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## Can We Be Brutally Honest About Investment Returns?

Pension funds have fantastical expectations of the market

*By Jason Zweig*

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With U.S. stocks at all-time highs, it's more important than ever that investors be brutally realistic about future returns.

Some of the most purportedly sophisticated investors in the world, the managers of giant pension funds for state and local government employees, might not have absorbed that lesson yet. You can learn a lot from these folks — if you listen to them and then do the opposite.

A new study by finance professors Aleksandar Andonov of Erasmus University Rotterdam and Joshua Rauh of Stanford University looks at expected returns among more than 230 public pension plans with more than \$2.8 trillion in combined assets.

For their portfolios, generally consisting of cash, U.S. and international bonds and stocks, real estate, hedge funds and private-equity or buyout funds, these pension plans report that they will earn an average of 7.6% annually over the long term. (That's 4.8% after their estimates of inflation.) These funds often define "long term" as between 10 and 30 years.

Based on how they divvy up their money, how much are these pension funds assuming specific assets will earn?

They expect cash to return an average of 3.2% annually over the long run; bonds, 4.9%; such "real assets" as commodities and real estate, 7.7%; hedge funds, 6.9%; publicly traded stocks, 8.7%; private-equity funds, 10.3%.

Let's put all that in perspective.

Take cash first. Three-month U.S. Treasury bills yield 1.4%. The highest-returning institutional money-market funds yield 1.5%, according to Crane Data.

How could cash earn more than twice that rate of return over the long run?

To be fair, Treasury bills over the past half-century have returned an average of 4.8% annually, according to the Federal Reserve. But short-term interest rates would have to rise sharply for cash to earn close to that.

Next, consider bonds. The simplest reliable indicator of how much you will earn from a portfolio of bonds in the future is their yield to maturity in the present. With 10-year Treasuries yielding 2.6% and investment-grade corporate bonds averaging under 3.7%, it would take a near-miracle today to get anything close to 4% out of a high-quality fixed-income portfolio.

Yet the pension plans are expecting their bonds to earn 4.9%.

That isn't impossible, either, if they throw safety to the winds and buy boatloads of high-yield "junk" bonds and other risky debt. The whole point of a pension fund, however, is not to take excessive risks.

How realistic is the expectation that stocks will return an average of 8.7% annually into the distant future?

That's below the U.S. average of 10.2% annually over the past 90 years. But stocks were far cheaper over most of that period than they are today, so their returns were naturally higher.

The blogger "Jesse Livermore," who writes thoughtfully about financial markets at [\[REDACTED\]](#), pointed out in a recent post that stocks aren't likely to earn more than an average of 5.9% annually over the long run from today's lofty prices.

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Stocks could do better than that if the cost of living shoots up, investors become willing to pay much more for shares, earnings grow at an unprecedented pace or companies buy back

vastly more of their own stock.

Among those, the least implausible scenario is higher inflation. So the pension funds could hit their 8.7% stock return that way — but such a surge in the cost of living would crimp their bond returns. What they would gain on their stocks they would lose on their bonds.

Finally, consider how the pension plans estimate the future returns on private-equity funds.

Put some alcohol into anyone in the buyout business and you will get an earful about how competitive and overvalued that market is — and how difficult it will be for future returns to match those of the past.

But the new study of estimated returns finds that the older a pension fund's holdings of private equity are, the more likely its officials are to extrapolate those returns — as if the good times of the early 2000s, when deals abounded and buyouts were cheaper, were still rolling.

What's more, says Prof. Rauh of Stanford, the less experience a pension plan has with private equity, the more likely it is to make an aggressive estimate of future returns from buyout funds.

In other words, those with the least expertise in private equity think they can earn the most from it.

Why do expectations among pension plans run so high? Because they have to, the chief investment officer of a large public pension plan tells me. State laws guarantee generous retirement benefits for millions of current and former government employees. To appear as if they can meet those obligations, the pension plans have no choice but to set their expected returns higher than reality is likely to deliver.

That's the exact opposite of what the rest of us should do. Sooner or later, investors who build their expectations on hope rather than on arithmetic end up sorry.

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