As the bonds supercycle comes to an end investment advisors need to adopt a more flexible approach

# Time to get active

Olivier Zucker

The bond supercycle has in some ways acted like a large carpet under which a number of failed investment decisions have conveniently been swept. With the supercycle, which began in the early 1980s and has been driven by a global and concerted effort to eradicate inflation, now ending, this cover is no longer available. As a result investment managers are advisors are going to have to take a much more active approach.

Between January 1988 and December 2010, global government bonds have returned an average of 7.07% a year in US dollars, while the equivalent return from global equities is fractionally lower, at 7.03%, as measured by the JP Morgan Global Aggregate Bond Index and the MSCI Total Return Global World Index respectively (see chart). Over this period, equity investors have therefore not received higher returns for taking on more risk.

## New approach required

Throughout the supercycle, bonds have outperformed their own long-term average, enhancing portfolio returns beyond what could be reasonably expected. What's more, because the total returns from bonds have been so steady, the volatility of bonds has fallen, which has reduced the perception of overall portfolio risk. Looking ahead, we believe investment managers and advisors will have to dig much deeper to unlock value for their clients. Passive asset allocation strategies based on historic data will not work and, as the volatility of portfolios increases, so should the frequency of decision making and trading.

As investment consultants, our main focus is reviewing investment portfolios and advising investors, trustees and charities on the performance and underlying investment approach of their portfolios. In this capacity, we frequently come across investors whose decisions are based on asset allocation models that draw on very long sets of historic financial data. Typically, this results in a structural overweighting of equities and a corresponding structural underweighting of bonds.

This bias towards equities is unsurprising. It reflects the classic theory that, over the long term, total returns from equities should be higher than those from bonds, to compensate investors for accepting a higher degree of risk. Long range data going back to the nineteenth century suggest equities and bonds in the US and UK have, in fact, performed in line with this theory. However, the experience of the past two decades has been very different, as bonds have enjoyed an exceptionally strong run that is now coming to an end.

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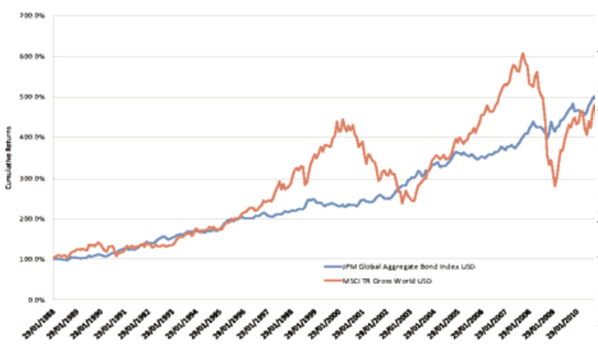
The bond supercycle that began in the early 1980s has been driven by a global and concerted effort to eradicate inflation. As inflation has fallen from highs of 15% in the US and 17% in the UK, interest rates have been gradually reduced, supporting a thirty-year rally in bonds that is only now coming to an end. Against that backdrop, bonds have generated returns far in excess of their long-term average of 5.5% per year.

**Global equities vs global bonds, since 1988**




The performance of equities over this period is much more mixed, a fact best illustrated by dividing the data into two segments of 11 years each. From January 1988 to December 1999, equities enjoyed one of the strongest ever bull markets, with falling interest rates and an expansion of valuations leading to a lower risk premium for equities and average annual returns in excess of 13%. In marked contrast, from January 2000 to December 2010, equities have performed extremely poorly, with average annual returns of less than 1%, well below the long-term average of 8.5%.

## Flexible approach

Overall, for most balanced private client portfolios, bonds have provided the bulk of the returns for at least the past 10 years, compensating for the weakness in equity markets. This is contrary to expectations, with most investors believing equities have driven returns, while bonds have played a secondary role, reducing volatility and providing some capital protection.

Investment advisors will need to adopt a much more flexible and open-minded approach to asset allocation. Passive asset allocation strategies will need to be replaced with a more active approach that is responsive to fast-changing trends in earnings and the global economy. Broad-based and fairly static portfolios are unlikely to produce the required returns, because the long and stable trends that have been evident over the past 20 years can no longer be relied on.

As the investment horizon shortens, some instruments that have been very popular – such as structured products and funds of funds – will need to be revisited. They may no longer fulfill a valuable role. In addition, as the volatility of portfolios increases, so should the frequency of decision making and trading. The choice of investment instrument and the costs associated with trading will therefore become increasingly important, with a much greater impact on overall returns. In the new world, the ability to take active decisions, rather than bet on long-term trends, will be the key factor in successful investing. ■