Remaco-Insight

What do institutional capital market expectations have to say about the investment year 2024?

By Tim Kröncke

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The majority of asset classes performed well in 2024. For example, the MSCI World Index (CHF hedged) has yielded a total return of 19.6%, and even Swiss Domestic Government Bonds 7-15 returned 3.9% (as of 18.12.2024). Consequently, most investors experienced an increase in portfolio wealth that exceeded the long-term average. Hurrah!

Or perhaps we should not be so quick to celebrate. There are at least two potential reasons why observed realised returns may be above their long-term average: first, cash flows may have been more favourable than expected. This story suggests that performance is being driven by good current fundamentals. The apple tree has borne more fruit than usual, without affecting the future harvest. Second, expected returns may have fallen due to a revision in risk preferences or uncertainty. Lower expected returns then drove up asset prices in exchange for lower future returns. According to such a narrative, the apple tree bore more fruit than usual, but in exchange for fewer apples to be harvested in the future. The data suggest that the latter channel seems to be a driving force this year, and this gives rise to a somewhat less euphoric outlook.

In our quarterly survey of institutional capital market expectations in Swiss Francs, we collect the assessments of up to 28 global asset managers and consultants regarding the 10-year expected returns and risks associated with various asset classes. As can be seen in the figure below, expected returns across asset classes have decreased significantly over the past 12 months. (The full report will be published in January.) Expected returns on government bonds decreased by 1.5%, corporate bonds by 1.3%, and equities on average by 1.8%. It is noteworthy that expected returns of risky asset classes decreased more than the expected return of cash (0.6%). Therefore, the decrease in expected returns is not solely due to current monetary policy decisions, but also due to a decrease of 10-year "rolled" expected short-term rates as well as decreasing risk premia.

This observation suggests that investors have indeed received an early Christmas present. The higher-than-usual performance this year is, at least to some extent, earned in exchange for a somewhat lower expected performance in the future. Given the decline in expected returns across a wide range of investment opportunities, what can long-term investors do about it?

Firstly, it seems wise to avoid simply extrapolating last year's performance into the future. The year 2024 exhibited above-average performance, and future investment years are likely to be less favorable. Therefore, the windfall from 2024 should not be used as a reason for additional expenditures; rather, it should be set aside as a future buffer whenever possible.

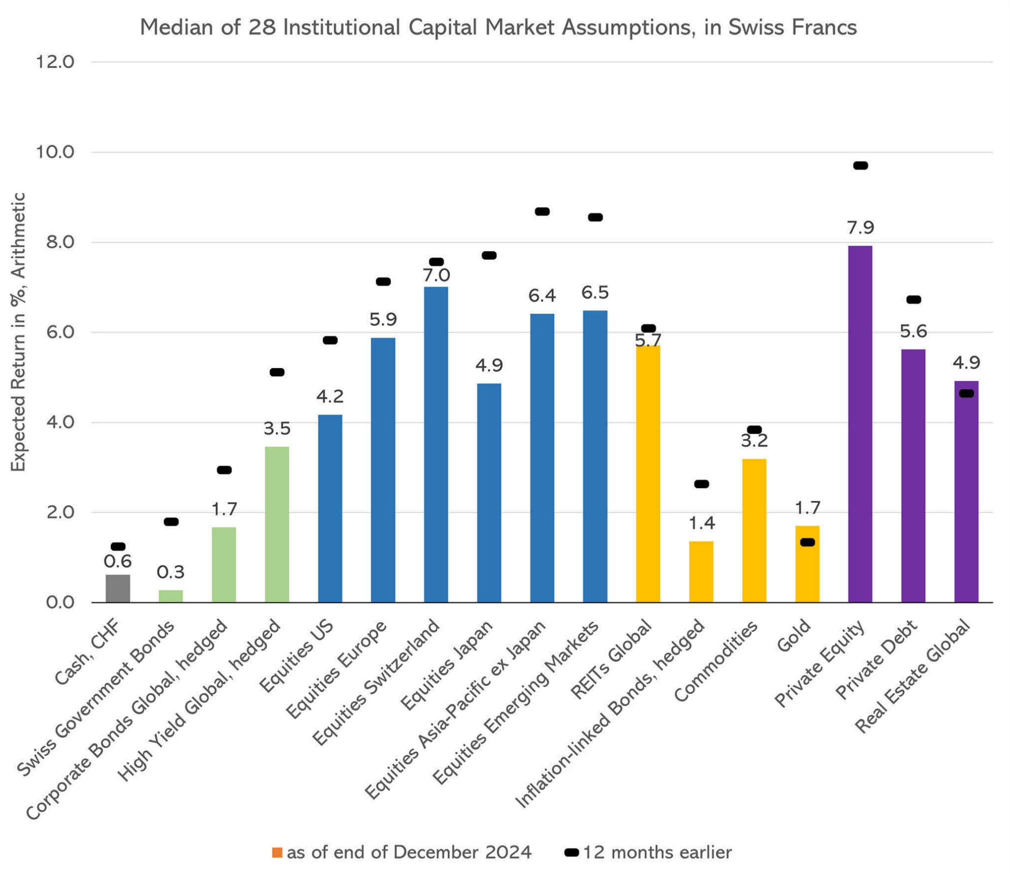
Secondly, the evergreen of diversifying globally across different asset classes allows for an increase in the expected portfolio return-to-risk tradeoff. For example, institutional capital market expectations summarized in the figure below indicate that US an Japanese equities have the lowest expected long-term return, while Swiss, European and Asia-Pacific equities are currently more attractive. Therefore, a portfolio tilt towards regions with higher expected returns appears to be an interesting possibility to consider.

Thirdly, we observe that expected returns on private market investments were also in decline. Nevertheless, private markets remain an attractive asset class in absolute terms, and it remains plausible that they offer the potential for diversification benefits.

Fourthly, alpha strategies have the potential to facilitate the generation of returns that exceed the market performance. It is now a good time to evaluate whether they are still likely to deliver economically significant performance in excess of additional fees and transaction costs. The market is now less likely help out investors who have made a bad selection of alpha strategies.

Lastly, long-term investors with a specific target return may wish to ascertain whether they have already utilized their entire risk budget. If the options above all have been already exploited, this might be the only path available to meet a target return with high probability.

The good news is that the year 2025 starts with an exciting challenge for forward looking investors and advisors. We can say with confidence that it will not be a boring year.



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