



Talking to Clients about Expected Returns

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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 lifestyle they can anticipate.

This is precisely why the most important conversation for advisors and investors today often relates to the future returns to expect on their portfolios.

In structuring that conversation, consider focusing on three key points:

- real (inflation adjusted) returns;
- maintaining a long-term view;
- the distribution of past returns in arriving at the right number.

Clients will sometimes come into this conversation with misconceptions based on recent market returns or on what they read in the press or hear on television. Identifying and responding to those misconceptions will build trust with your clients.

Confusion from media coverage

Media coverage about the returns investors can expect is often singularly unhelpful in bringing clarity to the question of the return investors can expect going forward.

In part, it's because all too often the media tends to feature attention-seeking apocalyptic voices of doom – think about the profile given to Harry Dent's recent book, *The Great Crash Ahead*, or to Robert Prechter of Elliott Wave Theory fame, a perma-bear since 1987.

And in part it's because when the media talks about someone's return forecast, they often fail to clarify whether that return is before or after inflation and whether it's for equities only or for a balanced portfolio.

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% that it's 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 Lawrence Fink, head of fund giant Blackrock, as saying basically 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.

One final example.

In my home market of Toronto, the leading newspaper (for which I happen to write a weekly column!) prominently featured a planner’s advice that clients should plan on a 4% return – without clarifying whether that was before or after inflation and again for equities or for a balanced portfolio.

Adding to the confusion was this planner’s advice that clients “stay in 70% cash until the economy and markets stabilize.” Hard experience suggests it is difficult enough to forecast the expected return of a strategic asset mix, let alone the outcome of a market timing call.

Framing a client conversation

Given the importance of forecasting the expected return on investments, this is one of the most important conversations you can have with a client.

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 after the market turmoil of 2008.

You could then acknowledge that in the last while, many credible industry voices have suggested that it would be over-optimistic to expect this kind of return going forward

When it comes to your return assumptions, there are obvious costs to being too bullish – overly rosy assumptions can lead to disappointment as people fail to save enough and fall short of their goals as a result.

Being too conservative has a price as well, as overly pessimistic assumptions can lead to undue stress and to investors making bad financial choices. After all, if you think you’re only going to get low single-digit returns on stocks, why not just buy T-Bills?

The key decisions

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

First, shift their thinking to after-inflation or real returns instead of the nominal, pre-inflation returns so commonly used. Help clients understand that doing this leads to a focus on



spending power – what really counts in retirement. Point out that this is how sophisticated pension plans and high-net worth investors do their financial planning.

Second, help clients extend their timeframe. The shorter their timeframe, the more dispersion they'll experience on returns – pick one year as your time horizon and you could experience swings of 50% in either direction.

Even five-and ten-year periods subject investors to substantial swings in returns on stocks, especially if your clients do what many investors do – and set their expectations based on what happened in the last three to five years.

The only way to bring stability to investors' expected returns is to follow the best practices of pension funds and high net worth investors – and look out 15 or 20 years.

That may seem an unduly long timeframe to some clients, but in fact that's the minimum horizon that most Americans need to think about. If your clients hesitate about looking out that long, point out that for a 65-year old couple, half the time one of them will live to age 90. And one-in-ten 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 all too often you'll be below it. Given the hardships imposed by underperforming, when forecasting returns for the equity component of their portfolio, help clients look beyond the average return to the distribution of returns that got to that average. That will tell them how badly they might fall short based on historical precedent.

Recently, I sat down with Michael Nairne and his team at Tacita Capital, an investment firm that focuses on high net worth families, and looked at long-run total returns (including both capital appreciation and reinvested dividends) on the S&P 500 index.

Since 1926, there have been 65 twenty-year periods. If we list the real returns during those 65 periods from highest to lowest – and look at how often those returns happened, here's what you end up with.



Annual return after inflation in 65 20-year periods - 1926 to 2009:

Return	% of the time this return or higher happened	Number of times this return or higher happened
13.3%	1%	1
12.7%	5%	3
11.9%	10%	7
10.8%	20%	13
9.3%	33%	22
8.5%	50%	33
5.0%	67%	42
3.3%	80%	52
2.2%	90%	59
1.8%	95%	62
0.8%	100%	65

Picking the right number

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

For those who want to be more prudent, choose one of the lower numbers – the 5% return that was outstripped two-thirds of the time or the 3.3% that was exceeded 80% of the time. In fact, a recent article in the Financial Analyst's 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, in 62 out of 65 twenty-year periods.

Of note, the worst real returns were 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 inflation.

Picking the return assumption to recommend for equities will vary with your and your clients' attitude towards 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.



** Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to www.clientinsights.ca.*

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