An Investor's Guide to Expected Returns

Announcer: Welcome to the Empowered Investor Podcast. Have you ever felt overwhelmed by the sheer volume of choices and voices telling you how to plan or invest for your future? With a straightforward approach, host Keith Matthews of Tulett, Matthews & Associates cuts through the noise to help you create a winning action plan for you and your family. The decision-making framework discussed in this show can transform you and your investment experiences and will increase your odds of becoming financially secure. Learn more and subscribe today at TMA-invest.

Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you?

Marcelo: Keith, I'm super excited to do this in person. It's the second podcast we do in person. So exciting.

Keith: It's my very first podcast. We've done three years of podcasts and it's always been in closed offices behind Zoom during the pandemic. And here we are live today in our office conference room and it's great to be doing this.

Marcelo: It's crazy how the online world changes your perception of a conversation. It's so different to do it in person. I don't know why. You get to pick different cues and it's just a different experience. Anyways.

Keith: So listen, we just finished tax season. Let's talk quickly about what that felt like, how it worked. We just finished doing about four episodes on tax for our listeners in both English podcasts and French podcasts. They were very well received. We covered general issues. We covered technical issues. It's good to be finished with the tax season though. How did it go in our office?

Marcelo: The office was buzzing. We saw a lot of people left and right. Clients are super appreciative of the fact that we do taxes. They appreciate the personal touch and the fact that we get to look at not only the investments and the financial planning but also at such an important part: tax. I find over the years that I've been here, it's a stressful issue for a lot of clients, and the fact that we can take care of that adds a lot of value.

Keith: Yeah, a hundred percent. I want to give a big shout out to Edmund and Hugh in our offices who essentially filed close to 600 individual tax returns. And I will remind us that we had the ice storm here in Montreal and our office was in the thick of the area that got hit hard. So our office was actually closed for four days.

Marcelo: Yeah, that's crazy.

Keith: During the last call, it was 18 days. So that productivity had to be really high in order to catch up for that lost time. So clients did a great job. Contacts did a great job. And Hugh and Edmund did an amazing job.

Marcelo: Yep. It's tough to lose four days when you really got a month to get it all done.

Keith: Absolutely. So listen, in today's episode, we're talking about expected returns. So we're going to review together what are expected returns, how investors and advisors should use them, why they're important in retirement projections. We'll review who and how they get created, which organizations create expected returns. And then finally, we're going to have a good discussion about today's current expected returns and how they look relative to historical returns. So it's a great topic, Marcelo. Let's jump in and have a discussion around what exactly is an expected return.

Marcelo: So it's a great way to start, and I think we have to define it so listeners can have an idea of what we're talking about. Expected returns are an estimate of the average return that an investment or portfolio should generate over a certain period of time. So in general, riskier assets or securities demand a higher expected return to compensate for the additional risk. So that's, I think, a lot of people can wrap their head around that. If you have a riskier asset, your expected return will be higher compared to a lower risk one. These are just labels, but it's just intuitive that the more risk you take, the higher the expected return should be for that risk that you're taking.

Keith: Yeah. And I guess expected return to some degree is a bit of a prediction. It's what are the markets expecting out of, for example, Canadian stocks or US stocks. What do markets expect international stocks to do? We've always built our investment philosophy on not relying on any sort of prediction around what markets will do in the next year or two or three. But what's interesting about expected returns is they need to be used so that we can model retirement plans. So we've got to use something, and expected returns are often based on valuations. So what does that mean exactly?

Marcelo: So valuations are just how much people are paying relative to something else. So for example, if you have a stock or a bond, you're going to have different metrics that tell you how much you're paying today relative to something—relative to earnings, relative to assets, relative to the market. And we aggregate this data and we come up with a number and we say the expected return based on valuations for the Canadian market is X, for the US it's X, for international stocks it's X. A good example we were talking about off mic is homes, right? So back in the day, homes were considered cheap because they were three times the average income in Canada. Now you fast forward 25 years, they're 10, 12, 13 times average income. So they would be considered more expensive than back in the day. So this is the way we think about valuations and how much we're paying relative to other times.

Keith: Yeah. And that's a great example. Home prices, those numbers you mentioned—in Toronto and Vancouver, lots of parts of Canada, they're maybe six or seven times family income, but the reality of it is it used to be three times. So when you use three times, that would be considered valuations that are cheap. You might have higher expected returns.

Now you have high valuations and you might expect lower returns. So the same thing is used in the stock market. And for bonds, it's a little bit easier because you have a yield curve, and that yield curve you can say, "What's a 10-year bond yielding?" And that is often used as a proxy for expected return over 10 years. Stocks are based on valuations on earnings and other metrics. So it is important because when we have a bear market and stocks correct and they go down, we often tell our clients, "Look, the good news about declining stock prices is the expected returns go up." So we're actually optimistic in a bear market about future returns. So let's talk about why we're having this discussion. There was a report that was released about a week or two ago, Marcelo, and that gave us the idea of saying, "Let's do a show on expected returns." What was that report and what did that report say exactly?

Marcelo: Yeah. So the report is published by the FP Canada Standards Council jointly with the IQPF Planification Financière in Quebec. So they come up with the numbers to provide financial planners and advisors an expected return of different asset classes so we can use them for our projections. So when we sit down here with people and we tell them, "You need to be saving X amount based on an X portfolio or an asset allocation," these are the numbers that we're generally using or that the industry uses for. So this report is useful. It's the anchor of what the expected returns will be in most of the financial plans, I would say all the financial plans in Canada.

Keith: What we're talking about here is the financial planning councils and the groups that are responsible to help guide financial planners in Canada publish these return reports. We use them in our financial projections, so you've got to use something to put in a financial projection, and you can't just, as an advisor, say, "I'd like to use a 15 percent rate of return." It doesn't work that way.

Marcelo: Yeah. I guess an advisor could go and use different reports by different groups like the Vanguard group, or you can do your own calculation on Excel. But at the end of the day, you have to use something.

Keith: So what did the most recent report from these planning organizations suggest with regards to expected returns for different types of asset classes?

Marcelo: So what they're saying is the borrowing rate for the next 10 plus years will be 4.3 percent. So that's the number we should use in our financial projections. Inflation, they have it at 2.1 percent. So that'll be surprising for a lot of people, but we still have that expected inflation at the average price—2 percent, which is sort of the historical one. Fixed income, they have it at 3.2 percent. Canadian equities at 6.2 and foreign developed markets equities at 6.5. So I include the US and most European markets and emerging market equities at 7.4 percent.

Keith: Okay. So those are in line with historical numbers. And one could argue, I guess you sit now today and say, "Look, inflation is much higher than 2 percent. Why would we use these lower numbers?" And I think the defense of using these lower numbers is things like, "Well, inflation is very high right now. The expectation is it's not going to stay super high

forever." Breakeven inflation, which is calculated off of nominal bonds and real rate return bonds, is about 2.3 percent. So the market is suggesting that inflation will come down and back to these numbers. There's an anchor, there's a benchmark that has to be used to put into financial plans. And so what they're suggesting is use 2 percent or just over 2 percent, and stocks and bonds will also reflect the fact that you're using the 2 percent. Okay, so that's what the Financial Planning Council has suggested. We also look at reports that have been produced by some of the largest investment management firms in the world such as Vanguard and other organizations. And what do those organizations suggest right now, Marcelo?

Marcelo: Yeah. So Vanguard, you're looking at US equities. They provide a range, so it's not exactly just one number. So the range they provide is 4.4 to 6.4. So anywhere that's the range they're projecting US stocks to do in the next 10 years.

Keith: And these are nominal returns. These are total returns. So those are not high returns.

Marcelo: No. So you have to subtract inflation and management fees and all that type of thing. So then you have global equities excluding the US unhedged, so you have that currency movement there, between 6.7 to 8.7. So you see it's higher than the US, and the US is coming from higher returns historically, so that makes sense. Emerging markets, again unhedged, so you have that currency movement, they have it between 6.3 and 8.3. So again, a bit of a higher range than the US. So if you look at the Vanguard report, the higher scale of the US is the expected return in the lower scale of the global equities and the emerging markets.

Keith: Yeah, but this is not that unusual. What we're hearing in this report, or we're seeing in this report, are individuals feeling that US stocks will not produce the highest returns, and that's based on current valuations, and that other securities around the world, whether it's Canadian securities, European equities, or emerging markets, will produce slightly higher returns. So let's take a step back here and switch gears and go into financial planning. And when we look at projections, so these are all these expected returns, how do they get used in a projection?

Marcelo: So it's fairly easy. We have a model, right? And then we have the asset allocation that we project every client to. So if we're sitting across a couple that's maybe 40 or 45 and their asset allocation is 80 percent stocks and 20 percent bonds, based on the expected return of each asset class, that portfolio will have itself an expected return. Then you factor in inflation, you factor in how much they're saving, and then we're projecting and we're trying to come up with a number that we can then tell the client, right? Like, "You are saving enough money in order to retire at 65 and spend 70 percent of your after-tax income today." I know that sounds like a mouthful, but that's essentially how we use this expected return.

Keith: Yeah, that's very well put. I even phrase it slightly differently. We find that most people that come to see us are trying to answer a couple of big questions: Do I have enough money? Will I have enough money to retire comfortably? Am I on track? These are the big

questions individuals come and ask us. And to answer those questions, we have to go to financial planning and modeling into the future. And then to do that correctly, we have to have expected returns. So I see expected returns as this wonderful piece of information that can help us solve people's concerns, questions, or worries around "Will I have enough?" And so when we look at the services that clients appreciate the most, it tends to sometimes circle around projections—having a guide, having a plan in terms of where they're going. So expected returns are critical.

Marcelo: Yeah. And then people need to understand too that when you have the expected return, just when we say—just go back to the previous example that I gave you—if you have a couple that has an 80/20 portfolio and you say the expected return for that portfolio is 6 percent, I'm just making that number up. It doesn't mean they're going to get 6 percent every single year. We believe that's the expected return, long-term average return going forward. But I think that's one of the things we have to qualify because people can get confused by looking at the expected return and saying, "Oh, that's what I'm going to get every single year." And that's not the case.

Keith: Yeah, no, it's not a straight line. And you use 6 percent. That's probably closer to an all-equity portfolio. Like we discussed, one of the things that individuals have to get used to is balanced portfolios or 60/40 portfolios pre-fees. Based on using these financial planning assumptions and guidelines, we're looking at about a 5 percent return. And if you take away management fees, you might be into the low 4s. And so that is the new reality of where we're at in a world of expected returns on financial securities. Now, I'd like to transition into this discussion on how does that look relative to historical returns. So here we've got these brand new numbers right now, and let's spend some time actually walking through history a little bit. One of the gauges we're going to use is not just nominal returns, but we're going to use real returns.

Marcelo: Which is nominal minus inflation.

Keith: Correct. So how do current returns look relative to historical returns, Marcelo?

Marcelo: Yeah. So we're not far off, but they do look different. So on the 60/40 portfolio you mentioned, if we look at the IQPF and the Financial Planning Council returns for the 60/40 portfolio, that's 5 percent minus fees and inflation. So if you look at 5 percent minus the 1 percent fee and inflation, you're looking at a 2 percent return.

Keith: 2 percent real return. Let's be very careful here. And that's because otherwise, when you start using low numbers, it gets people worried. How does that look? And that seems outrageously low. So we have in our portfolio an all-equity portfolio. TMA's all-equity, we use just broad benchmarks—a third US, a third international, and a third Canada. We have expected returns of about 6.27, which turns out to be about 4 percent real after inflation. So let's just talk about equities right now. 4 percent real. We're going to refer now to the Dimson, Marsh, and Staunton reports, which look at 100-year returns.

Marcelo: 121 years.

Keith: Wow, you're right. 121. And they referenced real returns. So how does our current real return look relative to the past 100-year real returns?

Marcelo: Yeah. So for us right now, it would be 4 percent. The current one, the historical is 5 percent. So it's about 1 percent difference. And it's not far off, but it is different, right? But we're still looking in line. If you're looking at something—if it was 4 percent versus 8 percent, I think that would be outrageous. But we're looking at a very similar line here.

Keith: Yeah. And just for the listeners, this is one of the preeminent books on expected returns. It was published in 2001. The name of the book was *Triumph of the Optimists*. And essentially it concluded that if you were optimistic and invested in securities, stocks in particular, your wealth grew by a significant portion relative to an individual investing in bonds or T-bills. And so the highest real return came out of the US. The lowest came out at 6.7 percent real over inflation. And these returns have been updated over the last 22 years. And so this group is based out of the London School of Business. They've produced really the results where they look at real returns of every single country over the last 120 years. So on aggregate, if you were a stock investor, you got inflation plus 5.3. And today's expected return is inflation plus 4.1. So that's where we're talking about the 4.1. It's not as good as 5.3. It's in the ballpark. We're going to talk about how to actually maybe play catch up and do the things you can to improve that, but it's not as low as 2 percent real. So when you look at the last 20 years, Marcelo, what has actually been the real equity premium over inflation?

Marcelo: Keith, the return has been 6.02 percent in the last 20 years for a global equity portfolio.

Keith: So that's like starting in 2000. The numbers are actually 2001 to 2023, so we're talking 22 years. If I would ask the average individual, "What do you think stocks have done in the last 22 years?" I bet you they would all say it's 10 percent, but the reality is it hasn't been 10 percent. It's 6 percent nominal, take away inflation, and it's actually come in at 4 percent real, which is where we expect future returns to be. Now that came out of two decades, two very different decades. So Marcelo, let's talk a little bit about the lost decade and then the decade after that. So during the lost decade, what did stocks do over inflation?

Marcelo: They were flat actually. So the nominal return was 2 percent. And if you look at the inflation, 2 percent, it's actually zero. If we're looking at the same portfolio—so a third in every index, the major indices—it's actually flat. So you made no money after inflation.

Keith: Yeah. And this was the lost decade, right? And so really it's made up of US investors. The US market had a horrible period—very difficult, negative returns for a decade. And Canadian stocks were positive, and international stocks were slightly positive. So what you ended up with was a 2 percent return over that decade to match inflation. So here we are talking about we expect stocks to produce 4 percent real, and we just went through a period for a decade where it was 0 percent real. What was the next decade after that? Obviously, it must be much higher.

Marcelo: Of course. So it's 9.5. So you take away inflation, that's 7.5.

Keith: So this is a great example of how returns aren't a straight line. But I will tell you, I remember being an advisor around the year 2000. And this was after the 1990 bull market in the US, and investors at large, if you ask them, "What do you think your return will be around the year 2000?" They all said it'll be 10, 12, 15 percent compound. The expected returns coming out of publications were taking into consideration valuations were high. They were actually predicting very low expected returns. And what ended up happening? Not only very low but negative. So valuations do matter, and they do impact expected returns. So when I look at expected returns now, US are expected to be lower. But if a global portfolio is expected to come in at real plus 4, I actually think that's pretty good, relatively speaking. And that's, we have a lot to work with. Our clients have a lot to work with. Investors have a lot to work with, and I'm actually quite optimistic.

Marcelo: Yeah. I always say this, that the market is a meat grinder of opinions. And I think human beings overall are generally optimistic people. And sometimes it's easy for one person to be pessimistic. The news really makes people be pessimistic about the market, but I think overall we're all hopeful of the future. I think that translates into the behavior of thousands and thousands of people trading in the stock market.

Keith: Absolutely. And when I look at expected returns, you look at bonds, they're probably lower. If expected returns on a bond are 3 percent with inflation at 2, it's probably a 100 basis points of real return. Maybe it's a little bit lower than the historic long-term average of one and a half to two. So it is lower. Stocks are lower, maybe by 1 percent. So investors are going to have to be cognizant of this in terms of their planning, their projections. Let's start wrapping up here in terms of what individuals can do to improve the odds of a successful planning and investment experience given that we have maybe slightly lower expected returns.

Marcelo: So I think one of the things we can look at is just with the financial projections, we can project different saving rates. We can think about taking higher risk if we're comfortable with that. And then when we project, we can think about stress testing the portfolio. And we can say, "What happens if you save an extra thousand dollars a month? What happens if we lowered the returns for another extra 1 percent?" So if the expected return, say, on a 60/40 is 4 percent on a real basis—not nominal—we can say, "Let's bring it down to 3 percent and keep your current saving rate and see how that looks like." We can also randomize the return. So instead of having a linear return, we can look at sequences of return and having—just like the weather, right? When people say the average weather in Montreal is 20 degrees, we don't get 20 degrees every single year. Some days you get minus 40, some days you get 35 degrees. So we can do the same thing with the financial planning software where we know that the average will be 4 percent, but we know that every year will look different. And that matters when you're saving, and it matters when you're withdrawing money from the portfolio.

Keith: Those are all great points. And you're talking about variability and working with different assumptions, but it doesn't necessarily help an investor when they're dealing with

lower expected returns here. So what are some of the things that are in—I'm thinking out loud, like here's some of the issues that you might hear from people. Obviously, they have to save more. So nobody likes to hear that.

Marcelo: Or spend less, yeah.

Keith: Or spend less. But saving more will allow them to reach their goal because the expected return is slightly lower. You do hear some people say, "Should I reduce my management fee?" I think that's a relevant question to ask individuals. So for some individuals who have the capability of managing money on their own, they can save a management fee. Now the reality of it is the vast majority of Canadians, and this is shown through data, still need to work with financial advisors, and they still benefit from working with a firm that can provide them guidance, a plan, and keep their emotions intact so that they're not making investment mistakes. When I look at the management fee issue, one of the things I would reflect on is 20 years ago when expected returns were slightly higher, management fees were significantly higher. So the average individual was maybe paying 2 percent management fees through classic mutual funds. Now you can get good advice. You should be able to get good advice, good value-added services for about 1 percent. So the management fees have reduced over time and firms are providing more services. So there is a positive trade-off there that has occurred.

Marcelo: And I think there's more transparency too. People are more aware of what they're paying, what they're getting, the type of services we're getting. You still have some murky situations where individuals have no idea what they're paying, and it's just a hidden fee somewhere in a statement. In the eighties it was like this, but not today.

Keith: Yeah, you're dating me, Marcelo, by saying I was an advisor in the eighties.

Marcelo: You just said it.

Keith: I was finishing university in the eighties.

Marcelo: Oh, okay.

Keith: So I was an advisor in the mid-nineties.

Marcelo: It's true. It's true. But why do you think that was though? Why do you think people didn't care back then to pay that much?

Keith: There was a bunch of things going on. I'll give you an example. You could have a—we're talking real returns right now. Fixed income coming at 1 percent. When I was a bond trader, real returns were 7 percent. Now why was that? Why? Because Canada had to fund itself by issuing bonds at 10 percent when inflation was 3 percent. Those were the glory years of being a bond investor.

Marcelo: That's great.

Keith: Horrible if you were a borrower.

Marcelo: Of course.

Keith: Horrible because you were paying high borrowing costs.

Marcelo: That's crazy.

Keith: But anyway, that's a walk down history. One of the things I would say that investors can do right now—and advisors—the biggest thing they can do is stay out of trouble. So what I mean by stay out of trouble is in terms of your investment journey, make the least amount of errors. The person or the firm that makes the least amount of errors in portfolios will get a person further ahead than any other strategy. So don't do market timing. Don't be chasing assets. Don't be chasing securities or asset classes that are flying on top, and then you're going to buy at the top and then have negative risk. If we can help investors stay away from pitfalls, keep them away from issues, that is a massive way to win. So I think the best ways to improve the odds of financial success given slightly lower expected returns is stay out of trouble and don't make any investment mistakes.

Marcelo: And at the end of the day, that's the value we bring to the table is having a goal and not only providing a goal—because anybody can say, "I want to retire at 65 and spend 500,000," right? Just to use a random number—but it's about how do we provide that process where we make it easy for people to understand and we have a way of looking at these different projections with the expected return and providing a plan to get to that goal. It's not only just saying, "I'm going to retire at a certain age," right? You have to have a process that works and makes sense. And like you said, sometimes these mistakes—people who do DIY, for example, they'll think, "Okay, I'm not paying an advisor. I'm going to save that fee." But sometimes you're going to make mistakes and it's going to end up costing you way more than what it would cost you to have an advisor.

Keith: Of course. Of course. So listen, let's wrap up. Last comments, Marcelo. We have expected returns here. Are you optimistic about the future?

Marcelo: Always.

Keith: That's a great answer. I like that answer. So I'm going to add in then, I am very optimistic about the future. If you have stock expected returns globally somewhere in the vicinity of 6 to 7 percent with inflation at 2, that's pretty good. And I think investors can really grow and secure their financial future by investing wisely. I feel much more optimistic today than some other periods where I was an advisor, for example, in double O. So I think it's a great time to be an investor, and I think individuals just need to stick to their plans.

Marcelo: I couldn't agree more.

Keith: So, Marcelo, you got the last words in terms of wrapping the show up?

Marcelo: Yeah. My only takeaway is just have a plan and make sure you stick to it. And yeah, thank you for listening.

Keith: Thanks to our listeners. Keith, it's been great doing an actual face-to-face podcast for the first time in our history.

Marcelo: A hundred percent. See you guys next week. Take care.

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