**Expectation management**

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Given the economic situation in Pakistan, which needless to say keeps one perpetually distressed, I was recently recommended a book by my one-time professor in university (now a close friend) on how to deal with an environment of low prospective returns. The book, his latest, by Antti Ilmanen, “Investing Amid Low Expected Returns”, is a fascinating read and an amazing effort in collecting data spanning well over a decade, updating it, correlating it and then making sense of it through research and by disseminating the underlying trends and lessons. Ten years ago, Ilmanen, a finance whizz, published “Expected Returns, a brilliant distillation of investment theory, practice and wisdom—it instantly became an international bestseller. In essence, the book attempts to sort the good stuff from the junk.

In an attempt to analyse some aspects of Mr. Ilmanen’s warnings and their relevance in today’s context to Pakistan, let’s start with a recap of the expected-return framework. There are two sources of return on investment: Income and Capital gain. The income, on for instance, a government bond is the interest paid once or twice a year. Bond prices and yields move inversely. So when interest rates fall, as did much of the past four decades, bond investors enjoy a capital gain. In essence, a capital gain of this kind brings forward future returns. Meaning, you get the income now that you were going to get later.

[President Alvi condemns Israeli aggression against Palestinians](https://www.nation.com.pk/05-Apr-2023/president-alvi-condemns-israeli-aggression-against-palestinians)

But as yields fall ever lower the scope for further capital gains becomes more limited. So low yields imply low expected returns. This bond-like logic also holds for other assets—equities, property, private equity and so on. And this is exactly what we have seen lately in the shape of financial sector (banking) erosion over the last 2 weeks or so. As interest rates started going up and the large treasury bonds that the banks were sitting on became low yielding with a depreciating capital value and when the investors and depositors got scent of the brewing risk, these banks simply didn’t have the cash or margins to pay-out, in-turn resulting in equity erosions or stock meltdowns from Silicon Valley bank in the USA to BNP Paribas in France to UniCredit in Italy to Deutsche Bank in Germany and the fallout continues. Now imagine the risk here in Pakistan where our banks hold almost on average an 85 percent exposure with the government.

As the interest rates today rise to unprecedented levels, the short-term gains to these banks may be tempting under the false pretense of sovereign lending, but the reality is that with mounting desperation from the government to borrow more and more with each passing day, the previous treasury instruments with these commercial banks start turning toxic quicker than they can fathom.

[Foreign vets give new lease of life to ailing elephant at Karachi Zoo](https://www.nation.com.pk/05-Apr-2023/foreign-vets-give-new-lease-of-life-to-ailing-elephant-at-karachi-zoo)

Even a slight hiccup in the system can result in a bank run on any of the weaker/smaller banks, thereby assuming a much larger domino effect taking down with it the entire domestic financial structure. It is for this reason that one not only needs to avoid any more interest rate hikes but also at the same time has to move quickly to restrain the government from borrowing more by instead consciously ceding space to the private sector.

However, the present-day concern in Pakistan is that the size of the government may already have reached unsustainable proportions! Mr. Ilmanen’s second warning comes from the current wave of global inflation, where needless to say Pakistan again appears to be at very high risk with inflation clocking around 47 percent. He argues that low expected returns can materialise through either “slow” or “fast” pain. In the slow-pain scenario, assets remain expensive and investors receive desultory bond coupons, equity dividends and rental receipts for years on end.

[Imran decides against appearing before IHC tomorrow](https://www.nation.com.pk/05-Apr-2023/imran-decides-against-appearing-before-ihc-tomorrow)

In the fast-pain scenario, the yields revert to their higher historical averages. This implies a spell of brutal capital losses followed by fairer returns thereafter. The choice is between well-heeled stagnation and a crash.

He opines that over the past 2 to 3 decades, globally in general, a low inflationary environment made the high asset price while maintaining low to standard yields. Many of the factors that kept a lid on inflation—globalisation, efficient supply-chain management, tight fiscal policy, an expanding global workforce—are now attenuating or winding. Ironically, in Pakistan, none of his theories hold ground in totality, because the markets have been continuously distorted by the state as a big player thereby leading to anti-trust violations and even rent-seeking. In addition, unchecked external borrowings and growth primarily led through imports resulted in a foreign currency crunch in turn leading to massive devaluation and hyperinflation. The trouble now is that instead of correcting course, the economic managers rather somehow keep the existing financial structure by further borrowing and some very counterproductive taxation. Something that is pushing Pakistan deeper into an era of low investment, low growth, business closures, stagflation, unemployment and poverty.

[SC stands up for constitution by rejecting doctrine of necessity: Imran Khan](https://www.nation.com.pk/05-Apr-2023/sc-stands-up-for-constitution-by-rejecting-doctrine-of-necessity-imran-khan)

Finally, the book touches on the dilemma that investors face when confronted with poor policymaking, diminishing returns, a hostile government and no real hope in sight. Perhaps nowhere would this phenomenon hold truer than in Pakistan today. Faced with lower expected returns, investors basically have three courses of action: they can take more risk to reach for higher returns (no longer applicable in the case of Pakistan); they can save more (again no longer applicable in Pakistanis owing to extremely high inflation, a devaluing currency and tax policies that in essence discourage savings); or they can accept reality and play the hand they have been dealt.

The last course seems to be perhaps the one for us as not only it provides solace by strengthening one’s belief in divinity, but also thankfully side tracks the big philosophical questions that for us in many ways are best left unanswered—saving the investors and entrepreneurs a lot of heartaches!