

## Historical Performance, Return Expectations, and Market Outlooks

TO BUILD an optimal endowment portfolio, we start with three tasks each requiring a set of informed judgments about the asset categories we are considering for investment. First, we make judgments about the likely returns provided by each category. Second, we make judgments about the risks associated with an investment in each category. Third, we make judgments about how the various categories are likely to perform relative to each other. The second and third tasks we take up in the section on risk and correlations. The first several sections on market outlooks are devoted to the first task, making judgments about likely returns.

We could use historical returns as proxies for expected future returns, but we won't for reasons we'll see in a moment. We start with historical return data, however, so we know the history, but we formulate return expectations based on current economic and market conditions. In formulating our return expectations, we are not trying to outguess the markets, we are just trying to understand the markets, for those who would build a portfolio without trying to do so are making themselves a slave of current market valuations (see the section on Asset Allocation: The Art and Science on page 41). An investor who bought the U.S. stock market in early 2001 cannot be faulted, unless he or she did so without understanding how the market was valued at that time.

We include sixteen asset categories for investment:

1. Large capitalization U.S. stocks ("large-cap")
2. Small capitalization U.S. stocks ("small-cap")
3. United Kingdom stocks
4. Euro area stocks
5. Japanese stocks
6. Emerging-market stocks
7. Venture capital
8. Real estate
9. U.S. long-term government bonds
10. U.S. intermediate-term government bonds
11. U.S. inflation-protected bonds (or Treasury Inflation-protected Securities, "TIPS")
12. U.S. long-term corporate bonds
13. U.S. high-yield corporate bonds
14. U.S. mortgage-backed bonds (or mortgage-backed securities, "MBSs")
15. Foreign investment-grade bonds
16. Emerging-market sovereign debt

Sound portfolio management requires that we understand the capital markets and where they are headed.



These categories cover the vast majority of securities traded in the global capital markets and in most cases can be bought individually through exchange-traded funds. Note that hedge funds are not considered a separate asset category. See the market outlook on hedge funds, page 18, to understand why. Also note that commodities and currencies are not included as separate asset categories. These will be addressed in subsequent issues of the *Asset Allocation Advisor*.

#### AVERAGE ANNUAL TOTAL RETURN RATES, ARITHMETIC AVERAGES

	20 year 1986-2005	10 year 1996-2005	5 year 2001-2005	1 year 2005	Long-term yrs	
1 U.S. large-cap stocks	13.2%	10.7%	2.1%	4.9%	12.3%	80
2 U.S. small-cap stocks	14.5%	15.4%	18.9%	5.7%	17.4%	80
3 UK stocks	12.1%	10.1%	6.8%	8.8%	11.8%	80
4 Euro area stocks	13.1%	12.2%	7.0%	12.0%	16.5%	22
5 Japanese stocks	10.9%	5.1%	8.6%	26.1%	15.4%	45
6 Emerging-market stocks	–	11.3%	21.7%	34.5%	19.0%	18
7 Venture capital	–	23.4%	-6.5%	1.1%	20.5%	17
8 Real estate	13.5%	15.8%	19.7%	12.2%	14.7%	34
9 U.S. long-term government bonds	10.3%	8.0%	7.9%	7.8%	5.8%	80
10 U.S. intermediate-term government bonds	7.5%	5.8%	5.3%	1.4%	5.5%	80
11 U.S. inflation-protected bonds (TIPS)	–	–	8.9%	2.8%	8.0%	8
12 U.S. long-term corporate bonds	9.7%	7.7%	9.4%	5.9%	6.2%	80
13 U.S. high-yield corporate bonds	10.3%	7.7%	8.6%	2.2%	11.2%	26
14 U.S. mortgage-backed bonds (MBSs)	–	6.4%	5.7%	2.8%	6.7%	14
15 Foreign investment-grade bonds	–	–	8.9%	-8.5%	5.5%	9
16 Emerging-market sovereign debt	–	14.0%	14.6%	9.8%	14.6%	14

**Figure H.1:** Historical Total Return Rates, arithmetic averages

**Sources:** Barclay's Capital, Bloomberg, Ibbotson, Merrill Lynch, Morgan Stanley, Reuter's Stock Val, Sand Hill Econometrics

**Figure H.1** shows historical return information for these sixteen asset categories. A quick perusal of the table shows why we have to make judgments about future returns. Historical returns are variable; if we were to use them as proxies for expected future returns, which returns would we use? Would we rely on long-term averages or more current averages? Where recent returns have diverged from longer-term averages, would we expect the divergence to continue, or would we expect returns to revert to the longer-term average?

Sound portfolio management requires that we try to understand the capital markets and where they are headed. We do this in the following market outlook sections.

