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Why investors may need to lower their sights

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The forces that have driven exceptional investment returns over the past 30 years are weakening, and even reversing. It may be time for investors to lower their expectations.

Given the waves of turbulence that have swept through financial markets in recent years, including the 2000 dot-com meltdown and the 2008 financial crisis, it may sound odd to describe the past three decades as a golden age for investors. But the reality is that total returns on equities and bonds in the United States and Western Europe from 1985 to 2014 were significantly higher than the long-term average.

These returns were driven by an extraordinary confluence of favorable economic and business fundamentals. Inflation and interest rates declined sharply from peaks in the late 1970s and 1980s. Global economic growth was strong, fueled by positive demographics, productivity gains, and rapid growth in China. And corporate-profit growth was even stronger, reflecting revenue gains in new markets, declining corporate taxes, and advances in automation and global supply chains that helped rein in costs. Publicly listed North American companies alone increased their post-tax margins by 65 percent in this three-decade period.

This golden era has now ended. A new McKinsey Global Institute (MGI) report, *Diminishing returns: Why investors may need to lower their expectations*, finds that the forces that have driven exceptional returns are weakening, and in some cases reversing. The big decline in interest rates and inflation is reaching its limits, global GDP growth will be lower as populations in the developed world and China age, and the outlook for corporate profits is cloudier. While digitization and disruptive technologies could boost margins for some companies, the big North American and Western European firms that took the largest share of the global profit pool in the past 30 years face new competitive pressures from emerging-market companies, technology giants, and digital platform-enabled smaller rivals. These forces may curtail margins going forward.

MGI's detailed analytical framework linking investment returns to the real economy finds that returns on equities and fixed-income investments in the United States and Western Europe over the next two decades could be considerably lower than they have been in the past 30 years. The report, written in collaboration with McKinsey's Strategy and Corporate Finance Practice, estimates that for equities in both regions, average annual returns could be anywhere from approximately 150 to 400 basis points lower, or 1.5 to 4.0 percentage points. For fixed-income, the gap could be even larger, with average annual returns between 300 to 500 basis points lower (3 to 5 percentage points), and in some cases even lower than that.

These lower rates of return could have a profound effect on all investors—both individual and institutional—and, by extension, on governments more generally. For example, a two- percentage-point difference in average annual returns over an extended period would mean that a 30-year-old today would have to work seven years longer or almost double her savings to live as well in retirement.

Public pension–fund managers in the United States assume that returns on a blended portfolio of equities and bonds could be about 8 percent in nominal terms, or 5 to 6 percent in real terms. This would imply equity returns as high as 6 to 8 percent, considerably above the level in our projections. As a result, these pension funds could face a funding gap that is even larger than the one they are struggling with today. Among others likely to be affected are asset managers, whose fees will come under pressure in a lengthy period of lower returns, and insurers that rely on investment income for earnings. On both sides of the Atlantic, policy makers may need to prepare for a later generation of retirees with less income.

It is of course possible that other exceptional circumstances might arise to give a renewed boost to investment returns, such as strong productivity growth accompanied by low inflation. Emerging-market investments might provide higher returns. But it is also possible that even our more pessimistic projection is too mild. What is important is for investors of all types—individuals as well as institutions—to start managing their own expectations and the expectations of the people who will be affected by their investment decisions.

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