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NEW TALENT TENSIONS IN AN ERA OF LOWER INVESTMENT RETURNS

Employers can differentiate themselves by adjusting to the changing financial realities.

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The financial markets are poised to impose new pressures on top-management teams. We're not talking about hitting earnings targets, contending with share-price gyrations, or engaging with activist investors. Those imperatives will not go away. But in the coming decades, they're likely to be joined by something quieter yet perhaps more sweeping: an era of overall investment returns that are substantially lower than those of the past 30 years. The implications are significant for a wide range of stakeholders, and they will spill over to large employers in ways that extend beyond pension management to the heart of many companies' talent equations.

New realities

The starting point for understanding these new realities is the standard disclaimer on investment-fund communications: "Past performance is not necessarily indicative of future results." Over the past 30 years, US and Western European stocks and bonds delivered returns to investors that were considerably higher than the long-term average. Real total returns (including dividends and capital appreciation) on US and Western European equities were between 1.4 and 3.0 percentage points higher in the period from 1985 to 2014 than the 100-year average from 1914 to 2014. Total real bond returns in the United States in those 30 years were 3.3 percentage points above the 100-year average, while in Western Europe they were 4.2 percentage points higher. Returns in this period have shaped the expectations of most investors and executives.

We can link equities and fixed-income investment returns directly to real economic and business fundamentals. Our analysis suggests that the exceptional returns of the past 30 years were underpinned by a confluence of four highly beneficial conditions: lower inflation; falling interest rates; strong global GDP growth that was fueled by positive demographics, productivity gains, and rapid growth in emerging markets, particularly China; and corporate-profit growth in excess of GDP, thanks to the expansion of global markets, lower

borrowing costs, lower taxes, and efficiency gains from automation and global supply chains.

But now each of these four conditions has weakened or reversed. The steep decline in inflation and interest rates that contributed to capital gains, especially for bondholders, is largely over, as rates hover around zero. The employment growth that contributed to GDP growth in the past 30 years is waning because of demographic shifts. And after a period of exceptional profitability, the strongest since the late 1920s, US and Western European corporations face tough new margin pressures from emerging-market competitors, technology firms moving into new sectors, and smaller companies using digital platforms such as Alibaba and Amazon to turn themselves into “micromultinationals.”[1]

As a result, our analysis suggests that total real US and Western European equity returns in the next 20 years could be between 1.5 and 4.0 percentage points lower than they were in the past 30 years. For fixed-income returns, the gap could be between 3.0 and 5.0 percentage points, and in some cases even larger (exhibit). In Western Europe, for example, our projections indicate that total real fixed-income returns could be near zero—or even negative for a few years.

New priorities

Before going further, let us pause to reiterate that these estimates are based on a long-term view of economic and business fundamentals. We are not investment managers or market prognosticators, and we cannot predict how these forces will interact to move markets in the short term. We also recognize that the economy and businesses have the potential to surprise us both positively and negatively—creating and destroying wealth and value in unforeseeable ways that could change the equation of future returns.

Nonetheless, the underlying shifts are real, and they suggest that, barring pleasant surprises such as a major surge in productivity growth, investment returns in the next two decades will be under significant pressure. An era of lower returns would prove challenging for many stakeholders. Municipal retirees, taxpayers, and bondholders, for example, will suffer if lower returns make it harder for already-strapped public pension funds to cover their obligations. (We estimate the deficit for US public-sector pensions could rise to as much as $3 trillion.)

The exposure of corporations is less obvious. Many have already replaced defined-benefit pension plans with defined-contribution plans or have been forced to take a more conservative view on the outlook for investment returns for their remaining defined-benefit liabilities.

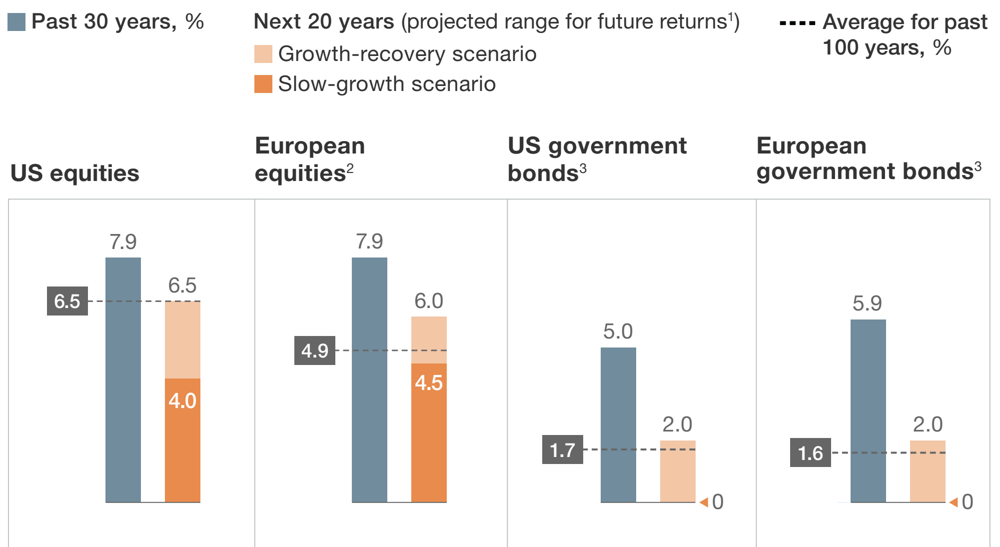
That may remove immediate financial pressure from the books of employers, but it doesn’t shield them from the impact of lower returns on their *employees*,

who now bear investment-market risk as they save for their own retirement. Individuals will feel the impact directly in their investment portfolios and pensions. A two-percentage-point difference in average returns over an extended period means that in order to live as well in retirement as would have been possible with higher returns, a 30-year-old today would have to either work seven years longer or almost double her savings rate—and this does not factor in the effect of rising life expectancy. No matter how you slice it, the implications for employees of a lower-return world are significant, suggesting some new imperatives for employers seeking to attract, retain, and motivate talented workers:

Make the most of long careers. What will happen if large numbers of financially strapped employees seek to extend their careers? On the positive side of the ledger, longer working lives could mitigate the severity of the demographic and skills crunch that many have forecast as baby boomers retire. But those benefits could evaporate if organizations cannot figure out how to make sure their aging workforces remain productive, engaged, and cost effective as the business world changes, the skills they need

Exhibit

After an era of stellar performance, investment returns are likely to come back down to earth over the next 20 years.



[1]Numbers reflect the range between the low end of the slow-growth scenario and the high end of the growth-recovery scenario.
[2]Weighted average real returns based on each year's Geary–Khamis purchasing-power-parity GDP for 14 countries in Western Europe.
[3]Bond duration for United States is primarily 10 years; for Europe, duration varies by country but is typically 20 years.

Source: McKinsey Global Institute analysis (for the full report, see "Why investors may need to lower their sights," on McKinsey.com)

evolve, and their compensation rises with tenure. What's more, older people extending their careers could create challenges for their younger coworkers. Many millennials are already glum about their growth prospects as they look up the corporate ladder. Incumbent companies will have to get creative to compete with start-ups with fewer aging workers.

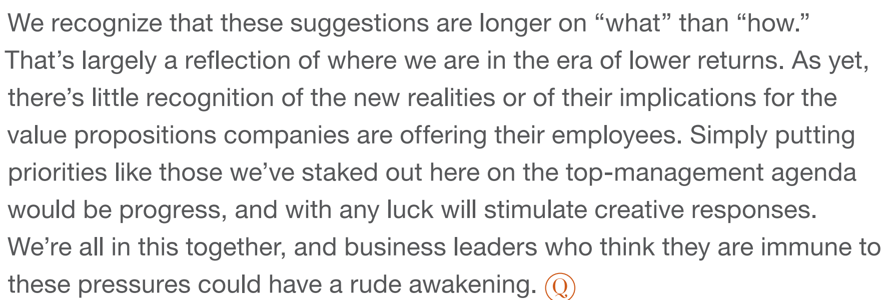
Many companies are now experimenting with alternative solutions, although few would claim they have solved the problem. Two critical steps will be to create different opportunities for would-be retirees and to break the link between tenure and compensation. Numerous surveys have shown that while many retirement-age people would like to continue working, few want or would be effective in traditional full-time positions, particularly those demanding physical strength. Job opportunities that offer flexible hours, part-time schedules, and the ability to work from home are particularly attractive and can be paid on a different scale. Occupations that emphasize training, customer service, advice, and mentoring can put to use the lifetime of institutional knowledge and company-specific skills that older workers have accumulated.

Promote smarter participation in retirement plans and rethink their design. To protect themselves from legal liability, companies have shied away from giving financial advice to employees investing in defined-contribution pension plans. But financial literacy should be a different story. Part of being a good corporate citizen in an era of diminishing returns is helping workers who are unaware of this looming change to plan for it. They need to make more realistic assumptions about their future assets and incomes, adjust their financial and savings behavior accordingly, minimize investment costs, and plan their career paths with new financial realities in mind. Companies that offer realistic financial education might be able to differentiate themselves as employers. In a world where individuals shoulder the risks of retirement, companies that help them think more intelligently about those risks are making a real contribution to their people and to society.

Beyond financial education for employees, behavioral economics has shown that a variety of "nudges" can shift people's behavior.[2] Making enrollment and investment in defined-contribution retirement plans automatic, with an opt-out provision, rather than requiring employees to sign up for them, has been shown to boost participation dramatically. Similarly, the initial monthly deposit into such accounts can be set low and automatically escalate each year. The default investment option for these plans, moreover, should be a diversified portfolio of bonds and equities, not a money-market fund. Many companies have begun to offer target-date retirement portfolios to their employees to simplify their decisions. These plans typically adjust over time, shifting from more-volatile equities to more-stable fixed-income returns as people approach retirement age. The fact is, in a busy world with many

competing demands, few people choose to use their limited time and mental energy to research retirement investment options or portfolio allocations.

Refocus compensation plans on long-term performance. Company stock plans and share-option schemes have become an important part of compensation packages—particularly for senior executives, as the compensation committees of boards have tried to link pay, in part, to their companies' stock prices. If stock-market performance lags behind the returns of the recent past, existing compensation packages that link executive and employee pay to stock-price performance won't deliver the results executives have come to expect. It also will be more difficult to meet shareholders' expectations, potentially intensifying the pressure on executives to deliver short-term financial performance. That pressure has been increasing since 2008, according to a recent McKinsey survey—which could make this an auspicious moment to reset incentive programs for executives and employees. Such programs could be altered to focus on long-term performance (five years is the time horizon urged by Fidelity Investments, the North America–based mutual-fund and financial-services firm[3]), to reward stock performance relative to the market or to the company's sector, and to incorporate operating metrics beyond a company's share-price movements.


We recognize that these suggestions are longer on "what" than "how." That's largely a reflection of where we are in the era of lower returns. As yet, there's little recognition of the new realities or of their implications for the value propositions companies are offering their employees. Simply putting priorities like those we've staked out here on the top-management agenda would be progress, and with any luck will stimulate creative responses. We're all in this together, and business leaders who think they are immune to these pressures could have a rude awakening.

[1] See Richard Dobbs, Tim Koller, and Sree Ramaswamy, "The future and how to survive it," *Harvard Business Review*, October 2015, hbr.org.

[2] See Cass R. Sunstein and Richard H. Thaler, *Nudge: Improving Decisions About Health, Wealth, and Happiness*, revised and expanded edition, New York, NY: Penguin Books, 2009.

[3] "Appendix: Proxy voting guidelines," fidelityinternational.com.

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Download the authors' full report, *Diminishing returns: Why investors may need to lower their expectations*, on McKinsey.com.