

Finding Goldilocks

When return assumptions are 'just right'

FOR PROFESSIONAL INVESTORS ONLY
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Why realistic return assumptions are key to long-term stability in asset allocation

Proof in the porridge: why consistency counts

- **Return assumptions matter** – asset classes that consistently perform in line with expectations support robust portfolio construction.
- **Consistency matters** – Portfolios that can be knocked off-track by manager underperformance face sequencing risk which can derail long-term goals.
- **Believe what you can see** – Income generating assets tend to meet return targets more reliably, so they can anchor a more dependable outcome.

With that context, we test how different assumptions change the risk a portfolio needs to take to meet its objective.

Why return assumptions matter for trustees

Defined benefit pensions are a forecasting business. Scheme Actuaries forecast future liability payments and investment advisers forecast future asset performance to help meet those liabilities. Expected investment returns on assets are a vital cog in the wider scheme funding wheel. These asset class assumptions drive portfolio construction. Accurate return forecasts lead to robust portfolios from a risk and return perspective.

In the world of Goldilocks, robust long-term portfolios need return assumptions that are not too cold, not too hot, but 'just right' to avoid a portfolio that takes far too much or far too little risk. The question then is: how do we know if our forecasts are accurate? This paper explores whether commonly used asset classes meet commonly held return expectations and what this means for building long-term portfolios.

The impact of unrealistic assumptions on portfolio risk

Setting assumptions too low or too high can have unintended consequences. The simplified portfolio below, which has the advantage of using perfect hindsight, shows how the choice of assumption changes the level of risk required to target Cash + 5%. (i.e. the assumptions have been set to equal what the assets did, we're not saying they're reasonable or unreasonable):

Metric	Prudent assumptions	Best estimate assumptions	Ambitious assumptions
Historical equity return (10yr)	Best estimate -2% p.a. (lower than w. hindsight)	Cash + 10% p.a. (perfect hindsight)	Best estimate +2% p.a. (higher than w. hindsight)
How assumptions impacts the portfolio	Low assumption → over allocating to risky assets	"Right" assumption → "Right" sized risky asset allocation	High assumption under → allocating to risky assets
Required equity allocation	60.0% (+10%)	50.0%	40.0% (-10%)
Return achieved (10yr p.a.)	Cash + 6.2%	Cash + 5.0%	Cash + 4.2%
Volatility (annualised)	7.1%	5.7%	4.8%
Max. drawdown	-9.3%	-7.5%	-6.3%

The equity exposure required to achieve a Cash + 5% portfolio with perfect hindsight over the past 10 years was 50%. The actual return achieved will vary depending on the assumed equity return versus the actual equity return over the past 10 years. Cautious investors may have been tempted to lower the assumed return from equities (or other risky assets) in the name of prudence – this would be a mistake. As would inflating equity return assumptions in an attempt to action a bullish view. Why?

Lowering return assumptions in order to be 'prudent', leads to higher allocations to risky assets (equities) to deliver the same portfolio return target, which raises the risk of losses and defeats the intent. Overly ambitious expected returns have the opposite effect: a lower risky-asset allocation that delivers lower portfolio returns than intended, contradicting a bullish view on equity markets.

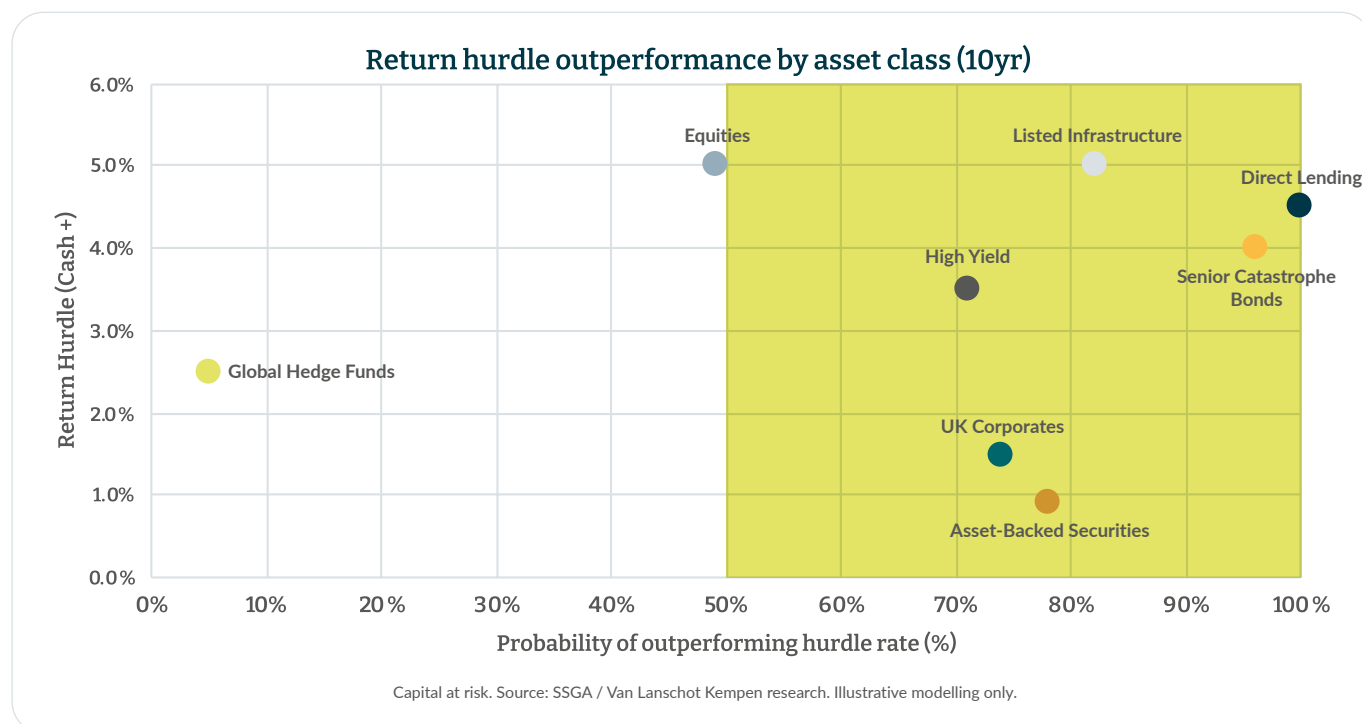
So how do we get assumptions right?

The above idea can be extended to the wider universe of asset classes. The remainder of this paper explores a dual concept built around what investors (generally) actually want to know:

- What is the right level of assumption for each asset? Getting this right is key to avoid under- or oversizing risky asset allocations. We have tested how frequently different asset classes hit some illustrative industry-wide 'best estimate' returns (not necessarily prudent) to test where these could be set.
- Are all assets equal? A key additional question. If two assets have the same (reasonable) return target but one delivers it much more frequently, with all else being equal, would it not be reasonable to focus portfolios towards these assets?

Which asset classes deliver consistently—and why it matters

To test reliability, we analysed 27 years of data across commonly used asset classes and assigned each a 'hurdle rate' of cash + x%, based on long-term expected return assumptions commonly used in the market. This shows how likely an asset class is to outperform its hurdle over different time periods. The higher the probability of outperformance, the more consistently the asset class contributes to a portfolio's required return, and the stronger the case for inclusion. The graph below summarises our findings:



Insights for portfolio design

Equities – worth the variability

Equities have the highest return target at cash + 5%, and still outperform in half of every rolling 10 year period analysed. This justifies the commonly held assumption that equities are high risk and high return. Over the long run, the return from equities form an important part of a successful investment portfolio. However, diversification can be beneficial given they can be inconsistent in hitting their return target.

Cash-generating equities – consistent performers

Cash-generating equity assets like listed infrastructure equity perform well in our analysis, meeting their return target 82% of the time. The income element of these assets creates more dependable returns than more sentiment-driven equities. Taking listed infrastructure as a proxy for income focused equities asset (for example unlisted infrastructure or high-dividend equities) shows these assets could be useful if dependability is a focus. The trade off? They may not fully participate in the extreme positive returns that growth-focused equities (for example tech-dominated strategies) have earned in recent years. A balance, but one with potential value.

Credit, bonds and income assets – consistent performers

The returns from different income-generating assets vary greatly based on factors such as credit rating, illiquidity or complexity. However, all income-generating assets studied have managed to meet their return hurdle more than half of the time, meaning that these are integral assets in a robust long-term portfolio, helping return targets to be achieved with higher predictability than equity markets.

Alpha driven assets – lacking consistency

Assets that derive most of their value from 'alpha generation' and 'beating the market' do not consistently meet their return hurdles. In particular, broad hedge fund indices often fall short of those hurdles, and so do not provide the consistent 'hedge' that they claim to. Where used within long-term portfolios, the purpose of the asset class should be carefully considered in light of the other opportunities available. If hedge funds are viewed as an attractive asset class, manager and fund type selection is of utmost importance. Picking managers that you are confident are able to perform across a variety of market environments is key to ensuring robustness of the long-term portfolio.

Necessary trade-offs

Risk appetite and time horizon are key factors to consider in building portfolios. Short-term equity returns are notoriously difficult to forecast, but the evidence shows we can be reasonably comfortable with the long-term performance of the asset class, as long as there is enough risk appetite to weather short-term volatility. Conversely, current yields on income assets provide a reasonable estimate of shorter-term returns, although these are likely lower than their equity counterparts. If a portfolio aims for stable, mid-level returns, over a short to medium term, income-generating assets will play an important role. If consistent high returns are needed longer term, equities will be an important contributor, as long as short-term volatility can be weathered in order to achieve the higher returns.

These results translate into practical actions for trustees and scheme governance.

Strategic implications for DB Pension Schemes

Trustees should focus on practical steps that strengthen governance and improve portfolio resilience. Key considerations include:

- **Believe what you can see:** Income yields are contractual income available in the market now. They are easier to capture than the uncertain promise of future manager skill.
- **Reduce reliance on alpha:** Building portfolios around alpha- driven strategies is not a sustainable approach. Portfolios anchored in income generation and market beta are more likely to deliver long-term value.
- **Avoid assets unlikely to meet targets:** Allocating to assets that rarely meet their return targets can derail the long-term journey, forcing schemes to depend on outperformance to get back on track.
- **Manage sequencing risk:** Alpha-driven strategies often deliver uneven results. A strong period of returns following a weak period must work harder to recover the initial losses, increasing risk for schemes.
- **Reflect current market conditions:** The assumptions tested in our modelling assumes static long-term assumptions. The point of this paper is not that assumptions should be fixed over the long-term. For example, if investing in credit over a 5 year time period, current yields over the next 5 years matter more than long-term best estimates. Aligning assumptions with the investment horizon will help to manage risk effectively.
- **Separate views from governance:** Avoid conflating current market conditions with subjective views ("do you like credit?"). Good governance and process are essential for building robust portfolios.
- **Understand implications of assumptions:** Where an asset class meets a return target by a thin margin, but delivers very negative returns when it misses, this is clearly not desirable. The extensions to this could span pages; understanding and testing assumptions and portfolios for robustness is key.



Where to from here?

Trustees should review long-term assumptions with their advisers and revisit portfolio allocations that rely heavily on manager skill. This is particularly important for schemes considering run-on portfolios or traditional 'de-risking'. When return targets are reduced, income-generating assets can help meet objectives across a wider range of market conditions, even if the traditional 'diversification benefits' of an equity/bond portfolio are reduced. A portfolio of fewer, but more dependable assets can often deliver greater consistency than one built around a larger number of more unpredictable assets.



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- i) the amount of weight that should be given to recent levels of market volatility compared to long term historic averages,
- ii) should future volatility levels be determined by the markets, through observation of derivative prices,
- iii) past performance should not be a guide, and
- iv) should the expectation of default risk and recovery rates for debt instruments be based on past data.

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