



The Investor Advocate®

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Managing Expectations

“Past performance is no guarantee of future results.” This often heard phrase is an important one, since investors cannot buy past performance. However, the phrase is often misunderstood and misapplied. To fund plan liabilities, meet retirement needs, or meet spending plans for charitable or other purposes, investors and fiduciaries must understand returns for various asset classes and styles. Prudent investors and fiduciaries should develop a realistic perspective of expected investment returns.

Great Expectations

The 1980s and 1990s raised investors’ expectations to the extreme degree of the Charles Dickens novel, *Great Expectations*. Many investors, fiduciaries and employees in participant-directed plans experienced the rewards of the marketplace in this period. Some seemed to think this outperformance might be sustained forever, or at least for a greatly extended period of time.

Most recently, the period from mid-2007 into 2008 (similar to March 2002 to March 2003) has been challenging, with the practical result seeming to be like Dickens’ Miss Havisham. Investors feel the disappointment of investment expectations not being met, which can cause extreme pain, anguish and, in some instances, denial.

The Past and The Future

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 historical returns can provide useful perspective on the investment markets and expected returns. This vantage point is derived from the SBBI Yearbook:

By studying the past, one can make inferences about the future. While the actual events that occurred from 1926 to 1997 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. Some of the most unusual events – the stock market crash of 1987 – the equally remarkable inflation of the 1970s and early 1980s [and earlier referenced 2000-2003 period]. From the perspective that historical event-types tend to repeat themselves, an 80+year examination of past markets reveals what may be expected in the future.¹

Perhaps Mark Twain said it most succinctly, “History does not repeat itself. It rhymes.”

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

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For the periods noted, the rates for return for large cap U.S. stocks, small cap U.S. stocks, core U.S. bonds and international stocks are contained in the table below.

	Large Cap (S&P 500)	Small Cap Stocks (Ibbotson/DFA)	Core Bonds (Lehman Aggregate)	Non-U.S. Stocks (MSCI EAFE)
1926-2007	10.35%	12.37%	5.66%	N/A
1957-2007	10.51%	13.95%	6.74%	N/A
1967-2007	10.83%	13.94%	7.59%	N/A
1977-2007	12.21%	15.37%	8.33%	12.80%
1987-2007	11.50%	11.14%	7.33%	8.55%
1997-2007	8.15%	9.20%	6.30%	8.39%
1995-1999	28.56%	23.67%	7.73%	13.15%
2000-2002	(14.56%)	(14.37%)	10.10%	(16.99%)
2003-2007	12.84%	17.79%	4.42%	22.08%

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

From Expectation to Evaluation

Often, what is expected is not achieved. The actual performance can exceed expectations and provide excess funds or funding, or the reverse can be experienced. The concept of minimum funding standards is helpful in this context to determine what minimal rates must be achieved, additional contributions made or spending and/or liabilities are to be reduced to achieve objectives. These requirements can be built into the analytical framework and funding approaches of defined benefit pension plans, including the provisions of the Pension Protection Act of 2006 (PPA 2006). Also, many charitable entities are utilizing total-return based strategies and spending based upon rolling balances to better match time horizons, risk tolerance, investment returns, investment volatility and spending.

Participant-Directed Plans

A large number of 401(k), 403(b) and other participant-directed plan sponsors have historically seen their plans' asset allocations skewed toward the more conservative asset classes. Inertia is also a term applied to participants in such plans – participants tend to stay where they start and adjustments seem glacial, if nonexistent. In response to this trend and to PPA 2006, a variety of target-date funds, employee

education, participant communication and individual advice approaches are being devised and employed. The more effective responses to these needs focus upon meeting fiduciary duties for communication, encouraging the understanding of individual funding needs, realistic expectations regarding risk, returns and the trade-offs. Successful strategies can enhance participants' prospects for success and, at a minimum, help avoid some employee relations problems.

Looking Forward

An expected rate of return is by its very nature a forward-looking concept. No single method of determining an expected result has proven perfect, including studying past returns. In some instances, assets and liabilities can be matched or dedicated. Other methods may match duration. For most, ranges of probability of return are accepted. The actual results, nominal and real, can exceed or fall short of expectations. Specific objectives should be determined and strategies tailored to achieve desired outcomes. Fiduciaries and other investors need to thoughtfully establish expectations, communicate them as necessary and implement strategies to meet or exceed the prospects for returns as well as the requirements of liabilities and/or spending.

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