The Role of Capital Market Assumptions

What are the roles of expected return forecasts?

How much does it matter which set of forecasts an investor uses?

Clients often ask: "*Why bother developing forecasts, when over any extended period actual returns for most asset classes differ (sometimes significantly!) from expectations?*" and "*Do differences among managers' and consultants' expected return forecasts lead to different investment outcomes?*"

We believe the more relevant questions are: "*What are we trying to accomplish by forecasting expected returns?*" and "*How might the forecasts affect investment outcomes?*"

There are two, somewhat independent, roles for asset class return forecasts. The first is to help investors set expectations regarding what their portfolios are likely to earn. The second is that the forecasts are an integral part of the asset allocation process. In this Viewpoint, we begin by illustrating the relationship between expected and realized returns and conclude by explaining the role of expected returns in the asset allocation process.

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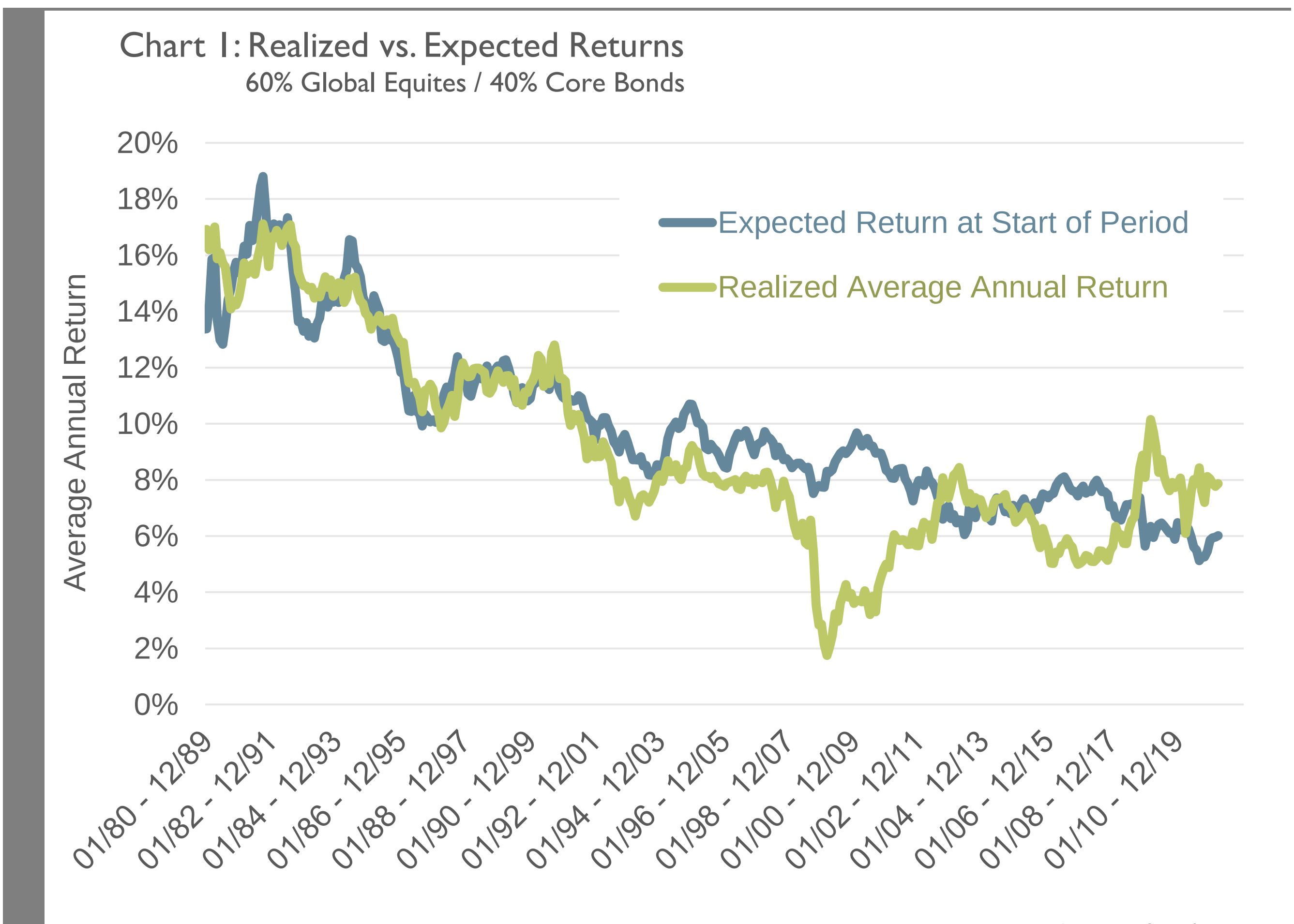
Expected vs. Realized Returns

Since investment results are ultimately determined by what actually happens in the economy and capital markets, expected and realized returns converge only when the world provides no major surprises. For many 10-year periods through the 1990s, results were similar to expectations, but over the past 20 years that was not the case.

Chart 1 shows rolling 10-year realized returns for an indexed 60/40 portfolio[1] and the expected return[2] at the start of each 10-year period. During the 1980s and 1990s, the two lines tracked closely as bull and bear markets were relatively muted. However, meaningful divergences between expectations and reality developed when markets experienced significant gyrations, first during the 2000 tech stock bubble and then during the 2008-09 global financial crisis. More recently, stocks' historic P/E multiple expansion caused another large gap between forecasted and realized returns.[3] Future divergences are possible and perhaps likely, but when, by how much, for how long, and in what direction are all, of course, unknown.



Data Source: Bloomberg, L.P.

Expected returns are an important input to the asset allocation process

Because portfolios with similar asset allocations will realize similar returns, the important considerations are a) how do differences in expected return forecasts lead to different strategic allocations? and b) by how much are different expectations likely to affect investment outcomes?[4] It turns out that for most institutional investors, the answer to both the allocation and outcome question is the same: not very much.

There are multiple reasons for this.

1. Investment policies typically aim to maximize long-term returns consistent with a prudent level of risk, and most institutional investors have similar risk (i.e., volatility) targets. As a result, their strategic asset allocations tend to have similar stock/bond mixes, regardless of different expected return assumptions.

2. Institutional investors tend to employ similar approaches and techniques in developing their long-term return forecasts.[5]

- For example, fixed income expectations are typically constructed by combining observable current yields with credit loss projections. Because the effect of rising (falling) interest rates on bond prices will be offset by higher (lower) reinvestment returns over long time periods, the effect of expected interest rate changes is less important when developing longer-term fixed income return forecasts.
- Expected equity returns are typically constructed using a building-block approach comprised of yield + inflation + real earnings growth + change in valuation. Because these components are proxies for widely observed trends, it is not surprising that forecasts using this common approach produce similar expectations.

3. Different sets of expected returns subject to the same risk target and asset class constraints are likely to produce very similar, potentially identical, asset allocation recommendations.

- When a portfolio is constructed using traditional mean-variance techniques, the optimal portfolio does not change when all expected returns are increased or decreased by a constant amount. Moreover, in simple stock/bond portfolios, optimal asset class weights for a given risk target do not change when the expected return of one is increased relative to the other.
- Even when the opportunity set expands to include multiple asset classes, the optimal stock/bond mix tends to remain relatively stable following the imposition of a risk target. Moreover, the effect of differences in expected return is moderated by asset class constraints – the more binding the constraints, the less sensitive the mix.[6]

Summary

Investors often ask, “*Which set of expected returns should I use?*” Consultants and asset managers usually prefer their own proprietary set of return expectations and eagerly explain why their forecasts are superior.

The reality is that if capital markets follow patterns and cycles similar to those exhibited during the past 20 years, analyzing differences among return projections is unlikely to provide any useful insight. Put another way, because asset allocation is the primary determinant of realized portfolio returns, a sound method for translating return expectations into strategic recommendations matters more than the specific set (however credible) of return expectations used.

Endnotes

1. 60% stocks (36% US, 24% international), 40% core bonds. Rebalanced monthly.
2. Expected US and international equity returns were provided by a large institutional investment manager. Expected bond returns were proxied using the yield-to-maturity of the Bloomberg Barclays Aggregate Bond Index.
3. The recent P/E expansion suggests that investors either raised their estimates of future earnings growth or lowered the discount rate they applied to future cash flows. Either way, the elevated equity returns recently realized were unexpected by the average investor.
4. This discussion focuses on the implications of differences in forecasts of longer-term asset class returns for strategic asset allocation. Successful tactical asset allocation requires skill in forecasting shorter-term asset class returns, or changes in expected returns through time.
5. Tactical (i.e., short- or intermediate-term) estimates of expected returns are usually developed using other factors and techniques.
6. In general, increasing the expected return of equities relative to sovereign bonds tends to result in slightly higher equity allocations, offset by a shift away from high yield to investment grade bonds. Increasing the expected return of sovereign bonds relative to equities produces the opposite pattern.

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