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Strategies that will help navigate a low-return market

ON INVESTING
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Here's a depressing thought: The expected net-of-fee, real return from a balanced portfolio of stocks and bonds is around 1.7 percent annually over the coming decade. Of course, that assumes you don't pay taxes. If you do, the expected return is less.

A recent study by consulting and research firm McKinsey Global Institute raised exactly this issue (though their numbers were a bit different), suggesting investors need to get used to lower returns. Others have made the same case.

Yale economics professor Robert Shiller has been arguing the past couple of years that the market is wildly overvalued and thus not likely to perform well in the future. Even John Bogle, the founder of the Vanguard Group, has a forecast for stocks that is well below historic norms. Bogle largely eschews market timing and forecasting but, interestingly, he also has an enviable record of forecasting the market correctly over long time horizons.

Most of these long-range forecasts expect stocks to earn somewhere around 6 percent to 7 percent annually for the coming decade. This is significantly below stocks' long-run return of over 10 percent annually since 1871. Relatively high stock market valuations, anemic economic growth, low labor force participation, and shifting demographic trends are all causing market pundits to sound the alarm on future stock market growth.

For bonds, the long-range forecasts predict returns of around 2 percent annually, which likely won't even keep pace with long-run inflation. This is because of the very low yield offered currently, as well as the likelihood that the Federal Reserve will raise interest rates over time.

If you combine expected returns for stocks and bonds in a typical, balanced portfolio with 60 percent in stocks and 40 percent in bonds, and assuming no investment management, mutual fund or trading expenses, you would earn approximately 4.7 percent per year. If you figure in 1 percent for costs (most studies estimate total investment costs are closer to 2 percent) and inflation of 2 percent (historically it has averaged around 3 percent), then your net real return would come to 1.7 percent, assuming you don't have to pay any taxes on your gains.

This is one reason many investors have become jaded on the capital markets. They would rather avoid the whole mess and just hold cash. However, since cash earns around zero percent currently, your real return, net of inflation, would be a loss of 2 percent annually.

Before you give up in despair, there are strategies to navigate a low-return environment and still reach your financial objectives.

The first, which seems ubiquitous in financial articles—and a little sanctimonious—is to accept lower returns and save more money. That makes for easy advice, but is not always easy to accomplish in the real world. Certainly saving more is a good thing, but I don't think this is likely to significantly change the fortunes of many investors, mainly because most of us won't or can't do it.

If you can't save more, you can at least make your current savings go further. Reducing investment-related costs and taxes is the surest way to improve net returns. Even if future returns are less than in the past, you might be able to earn the same net return by driving down management, mutual fund and trading costs.

You might also reduce the amount you pay out in taxes by implementing some smart but simple strategies. Rather than paying out your returns to financial intermediaries and the government, you keep your money working for you.

There are plenty of good low-cost investment choices these days. Exchange-traded funds are a solid option and cover almost every conceivable asset class. Replacing high-cost mutual funds with ETFs could help take a significant bite out of your investment expenses. Keeping trading to a minimum and seeking out low-cost investment managers can also help cut costs.

Also, using low-turnover investment strategies, harvesting tax losses when available, and holding the right investments in the right types of accounts (so-called asset location) can all help reduce the amount of money you pay out to Uncle Sam and local governments. Unchecked, taxes can be the largest drag on your investments.

With a little work, many investors will be able to reduce total costs and taxes by 2 to 3 percent annually. This will go a long way toward offsetting lower gross investment returns.

Finally, while diversification hasn't proven effective recently, it is likely to boost returns in the years ahead. Over the past couple of years, large-cap U.S stocks provided the strongest returns, but valuation disparities currently exist that could change that pattern.

For example, international, emerging market and U.S. value stocks all appear inexpensive relative to the rest of the market. The price/earnings ratio on these market segments is significantly below that of the S&P 500. There are still economic problems in much of the world, and value stocks are often underpriced for a reason.

However, buying stocks at low valuation levels, even with their uncertainty, has historically led to outsized long-term appreciation. This generally plays out over years, not months. Patience may be required, but it is often rewarded in the investment industry.

Diversification may help improve stock market returns, but that likely is not true in the bond market. While stocks should probably continue to be the core of most investor's portfolios, it may be time to pare allocations to bonds. Bond market returns could be low for at least the next decade.

While bonds do offer important risk controls, there may be other options available to reduce volatility. Now, even smaller investors can buy into asset classes once only accessible to the largest investment funds.

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The opportunity to diversify beyond stocks and bonds is significant, and can be quite additive to a portfolio's risk and return characteristics.

Novel asset classes like private real estate, alternative forms of lending and catastrophe bonds should be considered as a way to add investments with stock-like expected returns, but with lower volatility and low correlation to the fluctuations of the stock market. These funds are usually expensive and tax-inefficient, so caution is warranted. However, an honest assessment of their expected net returns may still show that they have the ability to outperform bonds without adding significantly more risk to your overall portfolio.

In a period of compressed return expectations, careful investing will be more important than ever. Managing costs and taxes will allow investors to keep more of their returns, and smart portfolio construction could help squeeze out more return for the risk you are taking on.

Of course, additional savings couldn't hurt either.

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