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## What to Expect

It is obvious that an investor cannot buy past performance. The often heard phrase "past performance is not indicative of future performance" is an important one, but can be misunderstood and misapplied. To fund retirement plan liabilities, meet retirement needs, or meet the spending plans for charitable or other purposes, it is helpful to understand expected returns for investments of various asset classes and styles. Investors should develop a realistic perspective of expected investment returns, and for fiduciaries this perspective would be prudent.

### *Great Expectations*

The 1980s and 1990s have raised investors' expectations seemingly to the extreme degree of the Charles Dickens novel. The S&P 500, for instance, achieved an annualized rate of return through June 1998 of 17.62%. The Lehman Aggregate Index of fixed income securities was 10.67% for this same period. Many investors, fiduciaries and employees in participant-directed plans have experienced the rewards of this marketplace. Some seemed to think this outperformance might be sustained forever, or at least for a greatly extended period of time.

The third quarter of this year is reminding many of 1990, 1987 and other past negative investment periods. It is being argued that the Asian financial crisis is spreading to Russia, Latin America and to the United States. This may be occuring, but a challenging, practical result is like Dickens' Miss Havisham, the disappointment of investment expectations not being met can have lasting, painful effects.

### *The Long and Winding Road*

Organizations such as The Center for Research in Security Prices (CRSP) at the University of Chicago and the work done annually by Ibbotson Associates in its *Stocks Bonds Bills and Inflation Yearbook* (SBBI) represent the position that the study of historic returns can provide useful perspective on the investment markets and expected returns. This vantage point is described in the SBBI Yearbook:

> *By studying the past, one can make inferences about the future. While the actual events that occurred in 1926-199[8] will not be repeated, the event-types (not specific events) of that period can be expected to recur. It is sometimes said that one period or another is unusual—such as the crash of 1929-1932 and World War II. This logic is suspicious because all periods are unusual. One of the most unusual events of the century—the stock market crash of 1987—took place during the last decade; the equally remarkable inflation of the 1970s and early 1980s took place just over a decade ago. From the perspective that historical event-types tend to repeat themselves, a 70+-year examination of past market returns reveals a great deal about what may be expected in the future.*[1]

*Continued on reverse side*


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From 1926 through June 1998 the rate of return for the S&P 500 was 11.15%. This rate of return is compared to small capitalization stocks for this period and the 1980s and 1990s to "show the historical trade-offs between risk and return."[2]

| | 1926-June 1998 | 1980-June 1998 |
|---|---|---|
| **Large Cap Stocks** (S&P 500) | 11.15% | 17.62% |
| **Small Cap Stocks** (Ibbotson/DFA) | 12.46% | 15.06% |

Past performance is certainly not predictive of future performance. It does set a useful backdrop to discuss and establish reasonable expectations with regard to returns, risk and the trade-offs among investment alternatives.

***From Expectation to Evaluation***

Often, what is expected is not achieved. The actual performance can exceed expectations and provide excess funds, or the reverse can be experienced. The concept of minimum funding standards is helpful in this context to determine what minimal rates of return must be achieved, additional contributions made or spending and/or liabilities reduced to achieve objectives. These requirements are built in to the analysis and funding approaches of defined benefit pension plans. Also, many eleemosynary entities have begun to utilize "total-return" based strategies to better match time horizons, risk tolerance, investment returns, investment volatility and spending.

***Participant-Directed Plans***

A large number of 401(k) and other participant-directed plan sponsors have historically seen their plans' asset allocations skewed toward the more conservative asset classes. In response, a variety of employee communication and education strategies are being devised and employed.

Alternatively, plans which originated since the late 1980s have experienced extraordinary growth and excess stock performance. In many of these plans asset allocations have been skewed toward potentially higher rewarding and higher volatility investments. Communications would benefit participants by focusing upon establishing personal funding needs, realistic expectations of risk, returns and the trade-offs. Effective education strategies and tools may help avoid, at a minimum, some employee relations problems.

***Looking Forward***

An expected rate of return is, by its very nature, a forward-looking concept. No one means of determining an expected rate of return has proven perfect, including studying past returns. In some instances, assets and liabilities can be matched or dedicated. Others can match duration.

For most, ranges of probability of return are accepted. The actual results can exceed or fall short of expectations. Fiduciaries and other investors need to thoughtfully establish expectations, communicate them when/as required and assess what strategies can help assets meet or exceed the requirements of liabilities and/or spending.

1. *Stocks Bonds Bills and Inflation Yearbook,* Ibbotson Associates, Published Annually

2. *Ibid*

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Any questions or comments, regarding *The Investor Advocate,* are always welcomed.