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Think 7% Returns Are Coming Back Anytime Soon? Think Again.

Two prominent investment strategists cautioned advisors about future gains in client portfolios at this year's FPA annual meeting

Advisors and their clients should not expect much more than 5% to 6% annual returns on their portfolios — possibly even less — over the next 10 years, according to the chief investment strategists at Commonwealth Financial Network and Russell Investments.

The odds of a correction or bear market are also increasing, though neither strategist expects that for another year or two.

"The conditions for a bear market are not in place right now but you can see them coming," said Brad McMillan, chief investment strategist at Commonwealth Financial Network, during his talk at last week's FPA annual conference in Nashville, Tennessee. "What we have right now looks a lot like 1999."

A few months after 1999 ended, the major U.S. stock market indexes peaked and declined almost steadily through a short-run recession during much of 2001 until September 2002. The Nasdaq didn't recover those losses until April 2015; the S&P reached its previous peak in 2007.

"We don't know what's going to happen now, but we do know what happened in 1999," said McMillan. "There's a good chance there will be stormy weather ahead. Think about what a storm will mean for you and your clients."

Erik Ristuben, chief investment strategist at Russell Investments, in his FPA presentation, said that advisors and investors should expect a year of investment losses within the next five years and a recession possibly as soon as 2019 but more likely in two years.

His reasons: The economic expansion and stock bull market are in their ninth year and stock valuations are extremely high. He titled his session: "The Low Return Imperative: Investing Uncomfortably."

The Shiller cyclically adjusted P/E ratio, known as the CAPE, has topped 31 and the more traditional P/E is over 25 – both at their highest levels since 2009.

In order to stay as high as they are or move even higher, equity valuations require strong earnings growth, which requires strong economic growth, but GDP has been relatively slow, according to McMillan. (GDP growth for 2017 is forecast between 2% and 2.5%.)

In addition to high P/E ratios, McMillan is concerned about the price-to-sales ratio and margin debt-to market ratio — both either at or near record highs.

Given these expectations for low returns and potential losses, both McMillan and Ristuben suggest that advisors and their clients adjust financial plans and portfolios to minimize potential damage. Here are some of their recommendations:

Adjust Financial Plans

If clients need a certain amount of money for retirement or any other financial goal, their plans should assume 5% annual earnings rather than say, 7% or 8% or higher. They need to save more — and invest more — to make up the difference, and they may have to spend less to do that.

Manage Portfolio Risk

"You can't invest the same way you have for the last few years," said Ristuben. You need incremental returns and risk management. ... Only take risks you expect to be paid for."

McMillan recommends lower-risk assets overall, including short-term bonds, more cash and lower-beta equities. And he recommended that advisors think of risk not as market volatility, where asset prices can decline, but as the risk of clients failing to meet their goals.

That includes "slow risk," where returns are not high enough, and "fast risk," involving big portfolio losses. "Focus on the risk of losing money … on return *of* capital rather return *on* capital."

Manage Portfolios Dynamically

"Buy and hold doesn't outperform when the market is expensive," said McMillan. "You can't put money aside and forget about it."

Both he and Ristuben recommend that advisors construct flexible portfolios that can be adjusted as market conditions change. These portfolios should be diversified, tax-efficient (for taxable accounts), relatively inexpensive and include undervalued assets.

According to Ristuben, the most undervalued equity markets are, in descending order: emerging markets, European stocks and Pacific Basin equities,

He also recommends rebalancing portfolios regularly.