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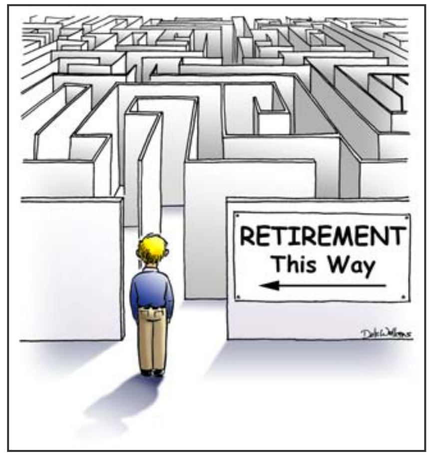
Planning On 9% Portfolio Returns? Time to Get Real…

Navigating the Retirement Maze



Baby Boomers have been quite fortunate when it comes to investment returns. From 1982 through 2010, a buy-and-hold investor would have made 8.8% a year in the S&P 500, and 8.9% a year in bonds as measured by the Barclay Aggregate Bond Index. (Note: We've yet to locate one of these mythical "buy-and-hold investors", so any reports of sightings would be greatly appreciated.) These figures even include the so-called "lost decade" of 2000-2009. So the past thirty years have indeed been good to investors.

However, the result of this market largesse is that investors have come to expect similar returns going forward. The problem with projecting 8-9% annual returns out to and through retirement is three-fold: 1) investors tend to move in and out of the markets at exactly the wrong times, 2) fund fees further reduce performance, and 3) high stock valuations and low bond interest rates are a recipe for low returns. Items 1 and 2 are topics for future columns. I'll focus here on the third point.

Forecasting the Future: Valuation Matters

It's mostly a guessing game figuring where the stock market is headed next week or next month. However, a 10-year forecast of the markets is not only more relevant to retirement investors, but there are methods for this that have proven to be remarkably reliable. The value-based market segment forecasts by Grantham, Mayo, Van Otterloo & Co. (GMO), a Boston-based investment management firm, and Robert Shiller's P/E10 Ratio are two such approaches.

At the end of 1999, GMO predicted the 10-year gains for eleven different asset classes. The results ten years later: a 93% correlation with their forecast. The likelihood of accomplishing this feat randomly is 1 in 550,000. So how did they do it? To put it simply, they compared asset category valuations to their historic averages.

The P/E10 ratio uses a 10-year average of the stock market price-earnings ratio (P/E) to gauge over/undervaluation. Comparisons of P/E10 projections to historical market performance demonstrate the reliability of this approach, as it correctly anticipated the market downturns of 2000 and 2008.

And the Results For the Next Decade Are…

… sobering. The P/E10 currently forecasts 10-year real returns (i.e., after inflation) for the S&P 500 at around 3.5% per year. GMO's most recent 7-year asset forecasts predict annual *losses* of -3.2% for US small cap stocks and -0.5% for large caps. Not quite the figures that make you want to put a deposit down on that retirement villa in Cancun.

Why so low? It's a combination of anemic projected economic growth in the U.S. – from excessive government debt levels here and in Europe, plus increasing competition from emerging markets – and high current stock market valuations due in part to the Federal Reserve's "quantitative easing" program. The dividend yield of the S&P 500, which has averaged 4.3% over the past century and typically accounts for half of the stock market's returns, is an anemic 1.75% today.

As we've seen with both tech stocks and housing, pricing bubbles eventually deflate, and valuations return to something closer to their historic averages. Unfortunately, this is a painful process to live through. Just ask anyone who is trying to sell a condo in Miami, or held onto their Pets.com stock a little too long.

Improving Upon Lackluster Returns

Rather than throwing in the towel and relegating your portfolio to a decade of marginal performance, there are some remedial actions that you can take:

- In pre-retirement – Spend less, save more. Boring, but worth mentioning.
- Consider alternative investments – Just because most US stocks are overpriced doesn't mean that all markets are. GMO estimates that emerging markets will return 4.5% over the next seven years. Commodities are still in a longer term upward trend. These asset classes are volatile, though, so keep your allocations moderate.
- Dividends and quality still matter – Don't be a yield chaser, and be selective. GMO projects that US "High Quality" stocks – large caps with global markets, little debt, and consistently strong performance and dividend growth – will grow 4% annually above inflation, well above the broader market.
- Bonds rates will eventually provide more generous returns, as interest rates are likely to rise over the next several years. Just be patient.

Finally, scale back your projected portfolio gains to be more in line with current market realities, particularly if you are looking at a 10- to 15-year time horizon. This will reduce the chances that you'll be caught short when retirement arrives.

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