Seed Weekly

17 July 2019

Global Equity Return Expectations

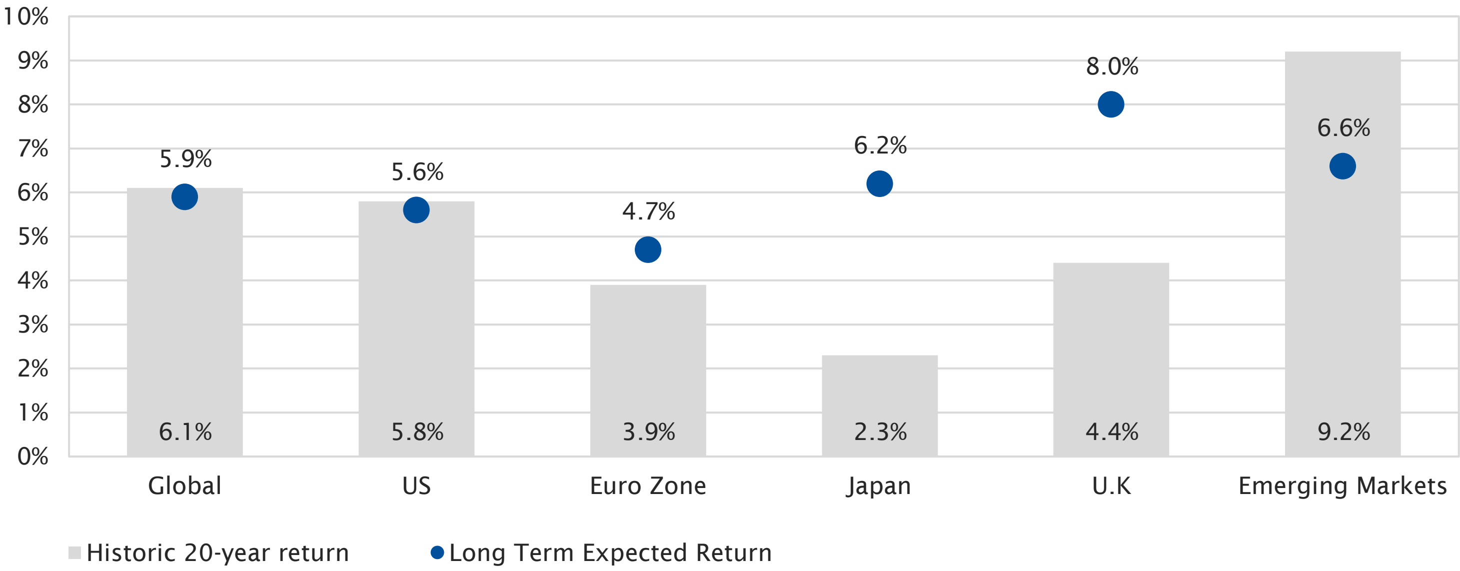
An important part of Seed's multi management process is to perform monthly asset class valuations using our in-house quantitative models. This process covers all the local and global asset classes that are suitable for inclusion in our multi asset class funds and model portfolios. The output of these models guides our tactical asset allocation decisions, where we under- or overweight certain asset classes in the short term, compared to our longer-term target weights.

On the global side we make use of respected Canadian research house BCA to inform our asset class views. Their detailed research and valuation models are based on the principle that all capital markets are directed by shifts in financial liquidity, money supply and credit.

Recently, BCA has updated their long-term return assumptions across all the global asset classes, using data from the last 20 years and a forecast horizon of 10 to 15 years. BCA recognises that historical returns are of little use to predict short-term returns or cycles. Instead, their view is that the long-term behaviour of asset classes can be used to forecast trend growth irrespective of market cycles.

Of most interest to Seed are the expected returns for global equities. As explained in a previous article (Global Investing for South Africans by Mike Browne), it makes sense for local investors to have substantial exposure to global risk assets should they decide to invest offshore.

The chart below illustrates the 10 to 15 year expected returns compared to the historic 20-year numbers for selected regions:



Source: BCA Research (30 June 2019)

While Global, US and Euro Zone expectations are broadly in line with historical numbers, the current attractive valuations in Japan and the UK result in much higher expected returns. For Emerging Markets, the lack of structural reform and declining productivity growth leads to an expected return which is much lower than the historical.

To calculate an expected long-term equity return for each of these regions, BCA uses the average result from six different models. The two most familiar ones are:

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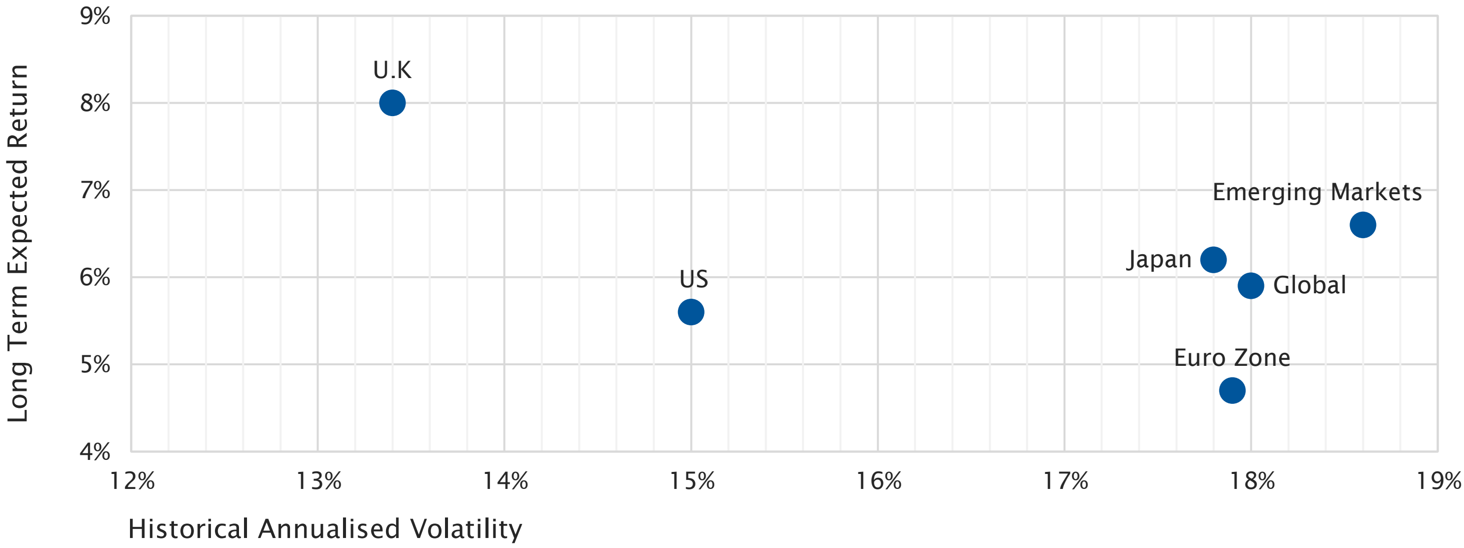
1) Equity Risk Premium Model

Over the very long term, investors can expect higher returns when investing into equities than into lower-risk assets such as government bonds. In the US, this Equity Risk Premium (ERP) has been fairly stable over time at about 3.5%. With the US 10 Year Bond yield at 2.4%, the expected return from US equities is Bond Yield + ERP = 2.4% + 3.5% = 5.9%.

2) Earnings Yield Model

Long-term shareholders in any business, i.e. those who do not trade in and out of shares for profit, are rewarded by growth in earnings and dividends over time. In any given financial year, companies can use profits to either pay out a dividend now or to reinvest into the business with the aim of paying a dividend in future. If a company can maintain its current return on capital, investors should not have a strong preference. Therefore, the current earnings yield of 4.8% on US Equities will be a very good indicator of future expected returns.

Asset class volatility is typically much more stable than asset class returns. BCA's research indicates that there has been no change in the long-term trend volatility for equities in these regions. Therefore, the 20-year historic volatility is a reasonable estimate of what can be expected over the next 10 to 15 years. The risk/return scatterplot below places the various regions into context:



Source: BCA Research (30 June 2019)

The best risk-adjusted returns can be expected in the UK and the US, while the Euro Zone carries the same risk as Japan but has a lower expected return. As expected, Emerging Markets have the highest volatility, but the Sharpe ratio (a measure of risk-adjusted return) is the same as for the US. In other words, investors should be justly rewarded for the additional risk taken on in Emerging Markets if they can stomach the volatility.

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At Seed, we read widely and always look for research and ideas that enable us to enhance our existing models and processes. BCA's research has been a very useful input in the management of the Seed Global Fund, and we have also applied some of their concepts in our own SA-specific modelling.

Kind regards,

Cor van Deventer ***CFA, FASSA***
Portfolio Manager

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ADDITIONAL INFORMATION (where applicable)

Performance has been calculated using net NAV to NAV numbers with income reinvested. Full performance calculations are available from the manager on request.

DEFINITIONS (where applicable)

Annualised Return	Annualised return shows longer term performance rescaled to a 1-year period. Annualised return is the average return per year over the period. Actual annual figures are available to the investor on request.
Highest and Lowest Annual Return	The highest and lowest returns, since launch, for any rolling 1-year period have been shown.