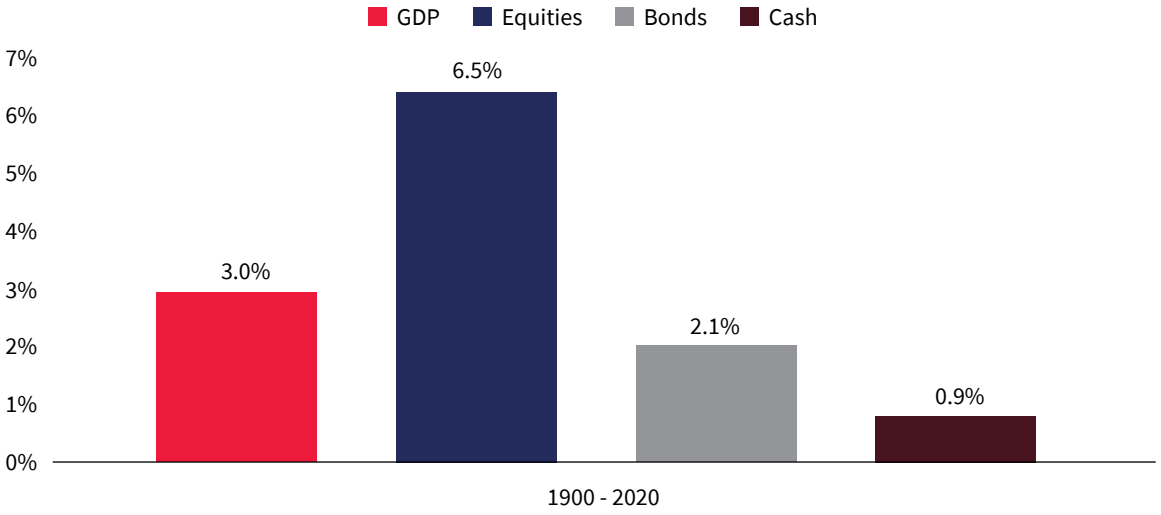
WHAT DOES IT MEAN FOR INVESTORS?

Between 1900 and 2020, global Gross Domestic Product (GDP) growth has been about 3% per annum (p.a.). The UK's globalised capital markets have reflected this growth perhaps more consistently than any other over this time: the annualised rate of total return for UK equities with reinvested dividends in that period was about 6.5%, net of inflation; the real total return from government bonds was about 2.1%; cash returned just below 1%. Similar patterns are observed in most developed markets.

[1] In the US soldiers returned home to receive GI Bill benefits which promised access to good jobs and affordable housing that made raising a family conducive; in Europe, the Marshall Plan funded huge reconstruction and was aided further by the first wave of Continental integration via the European Coal and Steel Community in 1951; the Japanese too rebuilt , quickly closing the gap with the United States in productivity and GDP per capita.

[2] https://vizhub.healthdata.org/population-forecast/

GLOBAL GROWTH AND UK REAL ASSET RETURNS



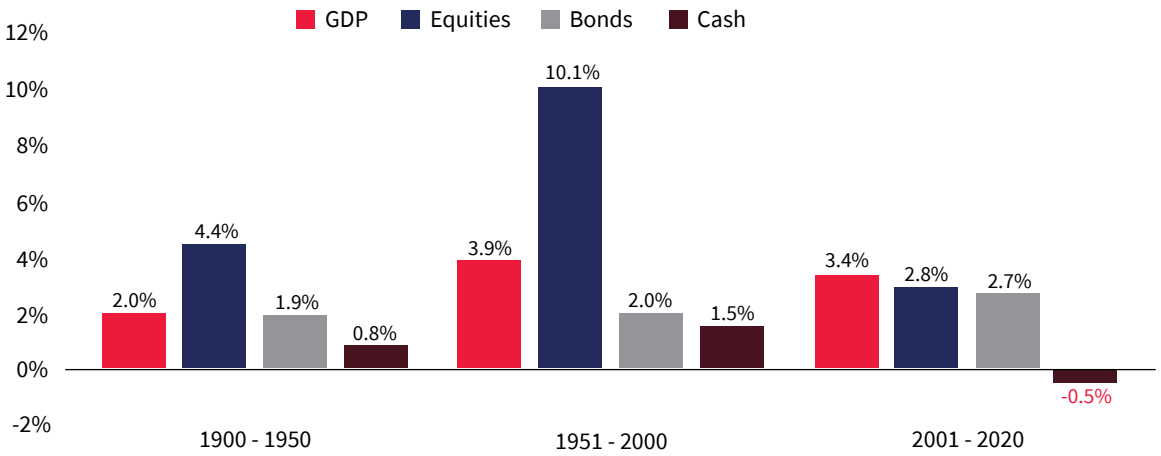
Source: GDP Calculation, (1900 – 1950, Morgan Stanley, Ruchir Sharma), (1951 – 2000, Our World in Data World GDP) and (2001 – 2020, IMF Global GDP). Equity, Bonds and Cash from Barclays Equity Gilt Study 2021

However, we know that population growth was slower in the first part of the century, but then rocketed upwards in the middle of the 20th century. Did that have an impact on market returns? Unequivocally, yes – and the impact was stark. Between 1900 and 1950, global growth amounted to about 2% p.a., and real total returns from equities, bonds and cash were 4.4%, 1.9% and 0.8%, respectively. One might surmise that the World Wars had a role to play. Counterintuitively, the drawdown between 1914 and 1918 was not dissimilar to that experienced in peacetime bear markets; and equities were actually up strongly between 1939 and 1945.

In contrast, from 1951 to 2000 – a period of uncommon proliferation of our species – average economic growth doubled to nearly 4%, which helped push returns from all assets higher: equities produced 10.1% p.a.; bonds 2.0%; and cash 1.5%. This was no fluke: a paper by the Federal Reserve shows population growth and the related distribution between young and old explains over 60% of the movement in the long-run trends in the equity market.

Critically, it's the second half of the 20th century which often forms the basis of our experience and where our expectations for the future tend to be anchored. That anchoring is biased heavily by a demographic growth profile which no longer fits. It is imperative we accept this bias and act accordingly. Indeed, more recent UK financial market performance would imply a paradigm shift already underway: from 2001 to 2020, UK equities merely returned 2.8% p.a., bonds 2.7% and cash -0.5% – secularly lower.

GLOBAL GROWTH AND UK REAL ASSET RETURNS



Source: GDP Calculation, (1900 – 1950, Morgan Stanley, Ruchir Sharma), (1951 – 2000, Our World in Data World GDP) and (2001 – 2020, IMF Global GDP). Equity, Bonds and Cash from Barclays Equity Gilt Study 2021.

[3] https://www.frbsf.org/economic-research/publications/economic-letter/2011/august/boomer-retirement-us-equity-markets/

BOTTOM LINE

For many decades, investment returns across asset classes have been such that it has been difficult to fail. Prices for most assets have increased over time, and as long as one's portfolio had been broadly exposed to markets, returns have been positive in real terms. Indeed, broad exposure has been not only sufficient, it has actually been a winning plan, helped on more recently by enormous central bank liquidity which has lifted all boats, more or less.

Nonetheless, the demographic tailwinds will reverse over time. While it might be imperceptible at first, it will gather steam quickly in the exact mirror image of the exponential "baby boom" of the latter half of the 20th century. Central bank liquidity will be unlikely to counter the population-led decline in economic growth, and there is no guarantee the monetary status quo will continue indefinitely either.

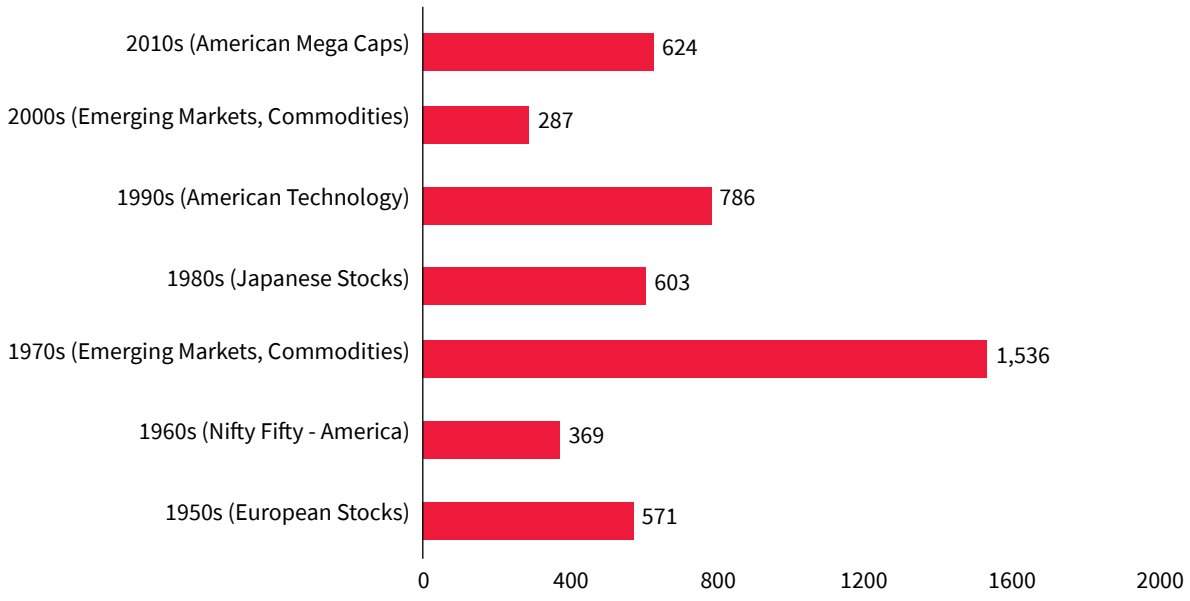
The only force that can help offset these demographic headwinds is possibly an increase in productivity. Here, there are favourable recent trends – but once again, it's unlikely to offset the economic impact of demographic decline in full. The result is future economic growth and asset price returns which will likely be lower than what we have experienced in the latter half of the last century, which truly was an idiosyncratic, one-off golden age.

Accepting a low-return paradigm as a probable outcome over the next years and decades is a first step. Planning for it is a critical second. Broad market exposure alone will likely not be enough to meet some or all financial goals. Agility will be crucial, and will include:

A. **Thinking globally and being aware of cognitive biases:** The US equity market over the last 10 years has delivered standout returns as it became the nexus between innovation, knowledge creation and capital flows. It wasn't always so. The decade before that saw market leading gains in emerging markets; the decade prior to that saw the US on top again; the 1980s were dominated by Japan; the 1970s by commodity producers; the 1960s was the decade of high-quality, consistent earnings growth companies ("Nifty Fifty"); the 1950s witnessed European equities shine. Indeed, no single region or investment style that has produced above average returns in one decade has repeated such proclivity in the subsequent one. Investors will have to be wary of recency-bias, home-bias, anchoring-bias – and complacency.

Dominant Investment Theme in Each Decade

Cumulative Return (%)



Source: Bloomberg, MSCI Indices.

While it is likely there will be few alternatives to equities for the foreseeable future, we must constantly test and retest our assumptions about where above-average equity returns are likely to come from in going forward. If history is any guide, it be different to the past and will surprise us. As ever, valuations, momentum and sentiment will be useful guides.

B. **Being passive until it hurts and active until it works:** Since the great Financial Crisis, passive vehicles have been a cheap and excellent avenue to gain broad exposure to markets which were generally going up, helped on by unprecedented central bank liquidity. This won't always be the case. Liquidity was drying in the run-up to the pandemic, when it exploded again. However, it is likely to slow down again as recovery from the pandemic becomes more entrenched. Also, the deluge has left markets broadly expensive. Technology companies – the mainstay of Growth investing – have seen a doubling in valuations over the decade, a feat unlikely to be repeated. Value companies are cheaper, but often for good reason. In such an environment, the rewards may reside in esoteric sectors such as niche healthcare, digitisation and Environmental, Social and Governance (ESG) opportunities. They are also increasingly likely to be in emerging markets, where many will finally have a clear demographic advantage and where valuations are more appealing following a lacklustre decade. Superior expertise in fund selection and thematic discovery will be a critical differentiator of returns. Equally as important will be the need to avoid value traps, or entire swathes of debt which entice with high returns but are likely poor bets.

C. **Planning to be surprised on the upside, not the downside:** In times past, a good understanding of your risk appetite and sensible asset allocation was likely sufficient to ensure your financial goals be it pensions, retirement needs or inheritance planning. However, if you simply plug in historical data from the golden age of high returns and assume 8% to 10% returns from equities every year, for example, you may be set up for great disappointment. Making realistic assumptions is more critical than ever. More importantly, where one cannot control the low return world, we can ensure high quality wealth planning with realistic scenario assessments is as paramount as a rigorous investment process and decision-making framework.

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