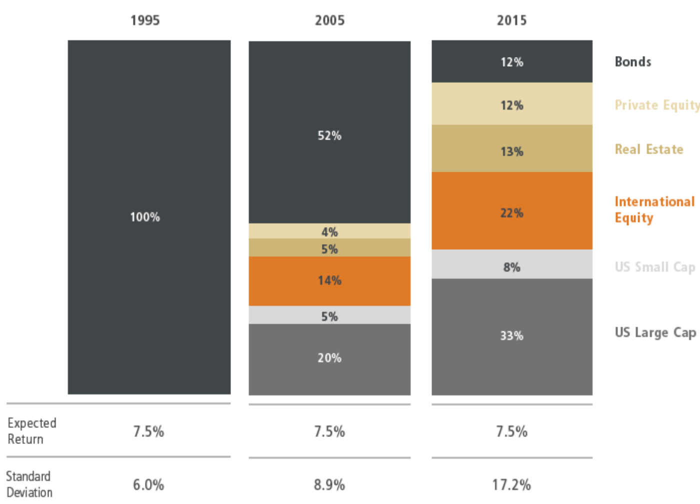
It is an adage in investment circles that risk is the currency with which you buy return. Risk, in this context, is defined as the uncertainty of outcomes that may result in a capital loss in one's portfolio. In other words, the more risk you are willing to take the greater return you can expect. Curious then that academic research suggests that many people view the risk-return to be negatively correlated – that is, that investments with better returns are perceived to be less risky.[1] This relationship between risk and return is an important consideration, particularly as the current bull market is inching towards record territory for its length – we are now 100 months into this bull market (which started in March 2009) while the longest bull market in history was 113 months (between October 1990 and March 2000).[2]

How has the relationship between risk and return evolved over the last few years? I will share a chart from a previous commentary that neatly encapsulates the relationship. The chart below shows that to achieve the same 7.5% return, an investor today would have to take almost **three** times as much risk. Investors, including institutional investors, are taking on more risk in the pursuit of incremental potential returns. Allocation to alternative strategies are increasing dramatically for institutions and for a growing number of private clients. While this makes sense for part of the portfolio, liquidity and income requirements from the portfolio, and simple human behaviour suggest that many may rue the day when they forgot the lessons of the past and the unbreakable link between risk and return. To be clear, alternative investments make perfect sense as a small component of a diversified portfolio; however, we are seeing far too many investors tempted to use these investments as the core of their portfolio, without realizing the risk exposure they may be adding to their portfolios.



For illustration purposes only.
Source: Wall Street Journal, Callan Associates

Bill Gross, former head of PIMCO and now head of Janus Henderson, says that US markets are at their highest risk level since before the 2008 financial crisis because of investors chasing returns.[3] He, nevertheless, sees the need to

[1] Alhakami, Ali Siddiq, and Paul Slovic. "A psychological study of the inverse relationship between perceived risk and perceived benefit." Risk analysis 14.6 (1994): 1085-1096.

[2] http://fortune.com/2017/03/09/stock-market-bull-market-longest/

[3] https://www.bloomberg.com/news/articles/2017-06-07/bill-gross-says-market-risk-is-highest-since-before-2008-crisis

stay invested and says that investors need to understand that it is a changed world, that returns are going to be lower and that being able to sleep at night requires one to accept the market as it is. We agree with Gross' comments and is exactly what we have been telling our clients. We also believe that diversified asset allocation and disciplined security selection, rather than simply buying the index, will be the best way to maximize risk-adjusted returns under current market conditions.

Let us also put return expectations in perspective. Historically, the link between government bond returns and equity returns has been stable although declining over recent years. As the table below shows, the "premium" one receives from investing in the S&P500 vs. a 10-year US government bond has averaged 3.42% over the 40 years from 1967 to the end of last year. Looking just at the period since the crisis, that premium has shrunk to 2.30% a year. But, to put it in perspective, the premium in the 30 years' ***pre***-crisis was 3.50%. So, the drop in equity market premium has only been about 1%. A good crystal ball as to what US equity returns to expect in the coming years (recognizing the role of volatility and market shocks) is to look at the 10-year US government bond yield and add 2 – 3 per cent (i.e. the historic equity premium). If that number looks low, (i) get used to it and (ii) thank the unprecedented low bond returns, don't blame equity markets.

Average Annual Returns	S&P 500	US 10 Yr. Govt. Bonds	Equity Premium
1967-2016	10.09%	6.66%	3.42%
2007-2016	6.88%	4.58%	2.30%
1967-2007	10.77%	7.26%	3.50%

Source: Aswath Damodaran, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html, accessed January 30, 2017, author's calculations

A recent move to increase rates in the US and Canada along with anticipated increases in other markets may be the beginning of the end of the post-crisis low return world. We would caution, however, that it is too early to start popping the champagne. A few lessons from the past that investors would do well to remember: (i) don't take on additional risk by chasing returns if you are not ready for the consequences and (ii) a diversified portfolio that is matched to goals and that avoids chasing returns through a disciplined investment strategy remains the best prescription for today's world. Talk to your Investment Counsellor and ensure that your goals and portfolio continue to be aligned.