McKinsey&Company

The Real Economy and Future Investment Returns

CalPERS

January 17, 2017

Summary

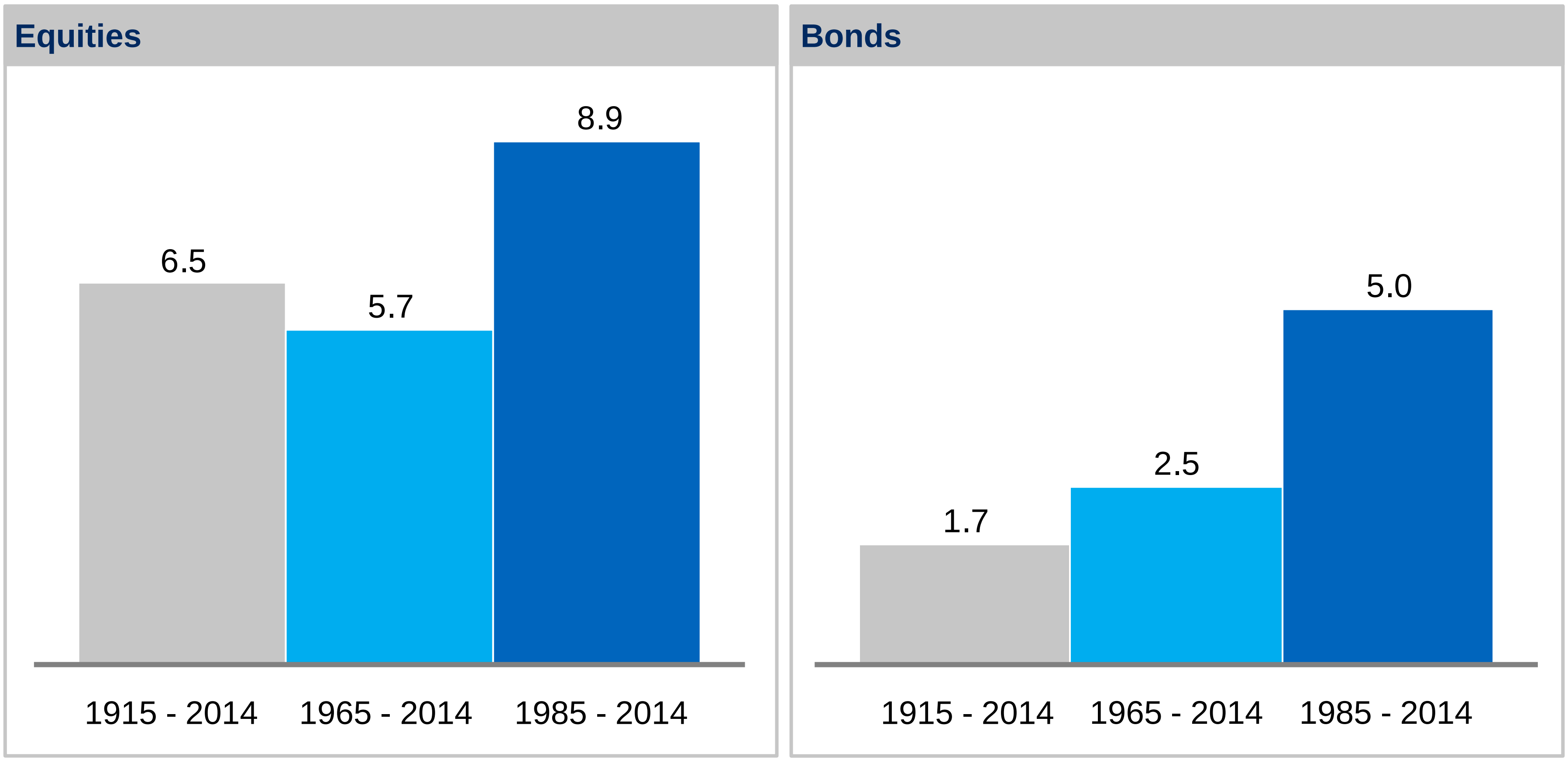
- Equity and bond returns driven by “real” economy
- Unique elements driving last 30 years returns are not repeatable (declining inflation/interest rates, increasing profit margins)
- Future long-term real returns could be 4.0 – 6.5% for equities and 0.0 – 2.0% for bonds
- Even under extreme scenarios, equities likely to outperform bonds under most time frames

SOURCE: Source

Returns on equities and bonds have been high over the past 30 years versus long-term average

Total real returns

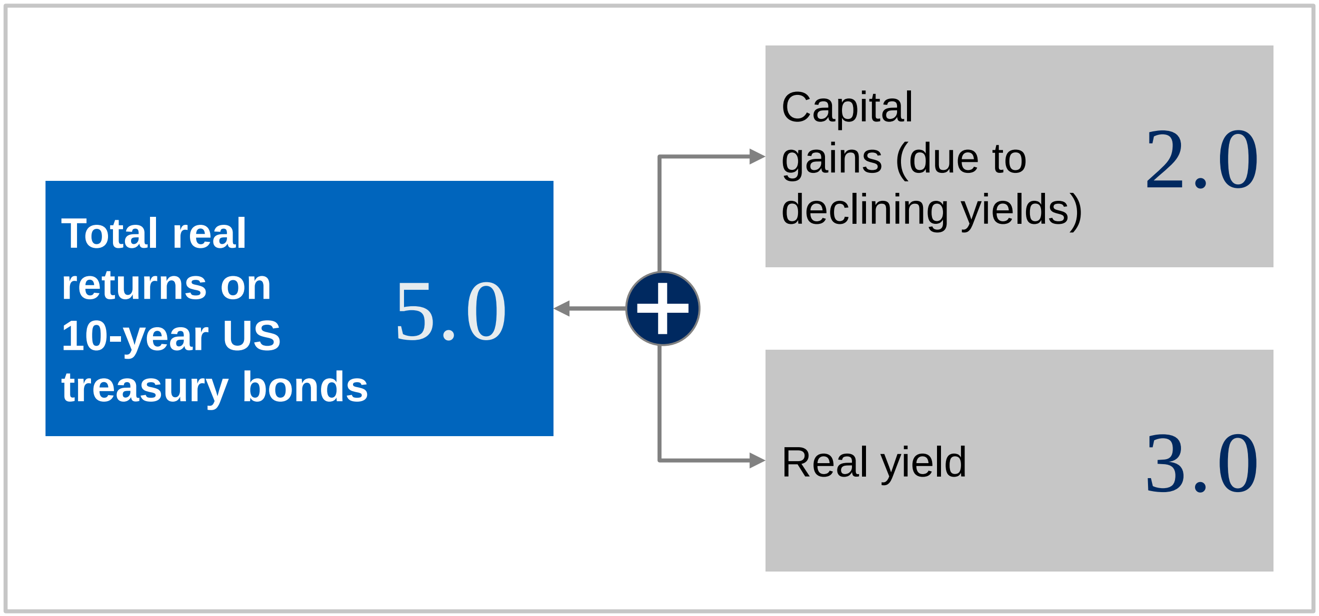
Annualized, based on 3-year average index at start and end years, %



SOURCE: Dimson-Marsh-Staunton Global Returns database; Damodaran database, Stern School of Business, New York University; Jutta Bolt and Jan Luiten van Zanden, The first update of the Maddison Project: Re-estimating growth before 1820, Maddison Project working paper number 4, University of Groningen, January 2013; Conference Board; McKinsey Global Institute analysis

During last 30 years, bond returns driven by capital gains

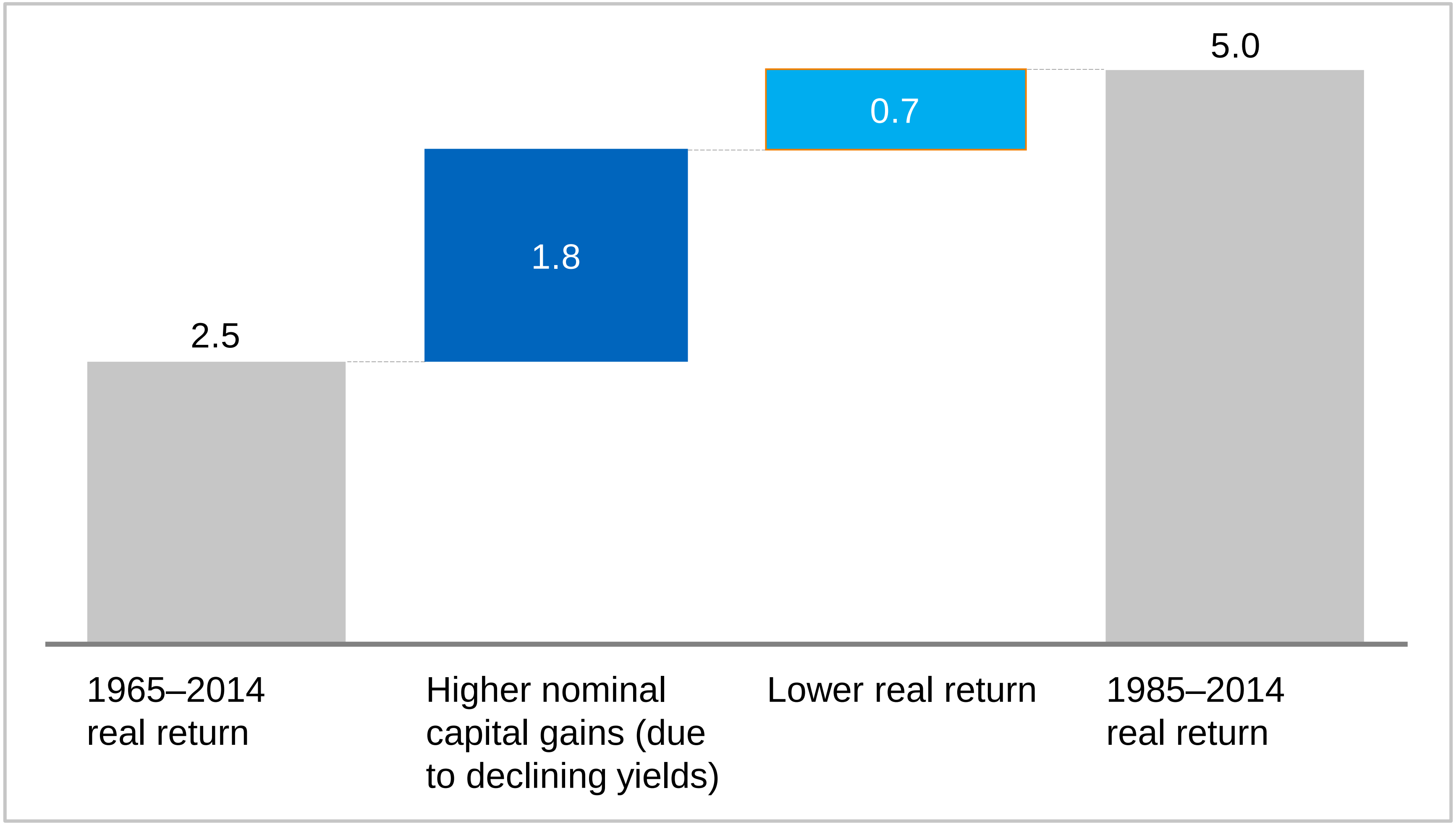
Percent, 1985 to 2014



Capital gains due to declining yields and inflation drove higher bond returns in the last 30 years

10-year US Treasury bond returns, annualized

Percent



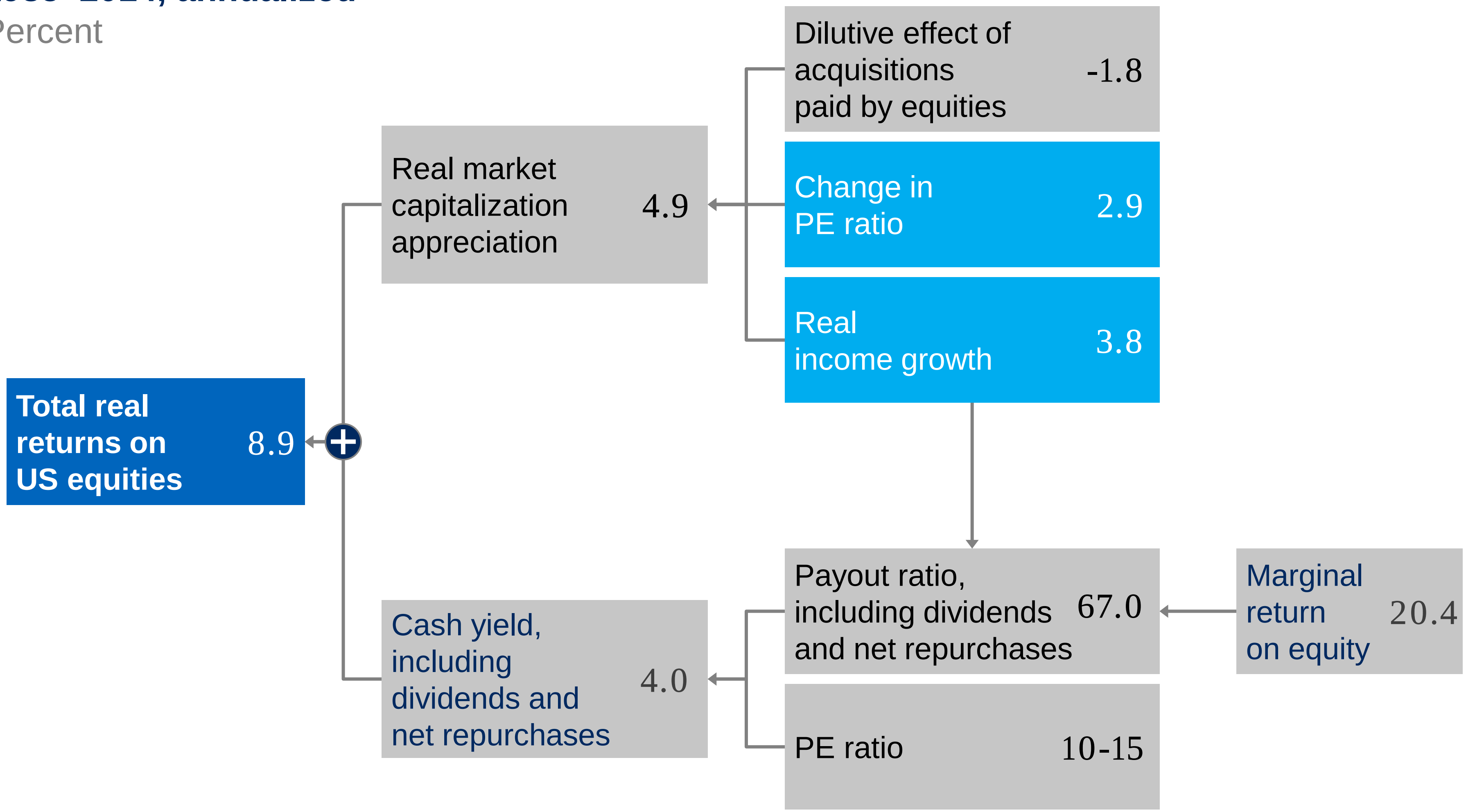
SOURCE: Dimson-Marsh-Staunton Global Returns database; Damodaran database, Stern School of Business, New York University; McKinsey Global Institute analysis

Equity returns linked to real economy drivers

Major difference from last 50 years

1985–2014, annualized

Percent

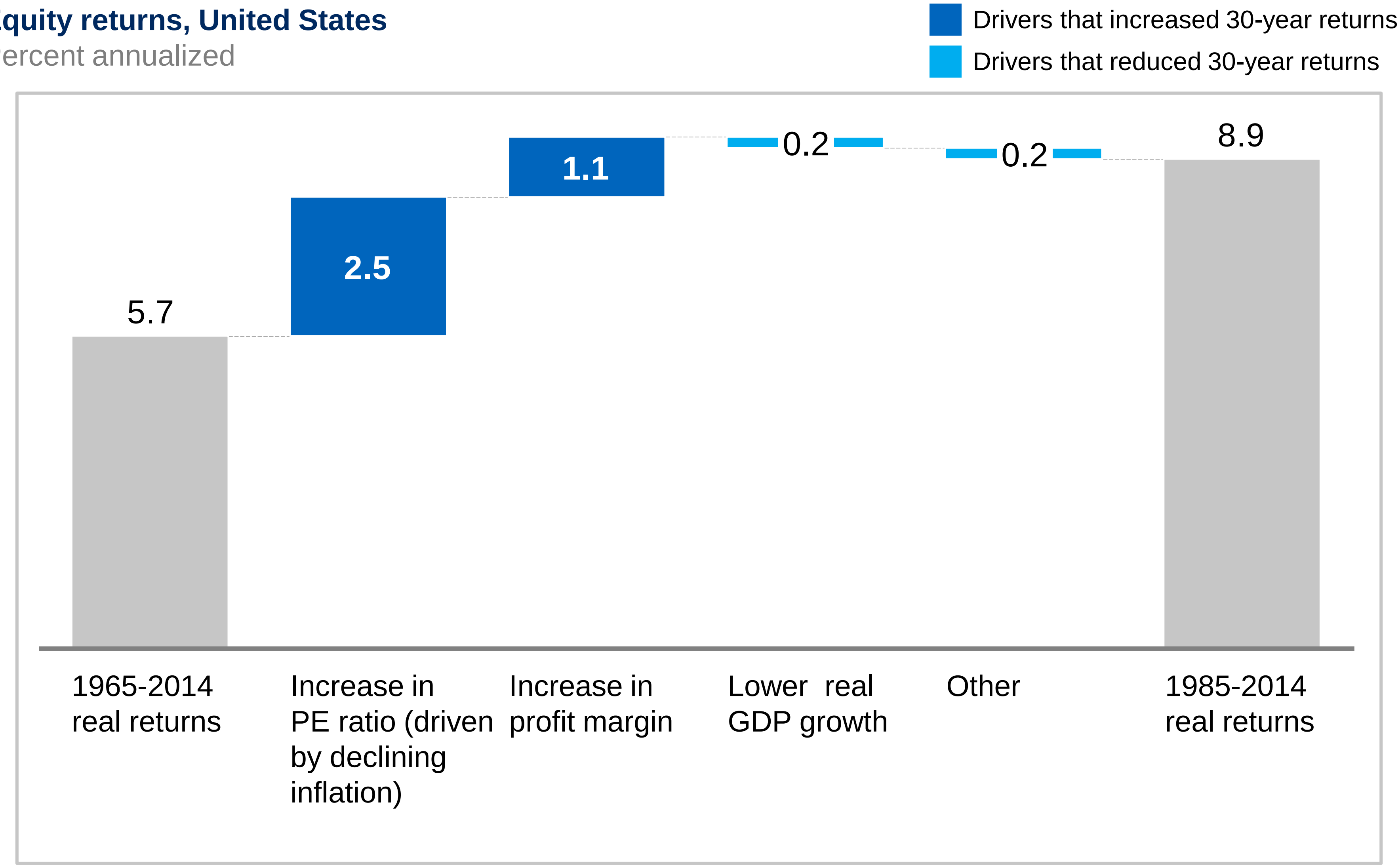


SOURCE: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Declining inflation, which increased PE ratios, and increasing margins drove higher equity returns in the United States in the last 30 years

Equity returns, United States

Percent annualized



1980s started with unusually high inflation and interest rates

10-year US Treasury yields and annual inflation

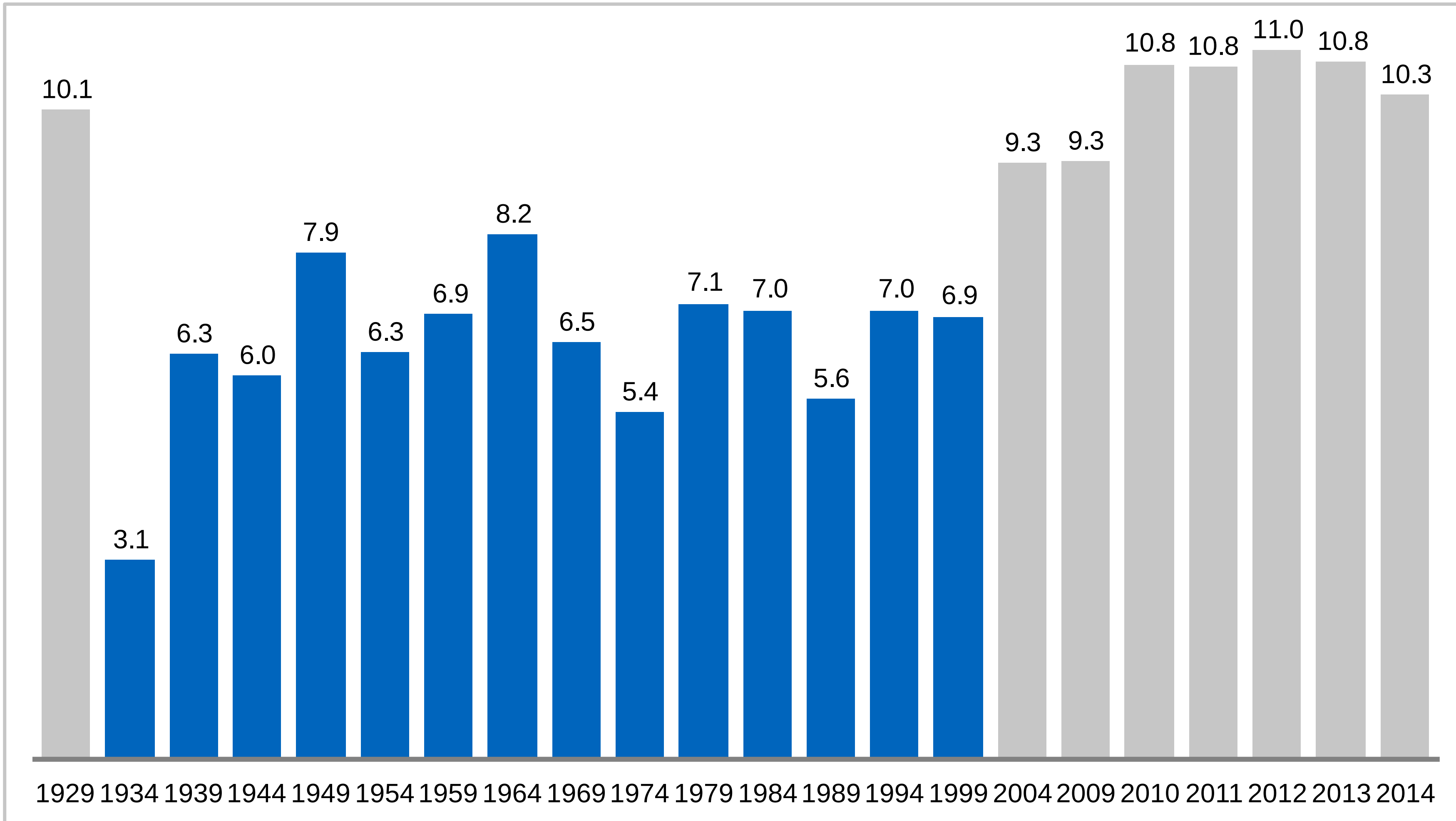
Percent

SOURCE: Source

US corporate profits are at their highest level vs. GDP since 1929

US after-tax corporate profits as share of US national income

Percent

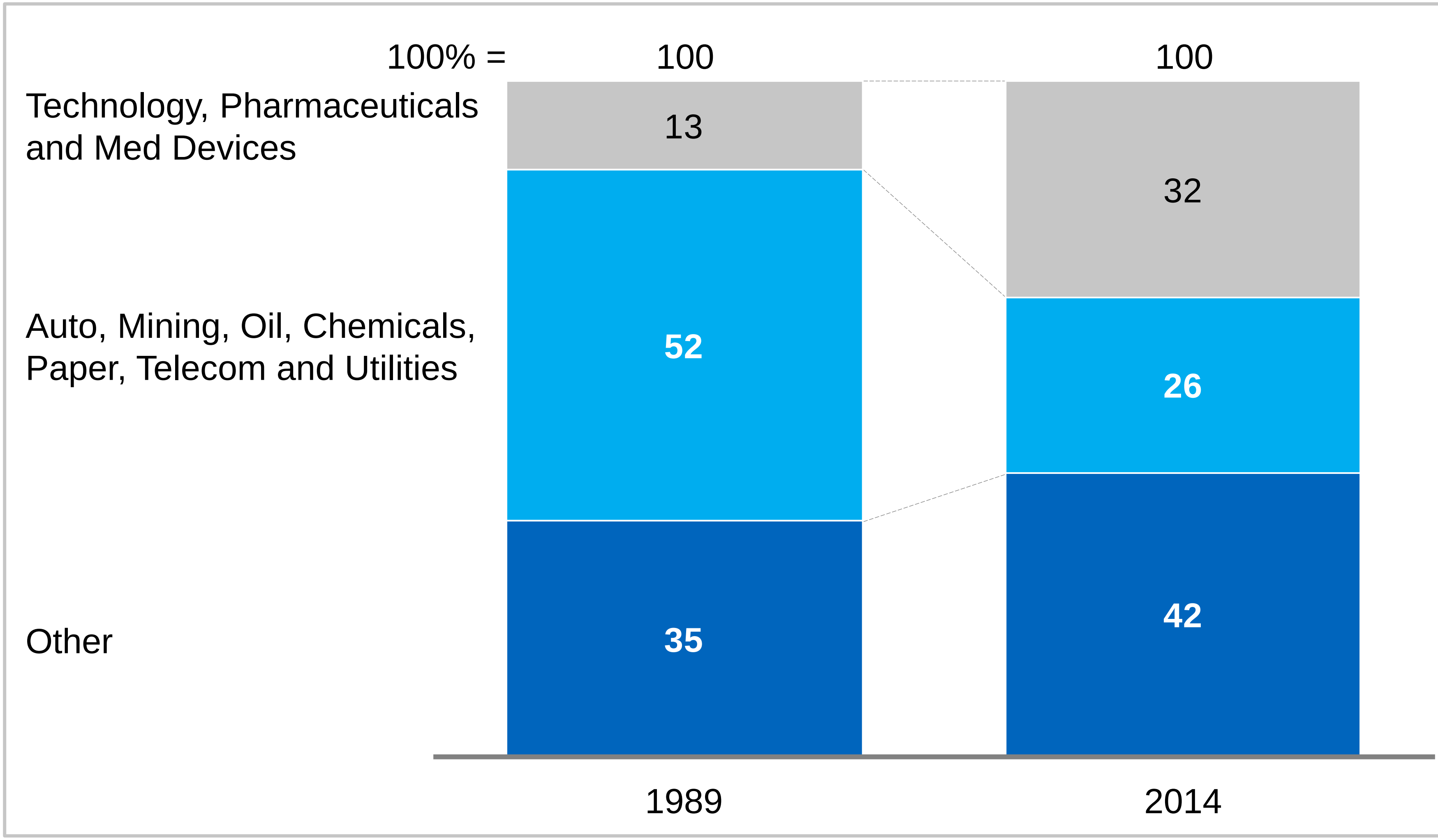


SOURCE: Source

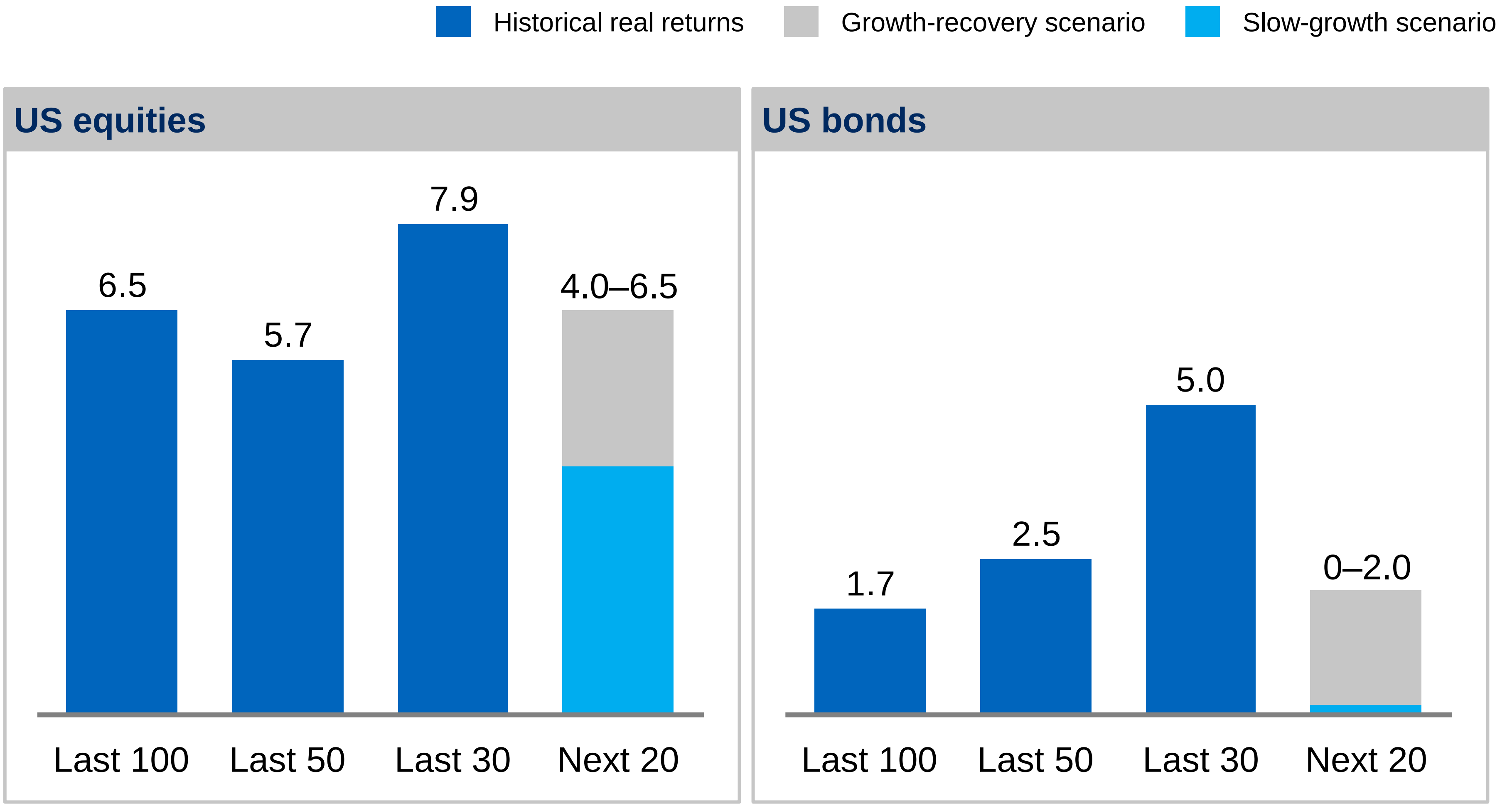
Significant shift in composition of US based companies led to higher profit margins

Share of total profits for US based companies

Percent

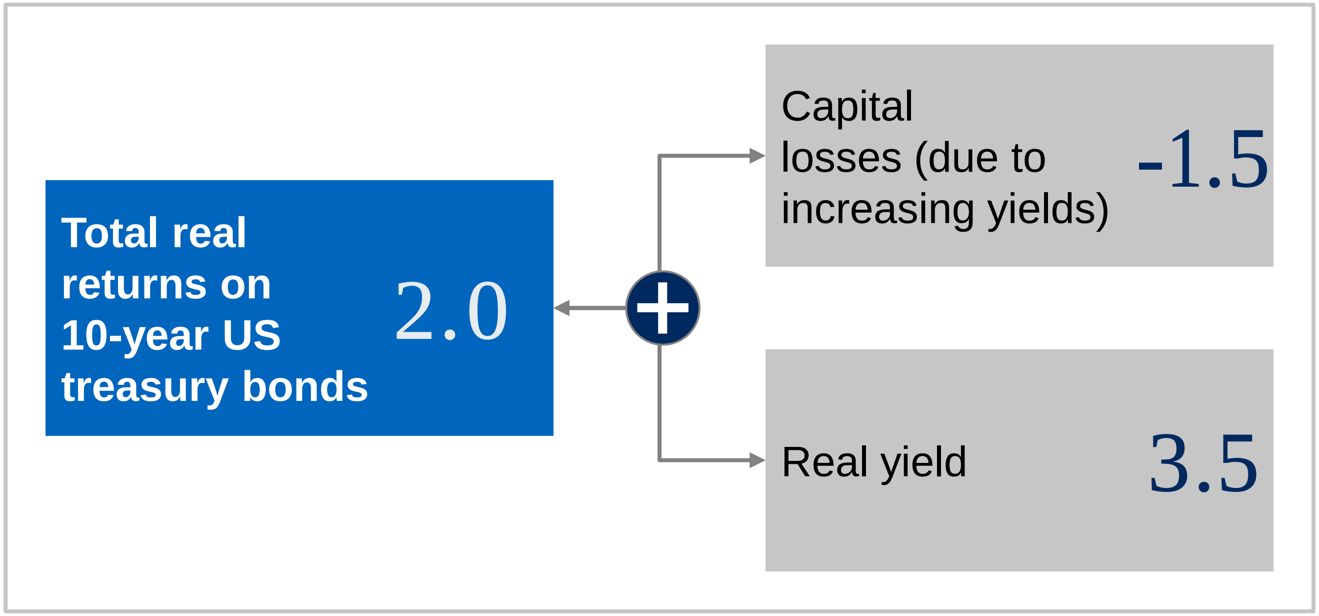


Returns over the next 20 years could be lower than long term averages



Future bond returns depressed by capital losses as interest rates return to typical levels

Potential bond returns next 20 years
Percent



Real economy factors driving future equity returns

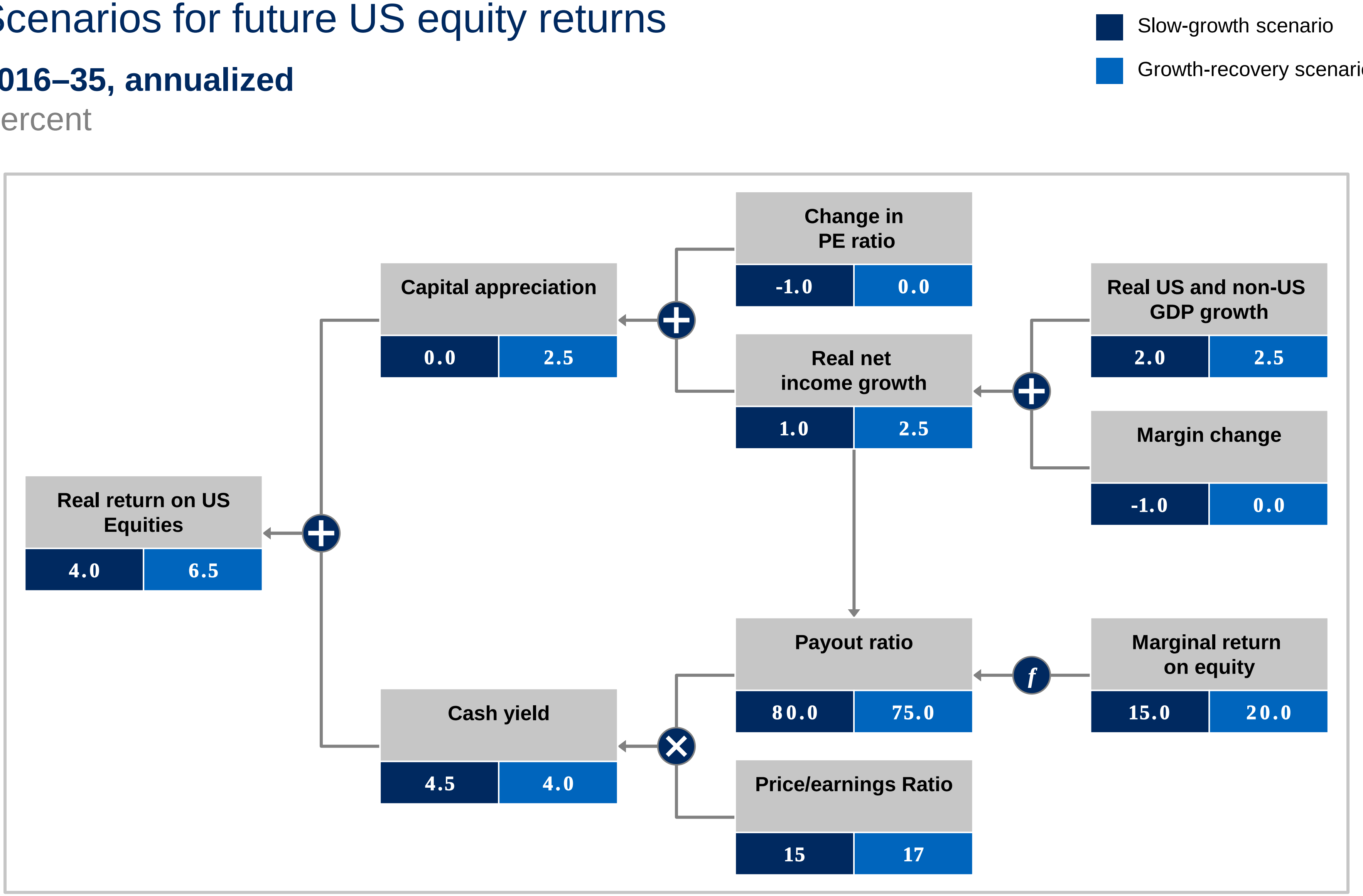
- No increase in P/E ratio
  - Inflation currently low
  - P/E ratios near “normal”
- Slower profit growth
  - Lower workforce growth
  - Lower productivity
  - Margins currently at all-time high
  - Potential pressures on future margins

SOURCE: Source

Scenarios for future US equity returns

2016–35, annualized

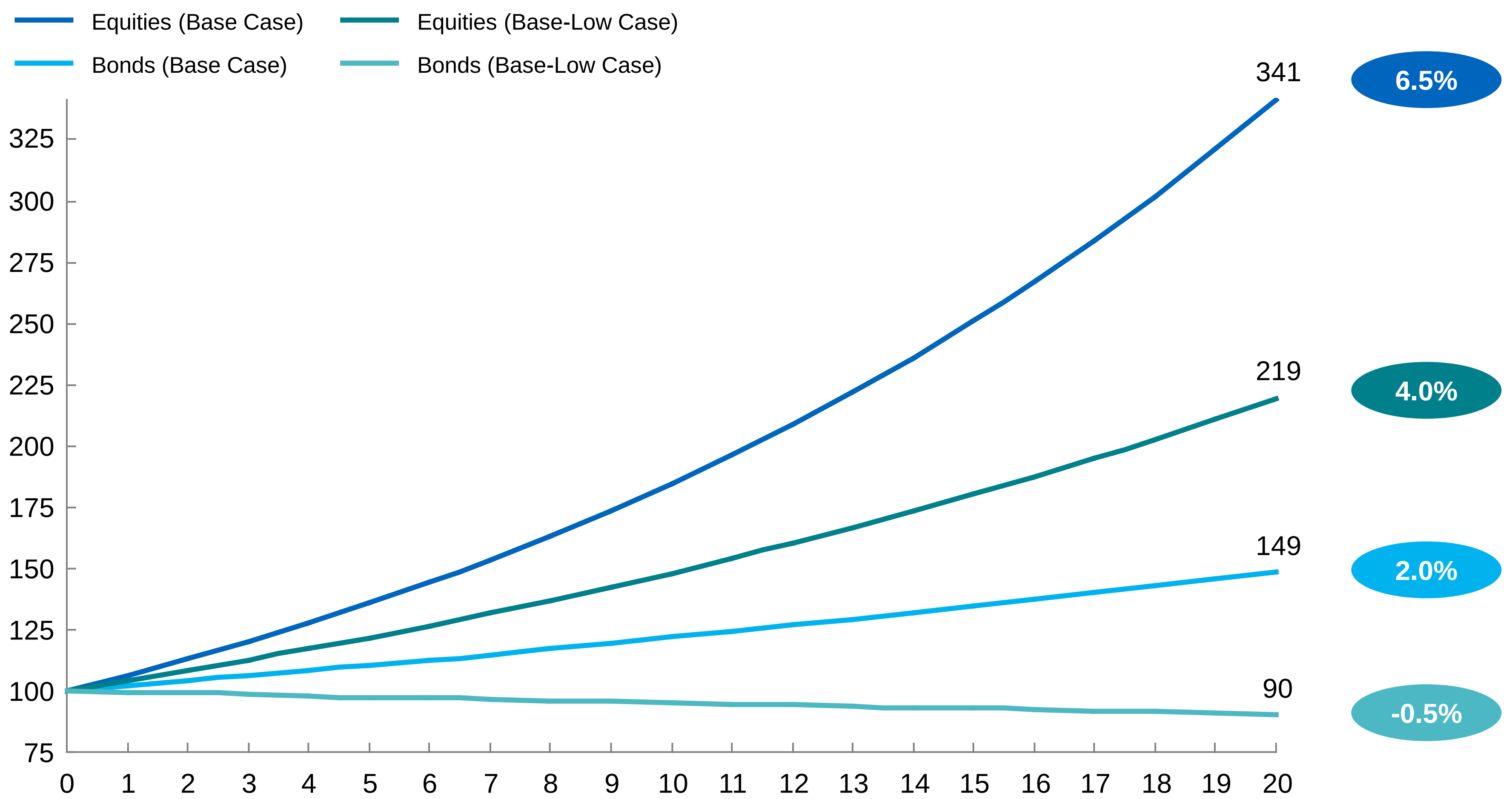
Percent



SOURCE: McKinsey Corporate Performance Analytics; McKinsey Global Institute analysis

Scenario returns

Equity and Bond Portfolio Total Return to Shareholders (Base and Base-Low Case)
Indexed at 100, year 0

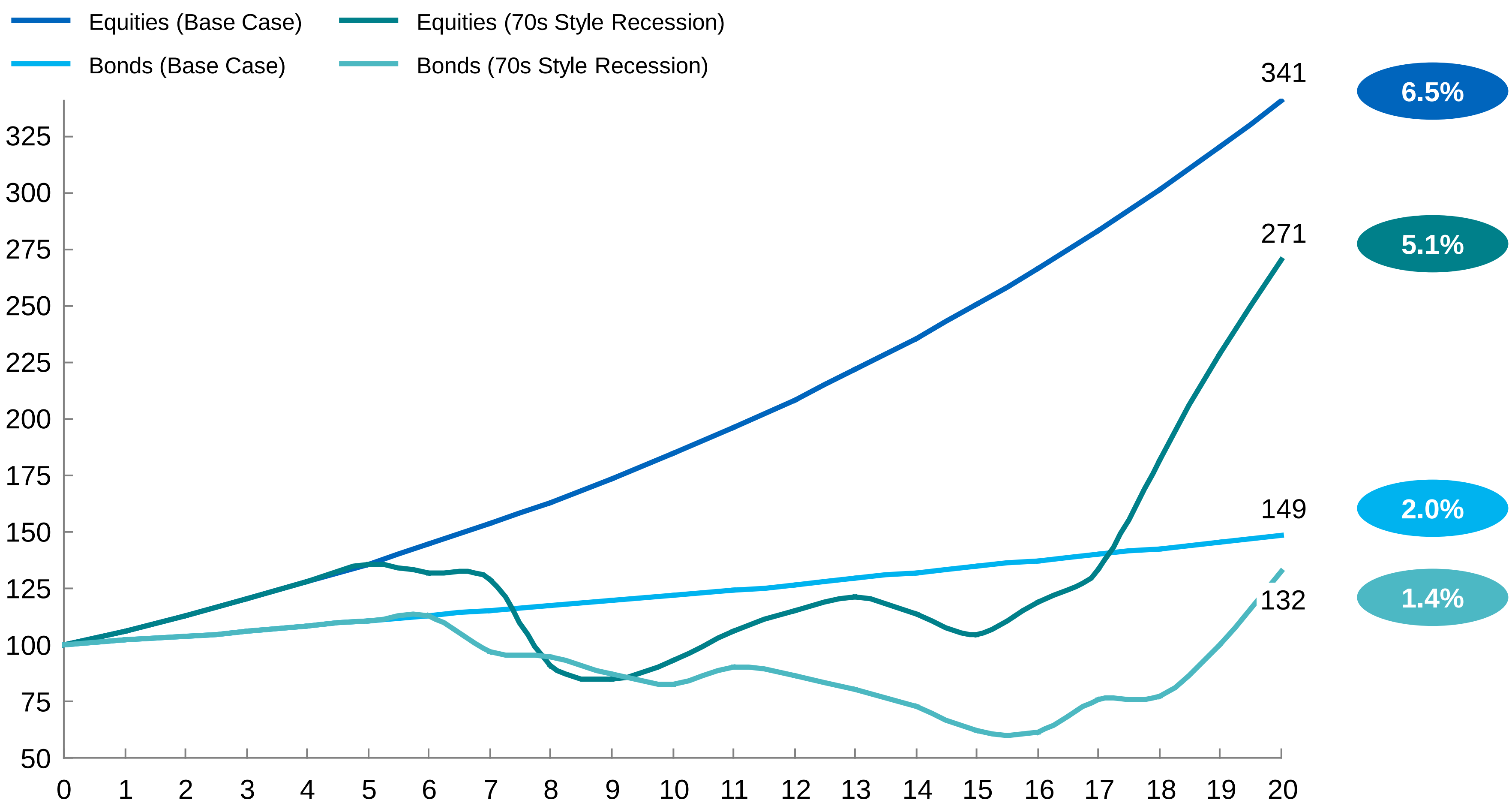


SOURCE: Corporate Performance Analytics, Bureau of Economic Analysis

Total real return on equities higher than bonds even under a 1970's style recession

Equity and Bond Portfolio Total Return to Shareholders (Base Case & 70's Recession)
Indexed at 100, year 0

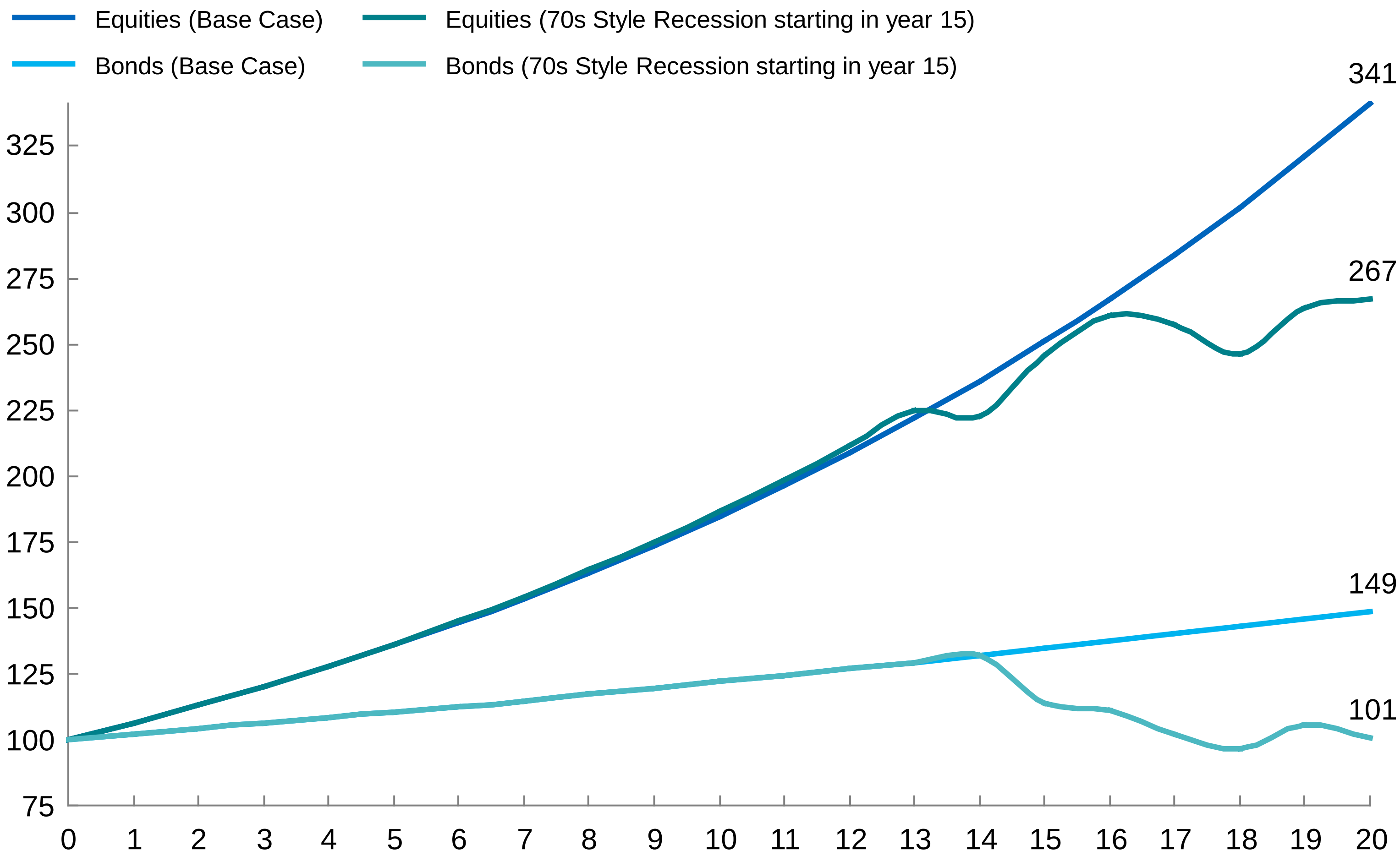
CAGR, 20 year
Percent



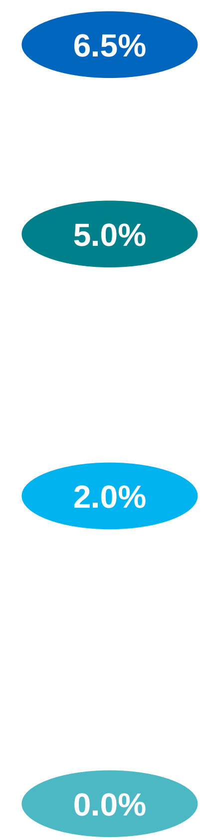
SOURCE: Corporate Performance Analytics, Bureau of Economic Analysis

Delay in 1970s style recession makes equities even more attractive

Equity and Bond Portfolio Total Return to Shareholders (Base Case & Delayed 70's Recession)
Indexed at 100, year 0



CAGR, 20 year
Percent

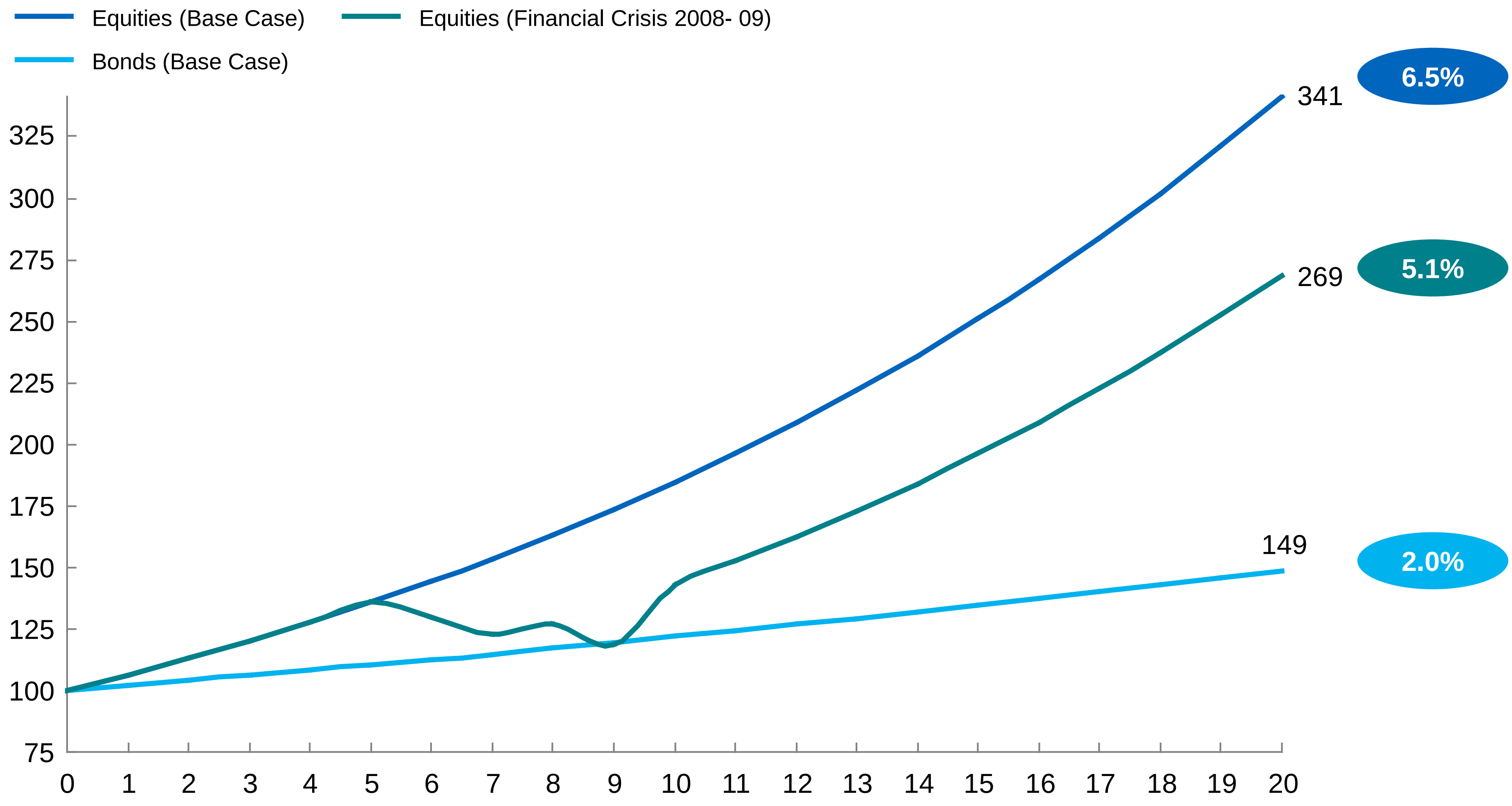


SOURCE: Corporate Performance Analytics, Bureau of Economic Analysis

Under a 2008-2009 financial crisis environment, equity returns remain higher than bond returns

Equity and Bond Portfolio Total Return to Shareholders (Base Case & ’08-’09 Crisis)
Indexed at 100, year 0

CAGR, 20 year
Percent



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