The Fortnighter

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In a post-script to the last few issues of the Fortnighter, one of the more significant issues related to the (possible) end of the 30-year bond bull market has to do with the question: "What sort of return can I expect on my portfolio in the future?"

Unfortunately, while this question is a fundamental part of financial planning and portfolio construction, it's not an easy one to answer. In general, the basis for any forecast is historical data. After all, what other information do we have to go on? Past trends can provide us with a great deal of useful information – but often the future simply turns out to be completely different.

That, I believe, is the case now – the "rate of return" future is going to be quite different from what we've experienced over the past few decades. The huge decline in interest rates we've seen since the early 1980s has had a PROFOUND impact on historical return data. So much so that I believe using this information as a basis for future return projections is not only unwise – it may be outright dangerous.

This became obvious when I began analyzing historical return data for the Investment Policy Statements I'm using for my managed account program (you may recall that I recently received my Associate Portfolio Manager designation).

It turns out that the long-term rates of return for **every** Asset Allocation model I tested, from very conservative to aggressive, had almost exactly the same 20 and 30-year annual rates of return! (about 7% and 9%, respectively) This makes little sense. Over long periods, growth-oriented portfolios should significantly out-perform cash and bond-heavy portfolios to compensate investors for their extra risk.

When I looked at the past 10 years, because of the huge decline in stock prices during the 2008 bear market, conservative portfolios handily outperformed more equity-oriented mixes during this period.

It's unrealistic to believe that bonds are going to return anywhere near the 10% they returned over the past 30 years – or the 6% they returned over the past 10 years. Bond portfolios may, in fact, experience **negative** annual returns over the next few years as rates adjust back upward.

A better approach for forecasting may be what I alluded to above – what sort of return premium (i.e. over inflation) will investors demand to compensate themselves for the risk of owning a particular asset class?

For cash, maybe 0% to 1% over inflation – say, 2% - 3%. For bonds, perhaps 2% to 3% over inflation - that means returns of 4%-5% over the long term. And equities? 5% to 6% over inflation seems to be a good long-term number. So, think 7% to 8% if inflation stays at its current levels….