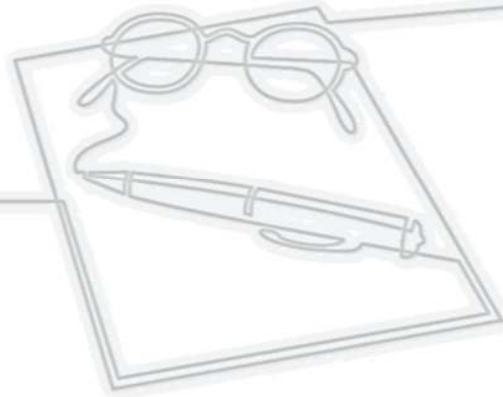


Are Your Investment Returns “Real” Or Not?

by: The RGT Investment Management Team | September 2019



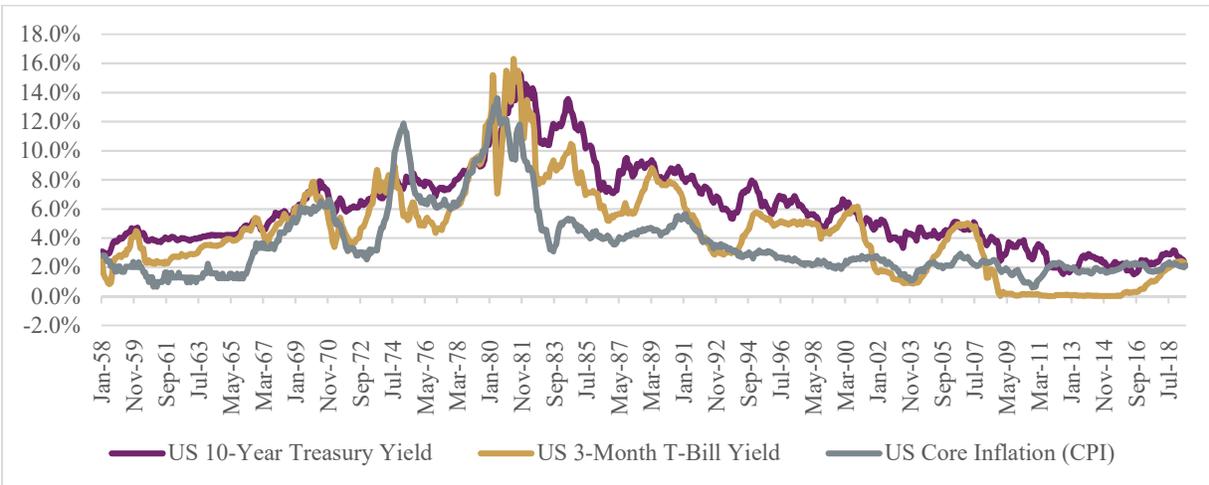
Annual rates of inflation are important to consider when investing for the future. Over the last several decades, annual inflation in the U.S. has ranged from as high as 13% in 1980 (based on the Consumer Price Index) to as low as 0.1% in 2015. Other countries have experienced much higher inflation than the U.S., sometimes for significant periods of time. The rate of inflation impacts cost of living and as a result, the amount of income required to meet expenses over time. Inflation also directly affects the anticipated returns from most investments such as stocks, bonds, commodities and real estate.

For investors, it's important to remember the “real” rate of return is critical. The “real” rate of return is often described as the “nominal” or stated rate of return minus the rate of inflation. Additionally, taxes decrease the net return from investing. In other words, if a portfolio is earning just enough to stay ahead of the general level of inflation and a portion of the return must be used to pay taxes, has the portfolio really grown in “real” terms? Probably not. In addition to taking this issue into account for private savings, the Social Security System also has the same challenge of keeping up with inflation while paying out enough income to retirees in order for them to be able to meet their basic needs. ***Determining whether the long-term average portfolio return is high enough to overcome inflation is important in achieving financial objectives in the future. Is retirement possible given one's current and future desired lifestyle? Which colleges will children or grandchildren be able to attend based on the rising cost of education? Will there be funds left over to support any favorite charities? And on, and on....***

During the 1980's, given much higher interest rates and levels of inflation than we have in 2019, investment return expectations were generally higher than they are today. For example, government bonds were paying as much as 15% per year and had virtually no credit risk since they were issued by the U.S. Treasury. Certificates of deposit offered 12%+ yields annually and featured FDIC insurance as a layer of protection against loss. Other income earning securities, such as mortgage backed bonds or

preferred stocks provided annual yields above 10%. To some investors, these were “the good old days”. Or were they? The answer depends on the investor’s perspective.

The chart below provides a comparison between interest rate levels over the decades. Since peaking in the early 1980’s, interest rates and inflation have been moving in a general downward direction.



If given the choice, would investors prefer to earn higher rates of interest on “risk free” securities, or would they opt for something else? Why do interest rates increase and decrease over the course of time? How do interest and inflation rates affect the ultimate annual returns and ability of investors to reach their financial goals? These questions are important to examine and, when evaluating, need to consider the “real” portfolio rate of return.

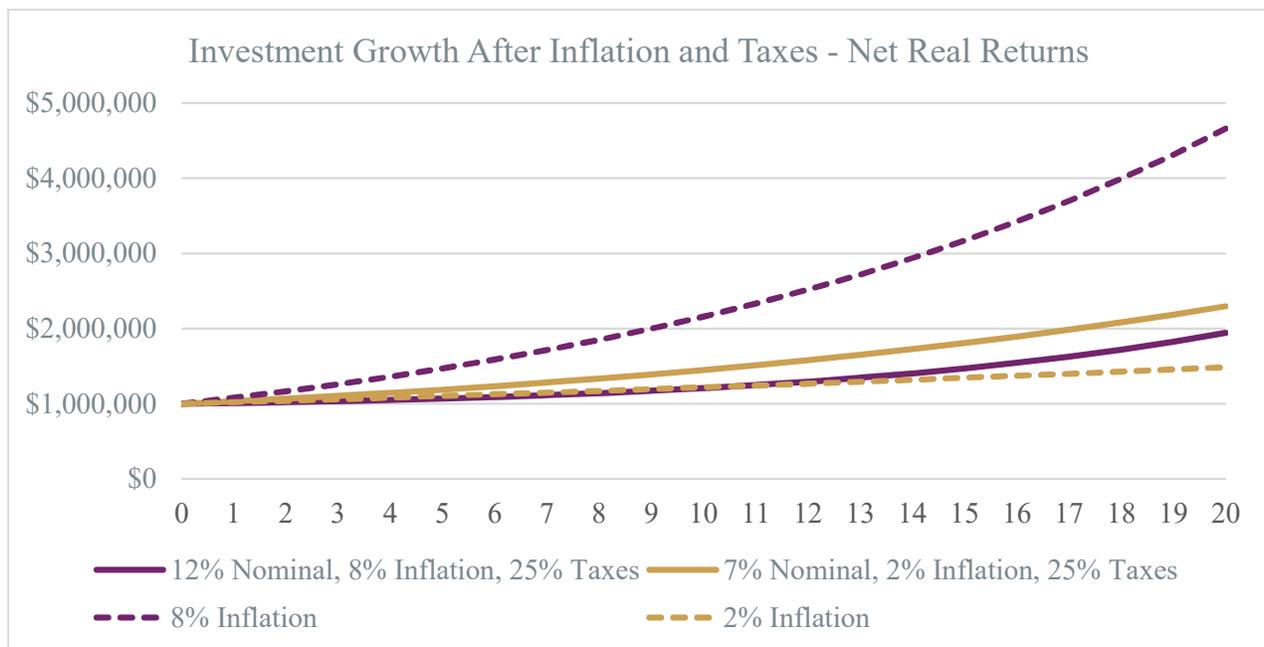
The market level of interest rates is influenced by many different factors. Some of these factors include the current level of inflation, expectations of future inflation rates, interest rates in foreign developed countries, current and expected economic growth rates, perceptions of credit risk, the term structure of interest rates, and income taxes. Suffice to say, interest rates and inflation move constantly due to many variables. Both are impacted by what market participants believe is important in the short-term and any changes that might occur over the ensuing months and years.

Why is this critical for investors to consider? The scenario below offers one example. Which investment should an investor prefer: an investment with a 12% annual return, 100% of which is derived from income that is fully taxable during a time when inflation is 8% or an investment with an annual return of 7%, all of which is derived from unrealized capital gains when inflation is 2%?

In the first example, if a 12% return is earned from current income and tax rates are assumed to be 25% on this income, the after-tax return is approximately 9%. **Subtracting the 8% inflation from this rate provides the net after-tax “real” return of +1%**, meaning the “real” rate of return is only barely positive

and the investment portfolio has simply kept up with inflation. In the second example, the total return of 7% is not currently taxed since it is deferred until the investment is sold. Assuming inflation of 2%, the “real” return on this investment is +5% in the first year. ***Thus, the investment has gained ground by 5% over inflation during this period.*** The goal of any investment strategy is to earn an after-tax “real” rate of return, so the investor can grow his/her portfolio to reach a specific financial goal. Earning a higher “nominal” return of 12% in the example above didn’t provide as much of a positive post-tax “real” return toward these goals. The differential, or “real” return is what is valuable.

Let’s see the impact of earning a “real” return vs. a “nominal” return on \$1 million of investment:



As you can see, the difference above is significant and is important to consider in the context of one’s financial objectives. Focusing on “real” portfolio returns is critical to understanding how portfolios grow and provide the means to reach retirement and other goals. Understanding the difference between “nominal” returns and the net “real” return of an investment allows investors to make more informed decisions and can help investors understand implications of the returns being offered in capital markets.

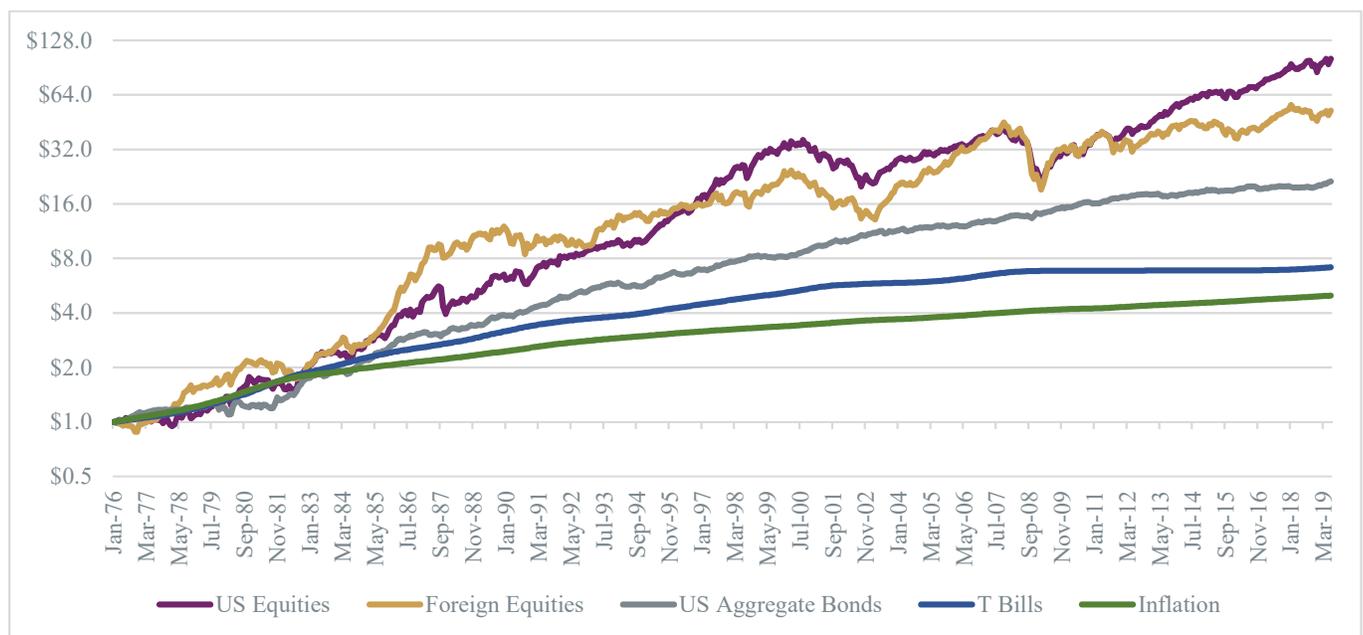
In today’s investment environment what is a realistic “real” rate of return to expect?

Inflation in the U.S. and in many developed foreign countries has been quite low since the financial crisis of 2007 – 2009. In the U.S., current levels of inflation are in the range of 1.5% - 2.0% annually. Thus, annual portfolio returns of 6-8%, less the impact from taxes (which varies depending on taxable/tax-free income and capital gains being realized), less inflation of 1.5 – 2.0%, equates to a “real” return of roughly 4 – 5%. ***As mentioned earlier, if “real” annual rates of return are positive, let alone over 4%, the portfolio has gained important ground relative to the general level of inflation. Historically, investment***

returns achieving post-tax “real” annual returns of at least 3% are considered difficult to consistently earn without increasing levels of risk.

Keep in mind, the purpose of beating inflation after the payment of income taxes through higher rates of return is designed to do one important thing - build a portfolio which will support future cash distributions for retirement income or other needs. So, using an example of a \$1,000,000 portfolio, the larger it can grow and the more often it earns a nominal rate of return which is significantly higher than inflation plus taxes, the more money is available to achieving one’s financial goals.

Looking back in history, long-term returns from various investment assets are shown below. Inflation and interest rates in the U.S. are also included in the graph. Please note how certain investments performed at a higher rate than inflation and others have not. It is important to keep this in mind when designing an investment portfolio.



Source: Bloomberg, Federal Reserve Bank of St. Louis. US Equities: S&P 500 Index; Foreign Equities: MSCI World ex-USA Index 1/31/76-12/31/87 then MSCI ACWI ex-USA Index thereafter; US Aggregate Bonds: Bloomberg Barclays US Aggregate Bond Index; T Bills: 3M T-Bill yields transformed into monthly returns from 1/31/76-12/31/91, then Bloomberg Barclays US Treasury Bill Index (1-3M) thereafter; Inflation: CPI for All Urban Consumers less Food & Energy (Core CPI), Seasonally Adjusted

Financial market history doesn’t always closely repeat previous cycles, but it is important to consider these prior trends when investing. Equities (which have higher volatility and expected returns) have produced positive “real” returns while other investments, such as U.S. Treasury Bills, have only kept up with the average rate of inflation over the long-term. In summary, investors need to fully understand how a diversified portfolio strategy can provide excess “real” returns at acceptable risk levels.

Please let us know if you want to discuss these topics further.

Thank you for the opportunity to provide this information and analysis.

Please contact RGT with additional questions.

5950 Sherry Lane, Suite 600 | Dallas, TX 75225 | 214.360.7000 | www.RGTAdvisors.com