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Talking to clients about expected returns

Too often, media reports omit inflation and asset classes from projections (includes chart)

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Of all the assumptions that go into clients' retirement plans, none has a bigger impact than the expected return on their investments. That number determines how much investors need to save, when they can afford to retire and the kind of retirement lifestyle they can plan for.

Coverage in the mass media about the returns investors can expect is often singularly unhelpful in bringing clarity to this question.

In part, this lack of clarity arises because, all too often, the media tend to feature "voices of doom." Consider the profile given to Harry S. Dent Jr.'s recent book, The Great Depression Ahead. Or to Robert Prechter, who developed the Elliott Wave Theory; he has been a "perma-bear" since 1987.

And, in part, the media's frequent failure, when discussing a client's return forecast, to clarify whether that return is before or after inflation, whether it's for equities only or for a balanced portfolio, also leads to confusion.

As just one example, a recent Wall Street Journal article indicated that the giant State of California pension plan, CalPERS, is reducing the projected return of 7.75% it has had in place since 2003. Lost in that article was the fact that this return was for its total portfolio of stocks, bonds, real estate and other investments — not just equities.

The same article quoted the head of U.S. fund giant and fixed-income specialist Blackrock Inc. to the effect that pension plans would be "lucky to earn 6%." Again, nowhere was it clear whether this 6% was for equities alone or for a total portfolio.

And a recent article in a Toronto newspaper prominently featured a Toronto planner's advice that clients should plan on a 4% return — without clarifying whether that was before or after inflation or, again, whether for equities or a balanced portfolio.

> Framing A Client Conversation

The discussion about the expected return on investments is one of the most important conversations you can have with clients.

You could start by reminding clients that over the very long term, stocks have averaged a pre-inflation return of about 10% a year – even considering the market turmoil of 2008.

You could then acknowledge that in the past while, many credible industry voices have suggested that it would be overly optimistic to expect this kind of return now.

When it comes to your return assumptions, there are obvious costs to being too bullish. Too rosy an assumption can lead to disappointment as clients save too little and, as a result, fall short of their goals.

But there's a price to being too conservative as well, as overly pessimistic assumptions can lead to undue stress and to inves-tors making bad financial choices.

A financial planning newspaper feature last fall profiled a 38-year-old single woman who had saved $40,000 over the past seven years. She asked if she could afford a $150,000 condo to replace the apartment she'd been renting. Her parents had offered to give her money toward a down payment. The financial planner who answered the question said that she could do it, but that it would be "touch and go." The reason this move would be iffy was very simple: the planner assumed an inflation rate of 3% and returns on her investments of 5% before retirement and 4% after retirement.

Run those return and inflation assumptions into your retirement calculator and chances are that at least 80% of retirement plans would fail.

The other cost to unduly pessimistic assumptions is that they could lead clients to make poor decisions about investing. After all, if you think you're going to get low, single-digit returns on stocks, why not just buy GICs?

> Two Key Decisions

To think intelligently about expected returns, you need to talk to your clients about two things.

First, shift their thinking to after-inflation, real returns instead of the nominal, pre-inflation returns so commonly used. This way, you'll focus on spending power — what really counts in retirement. This is what sophisticated pension plans and high net-worth investors focus on.

Second, you have to help your clients extend their time frames. The shorter the time frame, the more dispersion a client will experience on returns. Pick one year as your time horizon, and you could experience swings of 50% in either direction.

Even five- and 10-year periods subject you to substantial swings in returns on stocks. That's especially true if your clients, like many investors, base their expectations on what has happened in the past three to five years. The only way to bring stability to clients' expected returns is to follow pension funds and high net-worth investors, and look forward 15 or 20 years. That may seem a long time frame to some clients, but it is the minimum horizon most Canadians need to consider. Even if your clients are a 65-year-old couple, half the time one of them will live to age 90. And one in 10 couples will see the last survivor reach age 98 — a 33-year time horizon.

> Looking Inside Average Returns

The third key decision for investors is to look beyond averages. There is good data on stock-market returns in the U.S. going back to 1926. In the 85 years since then, after-inflation returns have averaged 6.6%.

The big difficulty with an average number is that often you'll be below it. When selecting the forecast return for the equities component of clients' portfolios, help them look beyond the average return to the distribution of returns that created that average. That will tell your clients how far they might fall short, based on historical precedent.

Recently, we looked at long-run total returns (including both capital appreciation and reinvested dividends) on the S&P 500 index, using Morningstar Inc.'s EnCorr software. Since 1926, there have been 65 20-year periods. The accompanying chart shows how often certain levels of return were achieved throughout those 65 periods.

> Picking The Right Number

In recommending the expected return for the equities component of clients' investments, you could pick the after-inflation return that's halfway down the list. That would give you a return of 8.5%. However, this choice leaves a material risk of underperformance.

For those clients who want to be more prudent, you should choose one of the lower numbers, for example, the 5% that was achieved two-thirds of the time or the 3.3% that was met or exceeded 80% of the time. A recent article in the Financial Analysts Journal forecasted a real return of 4% for U.S. stocks, so you would have some good company at these levels.

Or you could be really cautious and pick the 1.8% that was delivered 95% of the time.

Of note, the worst after-inflation returns all occurred during the high-inflation years in the 1970s.

As a result, your recommendation on the return assumption for the stock component of clients' savings will be heavily influenced by your concern about a return to inflation.

Picking the return assumption to recommend for equities will vary with your and your clients' attitude toward risk. There clearly is no one right number.

However, by focusing on after-inflation returns, taking a long-term view and digging deep into the range of historical experience, you can help clients end up with a realistic number that strikes the right balance between undue optimism and extreme pessimism. IE

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Historical returns

S&P 500 annual returns after inflation in the 65 20-year periods from 1926 to 2009:

Minimum return (%)	% of the time this return occurred	Number of times this return occurred
13.3	1	1 of 65 20-yr. periods
12.7	5	3 of 65
11.9	10	7 of 65
10.8	20	13 of 65
9.3	33	22 of 65
8.5	50	33 of 65
5.0	67	42 of 65
3.3	80	52 of 65
2.2	90	59 of 65
1.8	95	62 of 65
0.8	100	65 of 65

SOURCE: TACITA CAPITAL INC.

INVESTMENT EXECUTIVE CHART