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Probably the most common question arising from the many financial planning sessions we conduct for clients is "what is an appropriate Rate of Return to use for future planning purposes"?

The inference is that Rates of Returns achieved on most balanced or growth portfolios over the past 5 years have been, to put it bluntly, lousy – and well below what most financial planners would typically choose to apply to their models when projecting financial data into the future. Is it appropriate to use these historically (higher) return numbers when the past few year's results have been so far below that?

I believe that the answer lies somewhere "in between". Clearly, the days of expecting 8% or 10% returns on portfolios is long past. At the same time, do we believe certain market pundits who claim that the equity markets are "dead" and that we should expect stocks to return no more than 4% or 5% in the future? I think that's equally unreasonable.

I come back to the old adage that it's not the stock market, it's a market of stocks. And stocks represent companies that generate revenues, pay dividends and re-invest earnings back into their businesses.

A look at Earnings to Price ratios (i.e. the inverse of a P/E ratio) of the stocks that make up most of my portfolios suggests that a typical amount of earnings we're buying for every $100 of share price is about $8 (a P/E ratio of 12x). In other words, 8%. I'll argue that is a pretty reasonable estimate for what that stock should return (in both capital appreciation and dividends) over the years going forward.

Now back to that Rate of Return Estimate for an entire portfolio. For simplicity sake, let's assume a balanced portfolio of 60% stocks and 40% bonds. Bond returns going forward? Well, bond rates are pretty dismal now, but a good long-term average for investment grade bonds is about inflation + 2%. Let's then say our long-term bond returns are 4%.

60% of 8% is 4.8%. 40% of 4% is 1.6%. Add them together and we get a 6.4% projected return for the portfolio. A more conservative 40% stock/60% bond mix (after all, we are talking about retirement)? 5.6%.