

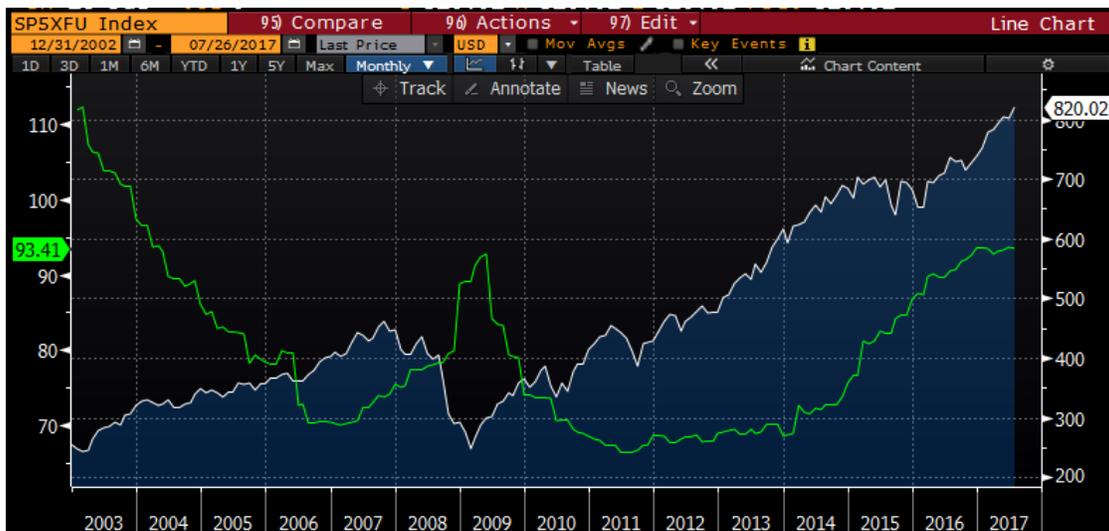
Debt-to-Equity Ratio: the past, the present and the “new normal”?

A number of reports have come out over the last few years which put forward the view that investors will have to come to terms with lower returns going forward than they are used to from the past several decades. The argument often boils down to: with rates, as low as they are, either bond returns will be low, or, if rates rise, stocks performance will be hurt. Here is one perspective on the stock performance portion of that statement.

Debt-to-Equity Ratio

The following graph shows the price and the debt-to-equity ratio of the S&P 500 Ex-Financials (SP5XFU Index in Bloomberg). Financials are excluded from this analysis because they underwent a massive deleveraging after the Financial Crisis and skew the data. The price is in white using the right axis, and the debt-to-equity ratio is in green using the left axis.

Price and Debt-to-Equity Ratio of the S&P 500 Ex-Financials (2003 – 2017)



Source: Bloomberg

There is a very interesting feature that jumps out from a cursory comparison of the two bull markets. In 2003-2007, the debt-to-equity ratio was dropping, which is the usual case during rising equities. However, in 2012-2017, the debt-to-equity ratio rose with equities.

Price and Debt-to-Equity Ratio of the S&P 500 Ex-Financials

2003 – 2007 (the normal pattern)



Source: Bloomberg

2012 – 2017 (the unusual result)

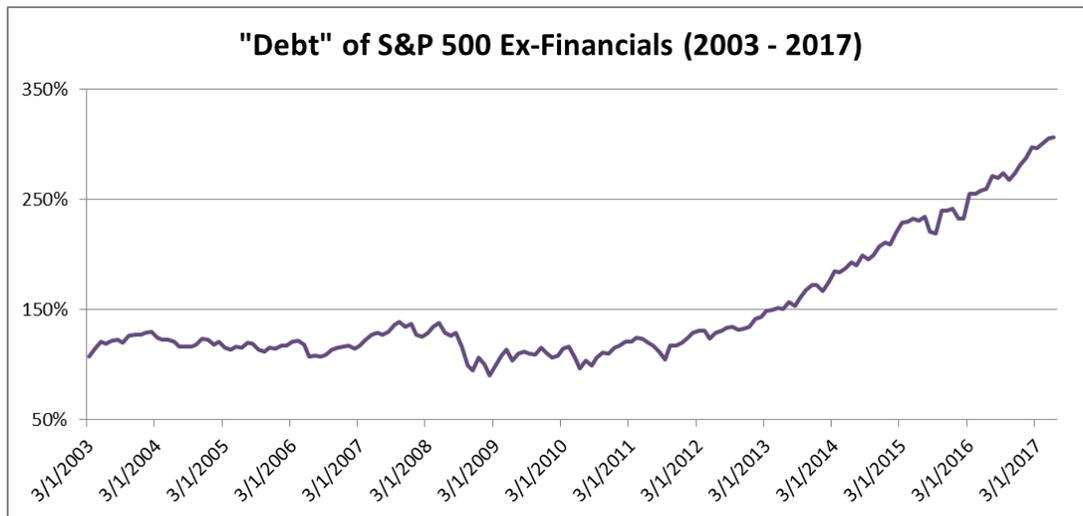


Source: Bloomberg

This changing pattern holds an interesting consequence for total debt. Here we use changes in price as a proxy for changes in equity. The approximation works for the purposes of this illustration. Under that approximation, the product of debt-to-equity with price (as a proxy for equity) is total debt, which we will call “debt” because of the use of a proxy.

$$\frac{\text{Debt}}{\text{Equity}} \times \text{“Equity”} = \text{“Debt”}$$

Here is a graph of “debt” from 2003 to 2017



Source: Bloomberg

Through a bull market, a crisis, and a recovery (2003-2011), “debt” varied from about 90% to about 140% of its 2003 value. However, from 2012-2017, that value grew over to 300%. Of course, it does make some sense to borrow and spend when rates are very low – that was part of the point of low rates, after all – but the resulting increased debt brings us full circle to the view that investors may be in store for lower returns going forward.

If rates go up, financing that debt may become burdensome for companies and take a toll on their stock prices. If rates do not go up, bond yields will remain low. Furthermore, there may be little or no additional room for growth of capital in bond investments if rates have little or no room to fall from current levels.

Conclusion

There may be no reason to expect a crisis. After all, that “debt” graph could have inspired calls for a crisis since 2014 (with unfortunate results for investors who bailed out of equities). However, there may be reason to expect a blended stock/bond portfolio to produce, perhaps, 4-6% per year in the

future instead of the 6-8% per year of the past 30 years. If that doesn't sound like much, consider the difference between a 5% return and a 7% return compounded over the course of a 40-year investment lifetime. The former produces a 604% gain; the latter produces a 1,397% gain. Put another way, it would take 55-56 years at 5% to produce the same total produced by 40 years at 7%. Those differences have consequences for every pension, individual, lifestyle, etc.

If measures are taken sooner to address the shortfall, then those measures may not need to be as drastic. That is where alternatives with high target returns may be useful. For example, a 33% return on just 6% of a portfolio can make up that 2% shortfall.

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