

Expectations

Paul Hancock, CFP® | October 14, 2016



Every four years we elect a new President. Every four years the most gifted athletes in the world compete in the Olympic Games. I don't know about you, but this election cycle is driving me crazy! So why don't we talk about the Olympics instead. Meet Clayton Murphy. Just 21 years old, Murphy earned a bronze medal in the 800 meters this past summer in Rio. It was the first time an American has medaled in the 800 meters since 1992. He finished in a time of 1:42.93, which was the third-fastest American time ever and faster than his previous personal record time of 1:44.30. He was an improbable bronze medal winner. Murphy's goal coming into the Olympic Games was to simply make the final. Murphy commented after the race,

"I don't know if (winning a medal) ever was a reality," Murphy said. "The big goal I had was making the final. A medal for me was going to be icing on the cake. I just wanted to have fun with it, and enjoy the minute and 40-some seconds I was out on the track. You never know how many times you're going to run in the Olympics. It's super exciting."

Murphy's expectations were to make the final, certainly not to medal! And certainly not finish behind 0.78 seconds behind David Rudisha, possibly the greatest ever to run the 800 meters. There was a study done on

Olympic athletes showing that bronze medalists are quantifiably happier than silver medalists. It all boils down to expectations. Here is what their research discovered:

“Silver medalists tended to focus on how close they came to winning a gold medal and so they weren’t satisfied with silver. Bronze medalists were focused on how close they came to not getting a medal at all! So they are thrilled with the bronze medal. They are happy to be on the medal stand at all.”

Expectations for Future Capital Market Returns

The story of Clayton Murphy should be a lesson to all investors. Be careful with your expectations, especially as it relates to expected returns from your portfolio. Ask many individuals what their expectations for returns from the stock market are in a given year and most people respond with a number between 8 to 10% per year. Many pension funds, endowments and insurance companies rely on actuarial assumptions of 7%+ for their portfolios in order to meet their expectations for future liabilities. And keep in mind, their portfolios are not 100% stocks! Can our capital markets produce such returns looking forward? I think the simple answer is no.

First, let’s frame this discussion with looking at historical returns for capital markets.

- Stocks have produced an annual return of 9.4% over the past 116 years.
- Bonds has produced an annual return of 5% over the past 116 years.
- Blended together at a 60/40 mix and you get an annual return of 7.6%.
- Over the past 10 years, a 60/40 blend has returned 7% annualized.
- Over the past 5 years, a 60/40 blend has returned 11% annualized.

Many prominent investors and institutions have argued recently for lower future capital market returns. From Vanguard to Bill Gross to Rob Arnott, future market returns look abysmal when compared to historical returns.

Expected Future Market Returns			
Investor	Stocks	Bonds	60/40
Charles Schwab	7.0%	3.0%	5.4%
Vanguard	7.0%	2.5%	5.2%
Bill Gross	6.5%	2.5%	4.9%
Larry Swedroe	6.2%	1.7%	4.4%
Burton Malkiel	6.0%	2.0%	4.4%
Ben Carlson	6.0%	1.5%	4.2%
McKinsey	5.0%	1.0%	3.4%
Jack Bogle	4.0%	2.5%	3.4%
Rob Arnott	3.5%	1.7%	2.8%
GMO	2.0%	0.0%	1.2%
Average	5.3%	1.8%	3.9%

The simple average of these predictions center around 4% for a balanced portfolio of 60% stocks and 40% bonds. While these projections span slightly different time frames and use slightly different benchmarks, the message is clear: Expect lower returns in the future for stocks and bonds.

Investment Implications

Investing can be very emotional. One way in which investors can keep their emotions in check is to set proper expectations for future returns on their portfolio. For a younger investor, expect 4-6% for an all stock portfolio instead of 8-10%. For an investor nearing retirement, expect 3-4% for a balanced portfolio instead of 6-8%.

Planning Implications

Proper expectations can greatly help as you plan for retirement and ultimately drawing down your portfolio.

- For those still saving for retirement, strive to save more than you otherwise planned allowing the power of compounding to help in a low-return world.
- For those nearing retirement, possibly look to work a little longer or bridge the gap to retirement with part-time work or supplement with other sources of income such as rental or business income.
- For those in retirement, watch your annual expenses as well as the percentage you are drawing out of your investment assets each year. A good benchmark is try to draw around 3% or less per year from your investment assets.
- For all investors, align your portfolio asset allocation to your specific goal (college, retirement etc.).

In a recent sermon at National Community Church, Lead Pastor Mark Batterson suggested the following:

“Your focus determines your reality. It is not your objective circumstances, it is your subjective expectations that determine how you feel and how you think and how you make decisions and how you live your life.”

Setting proper expectations in our financial lives can go a long way in determining not only how we set and achieve goals, but how we feel and react along the way.

References

- Clayton Murphy Photo: http://running.competitor.com/2016/08/photos/clayton-murphy-earns-bronze-800m_154446
- Clayton Murphy Story: <http://www.usatoday.com/story/sports/olympics/rio-2016/2016/08/15/clayton-murphy-800-meters-bronze-medal/88814806/>
- Mark Batterson Sermon: <http://theaterchurch.com/media/mountains-move/four-anchors>
- Historical Market Returns: Credit Suisse Global Investor Yearbook 2016
- Historical Market Returns: Kwanti Software which uses Morningstar Data
- Charles Schwab: <http://www.schwab.com/public/schwab/nn/articles/Why-Market-Returns-May-Be-Lower-in-the-Future>
- Vanguard: Vanguard's Economic and Investment Outlook 2016
- Bill Gross: Bloomberg Surveillance, October 7, 2016
- Larry Swedroe: <http://www.etf.com/sections/index-investor-corner/swedroe-perfect-storm-low-returns?nopaging=1>
- Burton Malkiel: <https://blog.wealthfront.com/us-stock-long-term-returns/>
- Carlson: Various articles from A Wealth Of Common Sense Blog
- McKinsey: McKinney Global Institute. Diminishing Returns: Why Investors May Need to Lower Their Expectations. May, 2016.
- Bogle: <http://news.morningstar.com/Cover/videoCenter.aspx?id=772785>
- Rob Arnott/RAFI: https://www.researchaffiliates.com/en_us/asset-allocation.html
- GMO: 7-Year Asset Class Return Expectations. Available online at www.gmo.com

DISCLOSURES & INDEX DESCRIPTIONS

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not reflect fees or expenses.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of June 2009 the MSCI ACWI consisted of 45 country indices comprising 23 developed and 22 emerging market country indices.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The Russell 3000 Index[®] measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

The Russell Midcap Index[®] measures the performance of the 800 smallest companies in the Russell 1000 Index.

The Russell 2000 Index[®] measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The MSCI[®] **EAFE** (Europe, Australia, Far East) Net Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America.

The MSCI Emerging Markets Index SM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2007, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The Dow Jones Composite REIT Index measures the performance of Real Estate Investment Trusts (REIT) and other companies that invest directly or indirectly through development, management or ownership, including properties.

The Barclays Commodity Index is composed of futures contracts on physical commodities and represents twenty two separate commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc.

The US Dollar Index is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

The Barclays U.S. Treasury Index is U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Treasury bills are excluded (because of the maturity constraint). Certain special issues, such as flower bonds, targeted investor notes (TINs), and state and local government series (SLGs) bonds are excluded. Coupon issues that have been stripped are reflected in the index based on the underlying coupon issue rather than in stripped form. Thus STRIPS are excluded from the index because their inclusion would result in double counting. However, for investors with significant holdings of STRIPS, customized benchmarks are available that include STRIPS and a corresponding decreased weighting of coupon issues. Treasuries not included in the Aggregate Index, such as bills, coupons, and bellwethers, can be found in the index group Other Government on the Index Map. As of December 31, 1997, Treasury Inflation-Protection Securities (TIPS) have been removed from the Aggregate Index. The TIPS index is now a component of the Global Real index group.

The Barclays U.S. Treasury: 1-3 Year includes securities in the Treasury Index (i.e., public obligations of the U.S. Treasury) with a maturity from 1 up to (but not including) 3 years.

U.S. Treasury Bill 90 Days Rate is an index comprised of short-term obligations issued by the United States government.

The Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least \$7 million and be issued as part of a transaction of at least \$75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

The Barclays U.S. Corporate Investment Grade Index is the Corporate component of the U.S. Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

The Barclays U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Barclays Global Aggregate Bond Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian government, agency and corporate securities, and USD investment grade 144A securities.

The Barclays Emerging Markets USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set.

Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Barclays US EM Index and history is available back to 1993.

The Barclays EM Local Currency Government

The flagship Emerging Markets Local Currency Government Index is designed to provide a broad measure of the performance of local currency emerging markets (EM) debt. Classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. Not every country classified as EM will be eligible for this benchmark as additional evaluations of market size and investability are also used to determine country eligibility for this index. Some local currency EM debt markets excluded from this index due to investability (China, offshore and onshore, India, and Taiwan) are eligible for the broader EM Local Currency Government Index. Historical index returns are available from July 1, 2008.

Index Date Sources: MSCI, Russell, Standard & Poors, Morningstar, Kwanti, Barclays, Hatteras

Past performance is no guarantee of future results. Diversification does not assure profit or protect against a loss in a declining market. While we have gathered this information from sources believe to be reliable, we cannot guarantee the accuracy of the information provided. The views, opinions, and forecasts expressed in this commentary are as of the date indicated, are subject to change at any time, are not a guarantee of future results, do not represent or offer of any particular security, strategy, or investment and should not be considered investment advice. Investors should consider the investment objectives, risks, and expenses of a mutual fund or exchanged traded fund carefully before investing. Furthermore, the investor should make an independent assessment of the legal, regulatory, tax, credit, and accounting and determine, together with their own professional advisers if any of the investments mentioned herein are suitable to their personal goals.

International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Small and mid-cap stocks carry greater risks than investments in larger, more established companies. Fixed-income securities are subject to interest-rate risk. Investing in high-income securities may carry a greater risk of nonpayment of interest or principal than higher-rated bonds. Investing in commodities is generally considered speculative because of the significant potential for investment loss due to cyclical economic conditions, sudden political events, and adverse international monetary policies. There are several risks associated with alternative or non-traditional investments above and beyond the typical risks associated with traditional investments including higher fees, more complex/less transparent investment strategies, less liquid investments and potentially less tax-friendly. Some strategies may disappoint in strong up markets and may not diversify risk in extreme down markets.

To receive a copy of Genesis Wealth Planning's ADV Part II which contains additional disclosures, proxy voting policies and privacy policy, please contact us.