Navigating a ‘4% World’

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Introduction

Investors face a unique set of challenges in today’s investment landscape. Perpetual’s approach addresses four critical issues:

- A low-return environment created by extended valuations for many assets which dominate benchmarks
- The potentially destabilising effects of passive investing
- The severe consequences of sequencing risk
- The unreliability of bonds as a risk mitigator.

By prioritising active management, downside protection, and income stability, our approach aims to effectively navigate these challenges while optimising income from varied sources. It seeks to strike a balance between enhancing returns and managing risk, while adjusting to the changing conditions of global markets.

Key points:

1. The ‘4% World’

The past decade of US exceptionalism - culminating in the extraordinary run of the Magnificent 7 tech stocks - has created very strong global equity returns. The stellar gains in US equities and their leading tech firms, represents a bring forward of investment returns, rather than a new steady state of ongoing out-performance. Passive investors who hug the benchmark and expect a repeat of the past 15 years may be shocked about the meagre returns on offer in the next decade, they risk unwittily sleepwalking into, and becoming trapped, in a ‘4% World’.

2. Tackling Passive Investing Risks

Using the benchmark as a barometer of investment merit can distort markets by concentrating capital in large companies, positively reinforcing overvaluation, thereby increasing systemic risk. In the end, passive funds are not truly “passive” as they engage in systematic momentum trading every day that can, through time, amplify market and systemic risks. In contrast, our approach advocates moving away from benchmarks as a way of reducing portfolio risk.

3. Mitigating Sequencing Risk

Sequencing risk is a danger where the order of investment returns negatively impacts a retiree’s account balance, and in a “4% World” this is a significant concern as low equity returns are always associated with elevated volatility. We illustrate how early losses can erode a retiree’s balance, even with the same average return and volatility. Effective risk management techniques to minimise the impact of early losses, ensures a better and longer retirement journey.

4. Enhancing Downside Protection

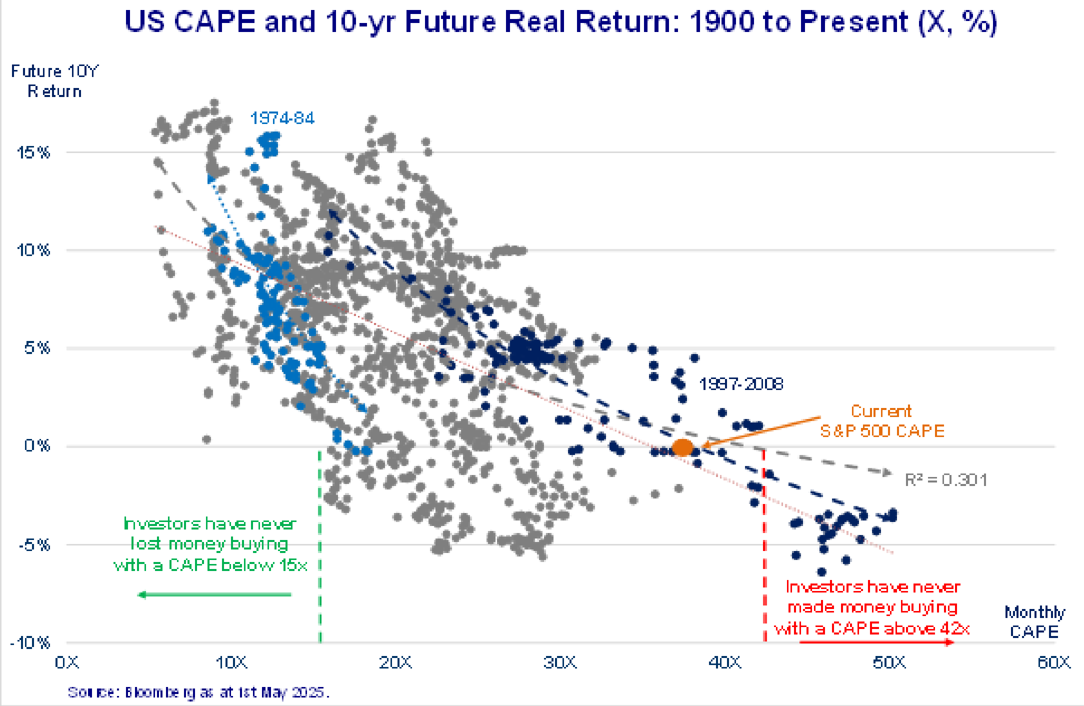
Historically, government bonds were effective diversifiers, but current low yields (e.g., 4.2% for 10-year US Treasuries as of March 31, 2025) and inflation concerns have reduced their effectiveness. This paper suggests augmenting the use of government bonds with explicit downside protection, offering reliable hedging.

Details

1. The '4% World'

The benchmark is a much riskier part of the investment universe, at a point in time where regulators are viewing it as the opposite. The past decade of US exceptionalism – culminating in the extraordinary run of the so-called 'Magnificent 7' tech stocks – has created very strong global equity returns for passive and momentum investors. By contrast, the rewards from diversification have been meagre, with some even characterising these times as a 'bear market in diversification'. Looking ahead, prospective returns in the US appear modest due to elevated starting valuations (Chart 1).

Chart 1 US CAPE valuation – near levels where the 10Y real return has never been positive



The Perpetual Capital Markets Estimator (PCME)[1] formulates 10Y expected returns for a wide array of assets. The chart below shows that investors today should not expect higher returns for taking higher risk in conventional global market cap indices (Chart 2). This is due to the extreme valuation starting point of US equities and the dominance of US equities within global equity benchmarks (representing a historically large (70%) share of the MSCI World Index). Today's environment is in stark contrast to other periods where investors were rewarded for talking additional portfolio risk. The capital markets line (CML) below shows that in 1996 an extra 2% of benchmark risk offered investors +160 bpts of additional benchmark return, and in 2014 it was a still rewarding +125 bpts. But in 2025, the additional benchmark reward for the increase in risk is zero.

What is the driver of lower expected returns?

The driver of lower expected is high starting valuations, and there have been four key drivers of this trend – falling discount rates in the first three decades of the period, four US Fed QE programs during and after the GFC and the pandemic, lower tax rates and more recently the investment hype around artificial intelligence (AI). The increase in valuation over the past 45 years has provided a +3%p.a. tailwind to equity returns (Chart 3), but there is no reason to think that this trend can continue. Accordingly, investors need to prepare for the possibility that the 3%p.a. tailwind enjoyed for many decades, may become a headwind over the next ten years.

[1] The calculated 10Y expected returns are nominal and make no allowance for tax or fees, and investors should be wary about interpolating the long-term expectations into shorter periods. That said, once the respective asset class output is calculate, we can use Strategic Asset Allocation weights to estimate the expected return for our array of traditional diversified funds.

Chart 2: A 4% world distorts the relationship between portfolio risk and return

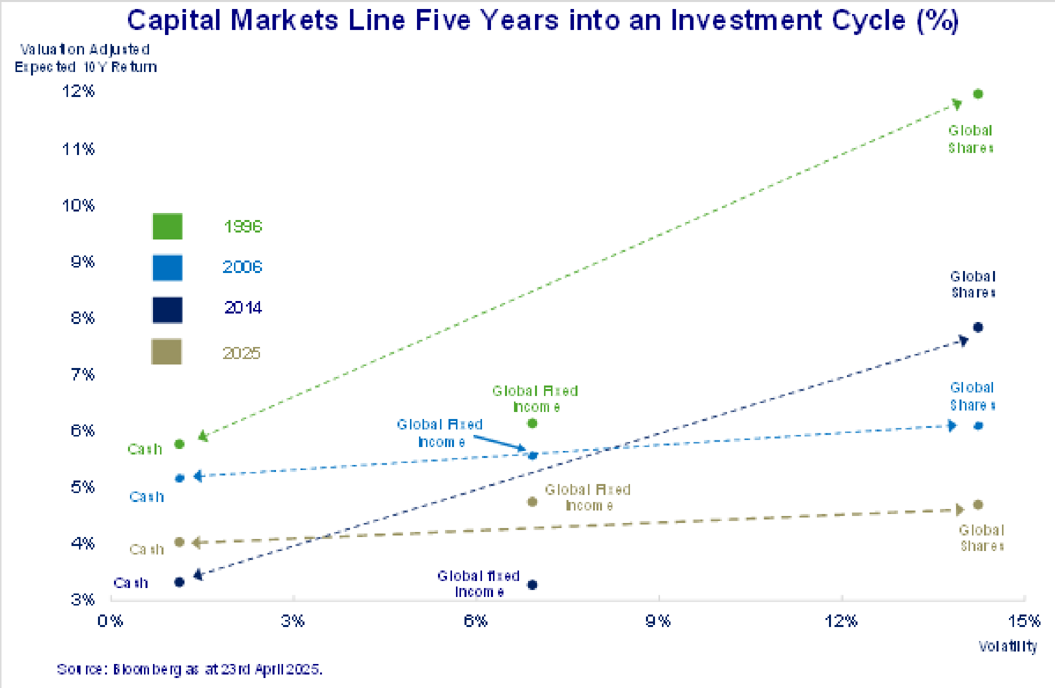
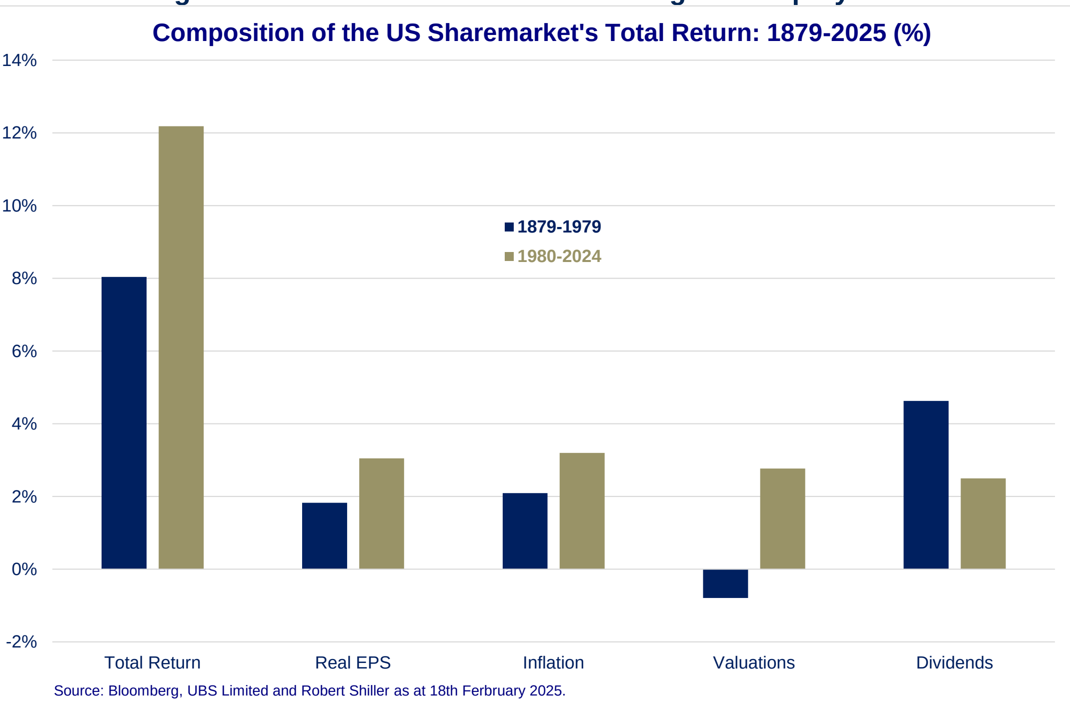


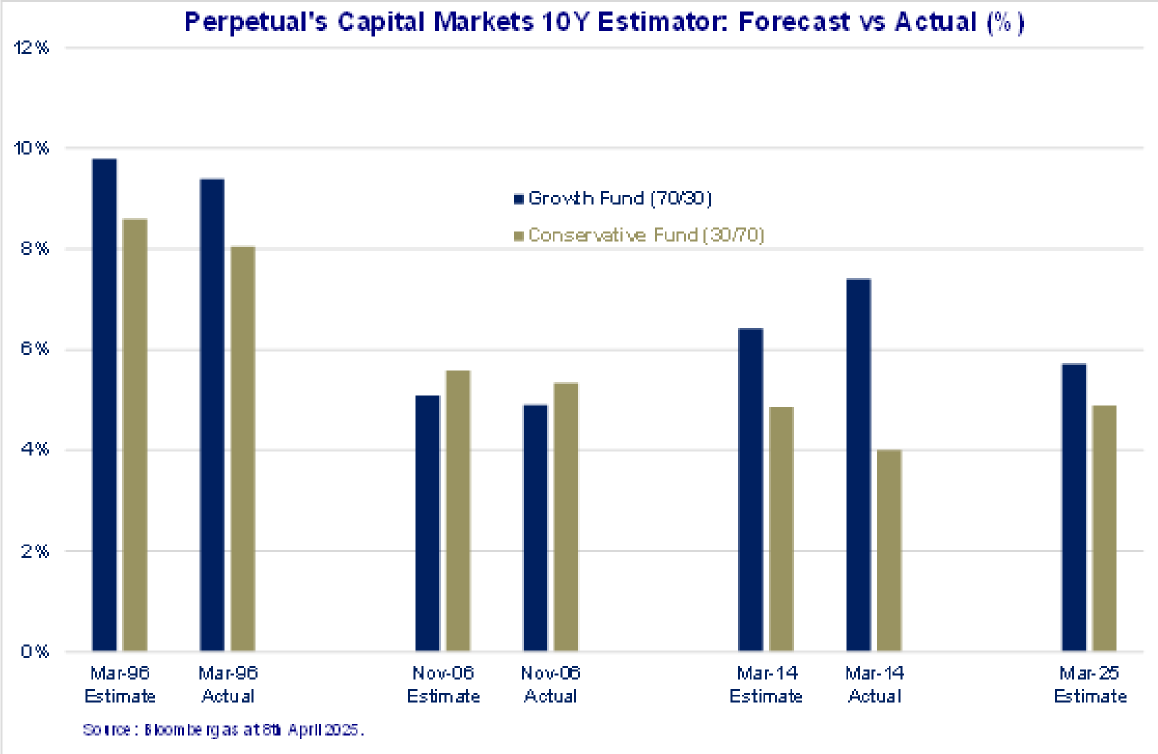
Chart 3: A large rise in valuations has driven stronger US equity returns since 1979



A very flat CML is unusual but not unprecedented. In the late 1990s during the dotcom boom, a low and flat CML preceded a long stretch of zero price returns for US investors which lasted 12 years, despite S&P 500 earnings nearly doubling over that period. Investors who bought at the top underperformed cash for 14 years, a stark reminder of the perils of overvaluation and following the herd.

Valuation-adjusted projections for "Balanced" and "Conservative" funds over the next decade (Chart 4), compared to past starting points, show diminished real returns and poor risk-adjusted outcomes. Surprisingly, both fund types now offer similar subdued returns—below investor hopes—prompting a call for retirees to rethink portfolio strategies.

Chart 4: The Fund level divergence between forecasts and actual is quite low.



2. The problem with passive investing

What is good for the individual building wealth, is not helpful for society in terms of the allocation of capital and is potentially detrimental to retirees in drawdown phase. Passive investing is beneficial for individual investors seeking low-cost market exposure, but collectively it has grown to a scale where it distorts market dynamics. More worryingly, market regulators believe in the purity of the benchmark and are potentially overlooking the growing systemic risk that it poses. This sets the stage for a disorderly market sell-off if flows into passive strategies reverse. What appears good for investors in accumulation phase can be very detrimental for investors who, like retirees, are exposed to sequencing risk.

The label "passive" is misleading. While passive funds aim to replicate an index rather than actively pick stocks, they still engage in frequent buying and selling due to inflows and outflows of investor money, index rebalancing, and corporate actions (e.g., IPOs, mergers). This activity makes them systematic, momentum-driven players in the market, not inert bystanders as traditional economic theory assumes.

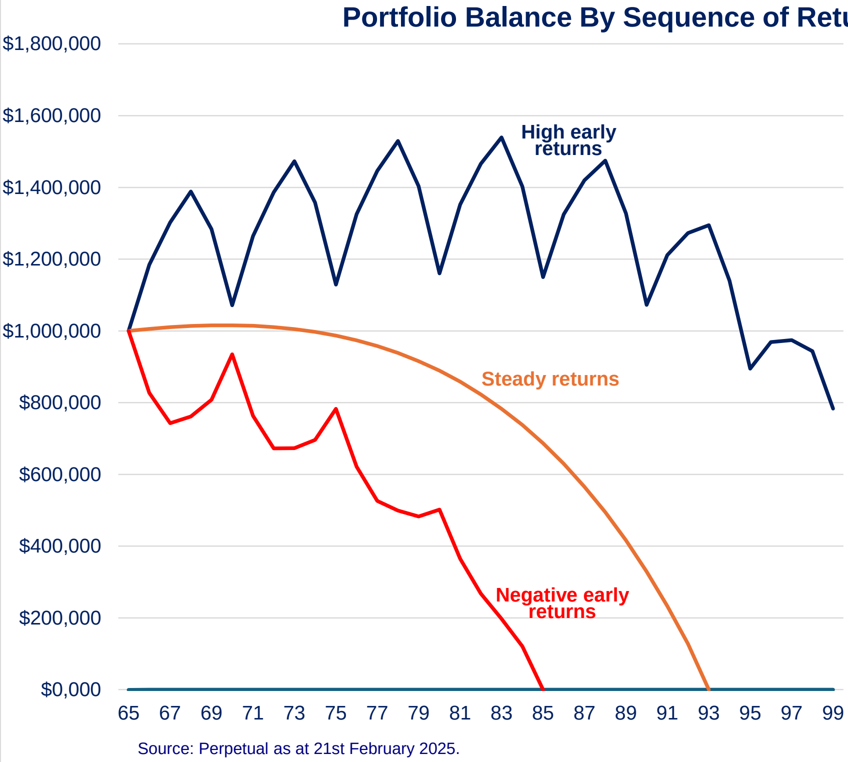
Passive investing concentrates capital in large, often overvalued stocks due to market-cap weighting, amplifying systemic risks and distorting price discovery. This herd-like behaviour can lead to bubble-like conditions and heightened volatility when flows reverse. Our approach moves away from passive, index-driven exposure, prioritising active management to avoid overcrowding in mega-cap stocks and thereby reduce exposure to these structural vulnerabilities.

3. The potentially catastrophic impact of sequencing risk

In a ‘4% World’ all investors, including retirees, must hold a long-term growth portfolio to meet expected investment outcomes. However, a high allocation to equities (or other growth-oriented assets) exposes retirees to sequencing risk. Sequencing risk is the danger that the order of investment returns, particularly early losses, can significantly impact the longevity of a portfolio, especially during the withdrawal phase, even if long-term average returns remain the same.

The following chart shows the hypothetical impact on a retiree’s balance with a starting balance of $1 million at age 65. We have assumed a net of fee and tax return of 7%p.a. over the investment period and an annual withdrawal of $60k per year indexed to inflation (+2.5%). The initial balance has an average compound return of +7%p.a. and the standard deviation of the high early returns journey and negative early returns journey are identical (+15.2%pa). The only difference is the order of returns – Journey 1 has large early gains, Journey 2 has steady gains, and Journey 3 has early losses (Chart 5).

Chart 5: In drawdown, the sequence of returns is central to outcomes



Key assumptions:
- Starting balance of $1,000,000
- Withdrawals $60k per year indexed to inflation (2.5%)
- Returns 7%p.a. in each scenario
- Standard Deviation of "High Early Returns" and "Negative Early Returns" are the same at 15.2%p.a.

	High early returns	Steady returns	Negative early returns
Yr 1	26%	7%	-15%
Y2 2	15%	7%	-3%
Yr 3	12%	7%	12%
Yr 4	-3%	7%	15%
Yr 5	-15%	7%	26%
Ave	7%	7%	7%

What is evident is the vast difference between Journey 1 and 3, and how much of a difference avoiding losses makes, particularly early on. Initial early losses for Journey 3 have the portfolio value eroded to zero within 20 years. In contrast, Journey 1 with high early returns, sits comfortably at $800k after 34 years, despite both having identical average returns and volatility. This shows the difference between average returns (same return and same standard deviation) and money-weighted returns – and the impact of early gains and early losses on how much is invested at that time. This is why downside protection is so critical and this example, does not include a large-scale bear market that can occur in the wake of extreme valuations in equity and credit markets.

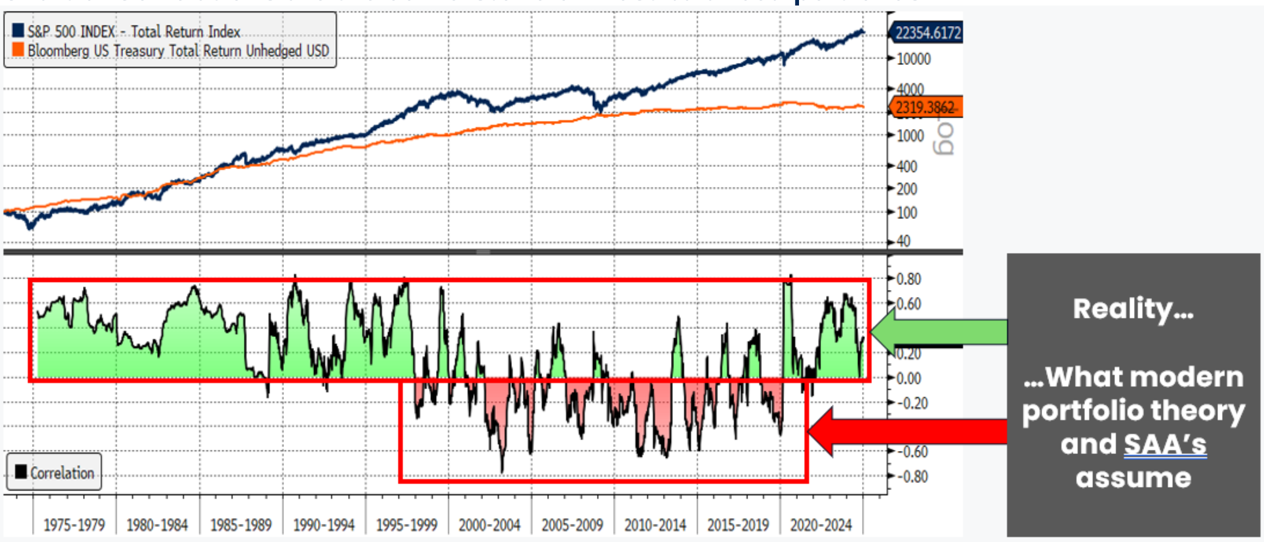
4. Explicit downside protection addresses the unreliability of bonds

From the 1980's to the early 2020s, government bonds excelled as a portfolio diversifier, offsetting equity risk thanks to falling yields (from 14%-15% in 1982 to below 1% by 2020) and negative correlations with stocks (often below -0.5 – Chart 6). This delivered strong capital gains and cushioned equity downturns, like the 1987 crash or the 2008-2009 financial crisis.

High starting yields and stable inflation meant bonds could reliably deliver steady income and capital preservation, enhancing their role as a reliable diversifier against equity volatility. Today, government bonds still offer liquidity and relative safety compared to equities, but their diversification power has diminished, due to lower yields and a less certain inflation environment. We know that the starting yield of a 10-year US government bond is 4.2%p.a. today (31 March 2025). That means that if this bond is held until maturity, the investor will earn 4.2%p.a. for 10 years. This is lower than most retirees' investment objective, meaning equities, must outperform to compensate.

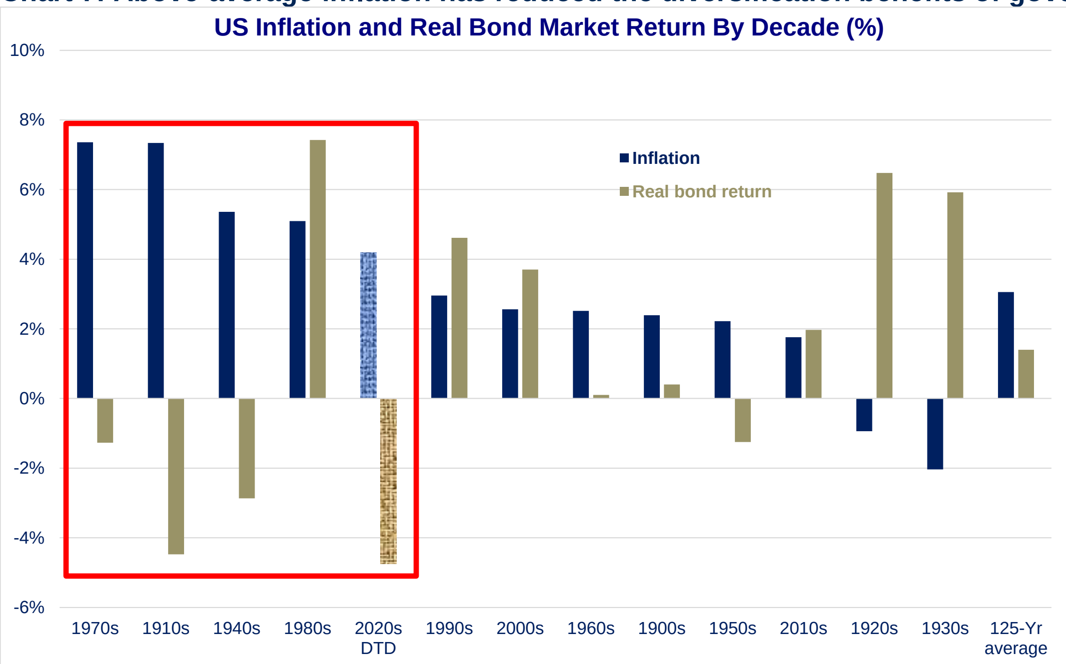
However, inflation for bond investors is of continual importance as higher levels of inflation have been associated with lower real returns in government bonds (red box in Chart 7). Decades with an annualised inflation rate above the historic average of +3.1%pa (as occurred in the 1910s, 1940s, 1970s and the current decade) have produced the worst decades of real bond market returns to investors.

Chart 6: Correlations are the cornerstone of most balanced portfolios



Source: Bloomberg and Perpetual Investments as at 22nd February 2025.

Chart 7: Above-average inflation has reduced the diversification benefits of government bonds



Source: Bloomberg as at 9th March 2025

Finally, we know that we must hold a lot of bonds to potentially cushion the portfolio from an equity market sell off. A 100% equity portfolio might have a standard deviation of ~18%, but adding 20% bonds (assume ~4% volatility, low correlation) only reduces portfolio volatility to ~14-15% (using portfolio variance formula).

How to manage downside risks in your portfolio diversifiers

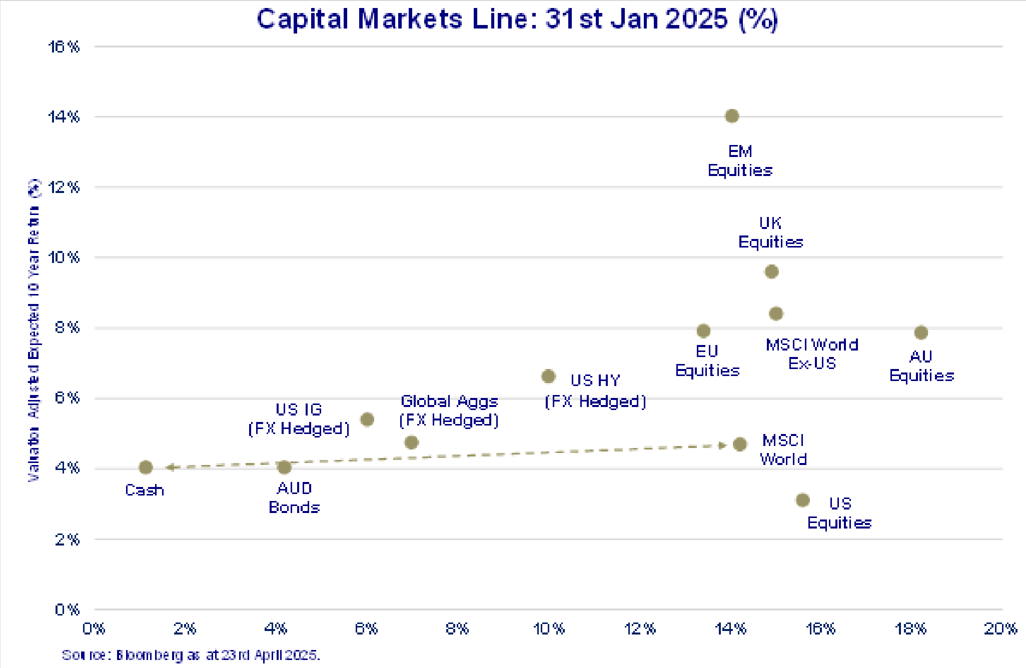
Given elevated Australian and global equity market valuations, investors, and in particular retirees, need portfolio diversifiers which deliver positive convexity in periods of equity market stress. Unlike government bonds, bought put options have three advantages. Firstly, the maximum loss is capped at the premium paid for the option. Secondly, put options are a highly reliable equity hedge, unlike bonds, where the effectiveness as an equity hedge is dependent upon correlations. Finally, owning options means a more efficient capital allocation, where investors do not need to sell a high returning asset, like equities, to buy a lower returning hedge, like bonds.

Our approach - Income and downside protection focus

Income and capital preservation are key features of Perpetual's investment approach. We emphasise dividends and buy backs (as they will provide a larger share, of what are likely to be lower returns in the coming decade), while embedding convexity through robust downside protection strategies. This ensures income stability and guards against severe market drops.

Current market-cap-weighted benchmarks, skewed towards richly valued sectors like technology, have depressed expected returns and heighten correction risks. Similarly, tight credit spreads provide insufficient compensation for default risk, rendering credit unattractive for now. Our approach is to tailor exposures targeting companies that have been overlooked by market cap indices (thereby keeping valuations low) and generate strong internal cash flows so that returns can be produced independently of and valuation re-rating. Chart 8 below shows some of the valuation opportunities for investors who are prepared to deviate from market cap indices.

Chart 8: Many regional markets are expected to deliver superior risk-adjusted returns than the US



Dividends and buybacks being a high proportion of total return is important because there is a lot less volatility in dividend growth than price growth (Chart 9) across nearly all markets. Most importantly, deep-value income strategies are available in all major developed markets and by using that as the core of the equity strategy, this will improve the probability of achieving our Funds' investment objectives and reduce portfolio volatility.

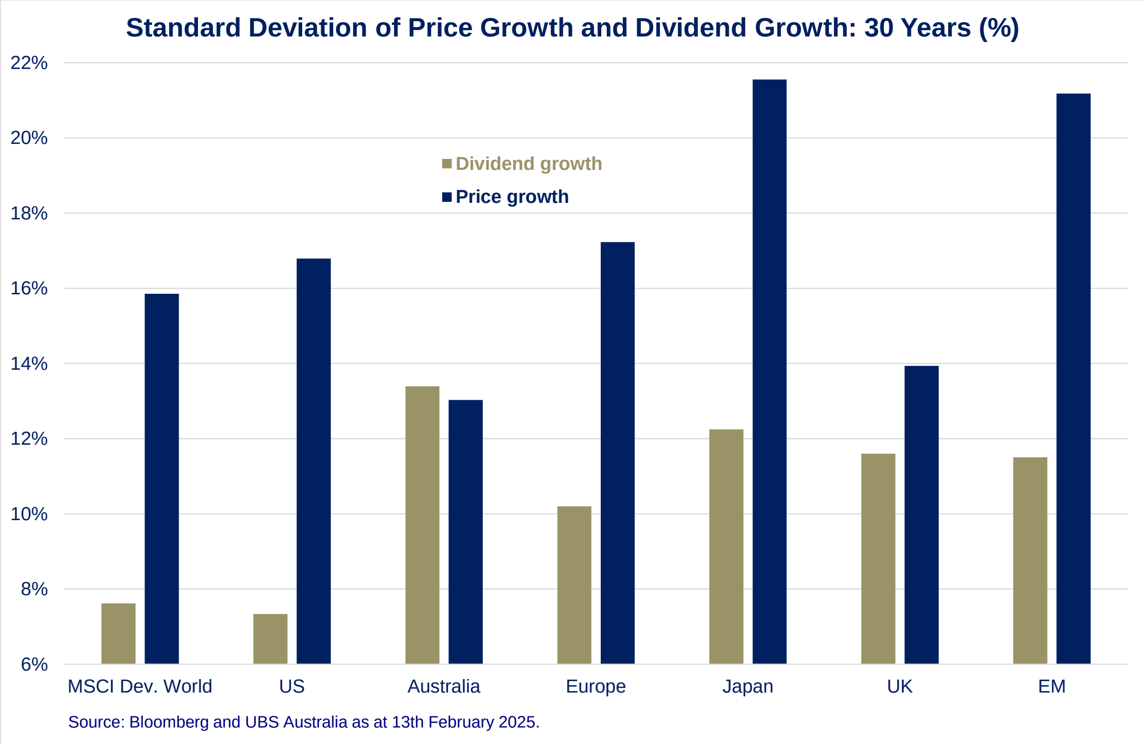
At Perpetual, minimising downside risk is partly achieved by directly managing valuation risk (avoiding expensive sectors within asset classes), while also implementing explicit portfolio protection. This may include equity put options, long USD positions, or other assets likely to be negatively correlated to the portfolio's equity allocation. Our track record protecting capital in 2020 and 2022 (and other times) is a testament to our skill in this area.

Concluding thoughts

The confluence of flat yield curves, elevated equity valuations, and tight credit spreads has triggered a low and flat Capital Markets Line, ushering investors into a benchmark-constrained '4% World'. This disconnect between valuations and corporate fundamentals amplifies risk for retirees grappling with heightened sequencing risk, and all investors are increasingly exposed to subdued returns and more fragile markets.

Some may turn to low-cost passive strategies as a remedy for this '4% World', and while regulators

Chart 9: There is a lot less volatility in dividend growth than earnings growth



deem these investments benign, they may lock investors into a cycle of high volatility, meagre returns, and outsized exposure to a select few companies with overstretched valuations. If benchmark returns are the bottleneck, the solution lies in stepping away from that benchmark and gravitating toward areas that resonate with a client's investment objectives. Beyond that, investors must rethink diversification, moving beyond an over-reliance on government bonds and illiquid assets, and adopt strategies that offer positive convexity during turbulent times – without sacrificing significant upside if markets climb over the medium term.

Our approach can be summarised by:

- **Income stability**: Analyse the stability of dividend payments across economic cycles and geopolitical risks.
- **Correlation management**: Ensure that the layers do not move in lockstep, thus providing true diversification benefits. This involves analysing how different asset classes or strategies correlate under various market conditions.
- **Bought equity put options** offers the advantage of built-in risk management, as the maximum loss is limited to the price paid for the option, and they are very effective hedges (they reliably make money when equities sell off).

This investment landscape, and the portfolio tools it demands, may feel unfamiliar to some. Thriving in this new reality calls for a shift in perspective – a readiness to adapt and a recognition that yesterday's playbook may no longer suffice. It's about approaching the terrain with curiosity and agility, adjusting strategies to ensure portfolios can still achieve strong risk-adjusted returns tailored to clients' goals.

Yours sincerely,

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