RISING PENSION LIABILITIES - A FURTHER DRAG ON LONG TERM RETURNS

Whilst the post GFC world has seen higher than average market multiples it has also significantly increased costs to equity holders, many of which are yet to be borne.

A simple look at the **state of corporate pensions** shows the scale of the costs to equity holders yet to be paid for. Taking future pension costs into account plausibly suggests S&P 500 at 2,304 in a decade's time – a nominal decline of 2.3% p.a. for 10 years.

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Our investment process looks at what today's asset base can reasonably be expected to return on a normalised basis - considering the range of cashflow needs for the business - before it can choose to reinvest in the business or return money to shareholders. In many cases these are subjective judgments that vary by industry or company to company.

One liability to shareholders that we use as a standard methodology for when considering a potential investment is pension liabilities. **Pension liabilities are increasingly precluding us finding value in many listed equities**. Pension liabilities typically matter most when the going is at its worst – revealing to investors the illusion of value precisely when they can least afford it.

While problems due to the state of the corporate debt market is something which has gained significant attention **we are surprised how little attention seems to be paid in current valuations** to the embedded risk to equity holders due to the state of corporate pension plans.

Corporate actuarial specialist Milliman recently stated that as at year end 2018, the largest 100 defined benefit corporate pension plans had a funded ratio of 87.1% **or a combined unfunded liability of slightly over $215bn** on total benefit obligations of $1.662 trillion. The liabilities were derived using a return on plan assets of around 6.6% and a discount rate of future liabilities of 4.01%

The 6.6% return assumption we think of as simply wrong and adjust this accordingly.

The easiest way is to do this is via an adjustment to the liabilities using the discount rate as equal to your return on plan assets. We consistently use 2.5% across all companies we analyse – higher than our internal 12-year US equity market return forecast and also higher than the global blended sovereign fixed income market yield on offer out to 20 years - so this could potentially prove optimistic.

Using 2.5% vs the 4.01% discount rate adds approximately $250bn to the total liability taking our estimate of the total level of **underfunding for these 100 companies to $465bn**. This gap between assets and liabilities is a **contractual obligation** that has been made in the past and **needs to be paid for out of future company cashflows.**

Assuming the obligation to members is made up over 10 years **these largest 100 companies need to contribute $46.5bn per annum** pre-tax. Milliman estimates the current $215bn under funding represents around 10% of the top 100 companies' market capitalisation suggesting a $2.15 trillion market capitalisation. Using the 2018-year end market P/E of 18.8x suggests aggregate net income of $114bn for these companies.

Using the US market average tax rate of 23% and 10x interest cover implies EBIT in aggregate of $163bn for the companies.

Therefore – factoring in the cost of pension liabilities to be borne by equity owners reduces the aggregate net income of these 100 companies to $77.4bn vs. the current reported $114bn. **Making this one adjustment** – which we do as part of our process in every instance – dramatically increases the P/E on this basket of securities from 18.8x to 27.8x. Or more pertinently **means a 1/3rd reduction of your normalised cash return** on your existing asset base all else being equal.

Is this reasonable to assume? The assumptions on the maths are factual – so the question is rather will equity holders be asked to make good pension obligations in full in the next 10 years? A look at the period from 2007 to today is informative in this regard.

In 2007 the same 100 companies had a combined projected benefit obligation to their employees in the pension scheme of $1.212 trillion and plan assets of $1.281 trillion. These companies were at the time overfunded as far as the market was concerned by **$68.8bn**. However, the obligations were derived using a discount rate of 6.16% (and at that time our estimates for equity market returns were closer to zero).

Over the next 11 years to the end of 2018, these 100 companies **made additional payments into pension plans (i.e over and above the service cost) of $184bn - yet still ended last year with a $215bn headline liability.**

So, despite $184bn of "unanticipated payments" - the total net liability to shareholders increased $284bn over the 11 years.

Taking this to the level of market returns:

If one accepts that pension liabilities, carefully considered and thought of in the context of future cash out of the business, then using the Milliman report as a proxy for the market, the S&P 500 P/E is not today's 21.8x but 33x. The recent low interest rate, low profit growth, high multiple world is not cost free to the equity holder as **plenty of liabilities have been negatively impacted by this environment – pensions being the most obvious and non-discretionary.**

As markets move higher, potential returns crystalise into gains. With the US market bounce since December 2018 the **S&P 500 currently trades on 21.8x US GAAP** earnings and has a running yield of 1.9%. Assuming one is invested in this index what would be a reasonable return expectation from today?

Long term nominal returns for equity investors is the starting dividend yield plus future earnings growth. It is difficult to responsibly suggest to someone that their savings when needed at some point in the medium-term future, will be worth much if anything more in real terms than they are today. Why?

US Federal Reserve data shows that since WWII corporate profit growth has been slightly over 6.5% p.a.

This period benefited from:

- The largest Demographic tailwind in history
- An increase in the quality of human capital as education became more widespread
- A marked decline in the share of output going to labour
- An increase in the aggregate capital stock driving productivity
- A dramatic rise in cross border trade
- A sharp decline in the effective corporate tax rate
- A switch from the Consumer being a provider, to a consumer of credit
- Declining average debt rates; and
- An increase in monopoly power

Looking forward and putting aside: -

- near record levels of corporate debt;
- historically very low interest rates;
- demographics acting as a headwind to growth; and
- corporate tax rates with limited ability to move materially lower…

…what could an investor in the S&P500 expect to receive by way of returns over the next 10 years assuming today's 1.9% dividend yield and 6.5% rate of profit growth?

Using the average valuation of the S&P 500 of 15x P/E as a guide for 10 years' time, an investor would receive a 4.5% p.a. return, with a little over 40% of this being in dividends and the rest in capital growth. Assuming inflation remains a moderate 2%, an investor in real terms can expect circa 2.5% p.a. real return over the 10 years.

Since the GFC the average US market P/E has been above historical average - so what is the outlook for returns assuming today's 21.8x PE as the new average *(really..really?)* Post the inventory restock profit surge, the level of pre-tax profit growth for US corporates post GFC has been 1.8%pa. to the end of 2018. Even assuming multiples stay nearly 7 turns higher than the historical average **thanks to the "new normal", an investor in the US stock market could expect a nominal 3.7% pa return over 10 years** comprising 1.9% pa dividend and 1.8% capital growth. So, an investor would receive a circa 1.7% real return for the next 10 years.

Taking into account pension costs as per above, but assuming a world in 10 years' time exactly like today – e.g. an exit multiple of 21.8x PE (!!), the average rate of corporate profit growth post-GFC and using today's starting yield of 1.9% - would leave US equity market holders with **a negative nominal return of (0.4%) pa for 10 years or the S&P 500 at 2,304 in March 2029.**

It is worth highlighting **the above maths assumes no decline in record corporate profit margins from today's level** over the next 10 years – a discussion for another day - though I would direct you to a recently published and easily found discussion of the topic by Bridgewater Associates for an excellent summary regarding the outlook in this regard.

Today, we have 17% of the portfolio in US listed equities and a total potential exposure to the region including our commitment to buy shares via put options of 33.9% of the portfolio.

Much of the fuel for strong asset gains the last decade has consequences for the equity holder that are yet to be paid for. **To value a stream of cash flows ignoring such obligations is not a practice we will ever apply for the management of our own money - and most certainly not yours.**

The further out in time you are willing to plan for – now is absolutely the time to use the luxury afforded by strong markets to re-set portfolios and carefully consider what level of asset returns client expenditure decisions are based on.

Our process which favours income over capital growth, numbers over narrative and value over growth is more than ever one which we believe is strongly placed to deliver better than market returns in the coming decade.