New Albany
Investment Management

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Portfolio Insight:
Estimating Long Term Returns & Implications on Your Financial Plan

"Do I have Enough?" This is the one consistent and foundational concern on every investor's mind who is approaching or in retirement. Answering that question involves making realistic assumptions on a multitude of variables. But the one constant factor essential to a solid financial plan is the assumption on growth of the investment portfolio over the life of the investor. If the estimate is too aggressive, the risk is running out of funds and forcing life plans to be significantly altered. Thus, when it comes to growth assumptions, erring on the side of conservative is both prudent and assuring to a solid financial plan. Below is a brief overview of how long term returns are estimated and a forecast of future returns.

How to estimate return assumptions: There are many different methods to derive return or growth assumptions but all estimates involve some combination of three parts: the **current risk-free rate** component which is the baseline for all asset classes; the **asset-class premium** that varies by each type of asset according to its specific risk; and finally, the expected **inflation rate**. Here is the process:

Step #1: The Risk-Free rate is the US 20yr Treasury rate. Although no investment is considered entirely free of risk, U.S. Treasuries are generally considered to be the least risky asset class (aside from cash). Today, the risk free rate or yield is approximately 2.5%. But as we all know, interest rates are volatile and therefore changes in the risk free rate have a direct impact on the pricing of all other assets. For example, when the rate rises, all other asset prices generally fall because they are now less attractive relative to this investment. Thus, it is essential to be aware of the risk free rate when it comes to making a sound financial plan.

Step #2: Asset Class Premium is the additional return demanded by investors for owning a riskier asset. Risk can be in many forms: default/credit risk, earnings risk, economic risk, country risk, or liquidity risk. For example, US stocks are less risky than Foreign, Large Cap less risky than Small Cap, etc. For Bonds, Investment Grade bonds are less risky than Junk; US bonds are less risky than Emerging Market bonds. Asset premiums will expand and contract as economic conditions change where investors will demand more premium when they are less certain about economic conditions. So asset class premium is another variable component in the equation of estimating growth.

Step #3: Future Inflation Rate is the silent but deadly bullet to any financial plan because it strikes on all fronts. Inflation directly impacts the Risk Free and indirectly the Asset Risk Premium. As inflation expectations rise, so do interest rates which in turn becomes a headwind to earnings and depresses stock prices. In addition, failure to factor in the compounding effect of inflation will drastically underestimate future cash flow needs and most likely cause life plans to be changed.

Putting it all together: Of course there are many more layers to estimating future returns, but the point is to recognize the components and the potential variability. The chart below shows the huge variance in growth rates over different time frames and recommended rates to use for stress testing a financial plan.

Asset Class	Range of Return 1970-2014	Historical Avg. Return 1970-2014	Schwab Forecast 10yr Return	Conservative Stress Test
US Large Cap Stocks	37% to -37%	10.5%	6.3%	0%-4%
Corporate Bonds	38% to -17%*	7.9%	3.3%	0-3%
Cash/3mo Treasury	14% to 0.1%	4.5%	1.8%	0%
Inflation	11% to -0.3%	4.2%	1.8%	2%-3%
10yr US Treas Range	33% to -11%	11.4% to 1.8%	n/a	

*Estimated

Observations:

- Note the **significant variance of <u>average</u> return verses <u>actual</u> yearly return from 1970-2014**. This is a reminder of how drastically returns can change.
- **Forecasted <u>future</u> returns are considerably <u>less than</u> average <u>historical</u> returns**. This is due to the low current risk free rate and expectation of lower inflation rate in future.
- **Stress test growth rates are purposely lower, inflation is higher** than the forecast to provide a high degree of comfort and validity to the financial plan. **<u>For every 1% change in growth rate, duration of retirement cash flow is changed by 5-10yrs, depending on level of rate!</u>**

In sum, creating a solid plan with radically shifting variables is a daunting task. It requires constant re-evaluation of all components, using conservative assumptions and then stress testing the plan with different growth scenarios. Only a slight change in assumptions will alter the trajectory of a financial plan making it obsolete. At the same time, the wide swing in returns of each asset class gives reason for an actively managed, diversified portfolio.

Portfolio Strategy: As expected, the markets continue to be choppy due to a strong dollar, slightly weaker domestic growth, and slowing earnings growth. The portfolios are broadly diversified to ride through this volatility and are performing well.

Please contact me with any questions or concerns.

Kind Regards,
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