

2013 ALM Workshop: Introduction to Capital Market Assumptions

Investment Committee Workshop

May 13, 2013

Contents

- I. Brief Overview of Capital Market Assumptions
 - Eric Baggesen and Ben Meng

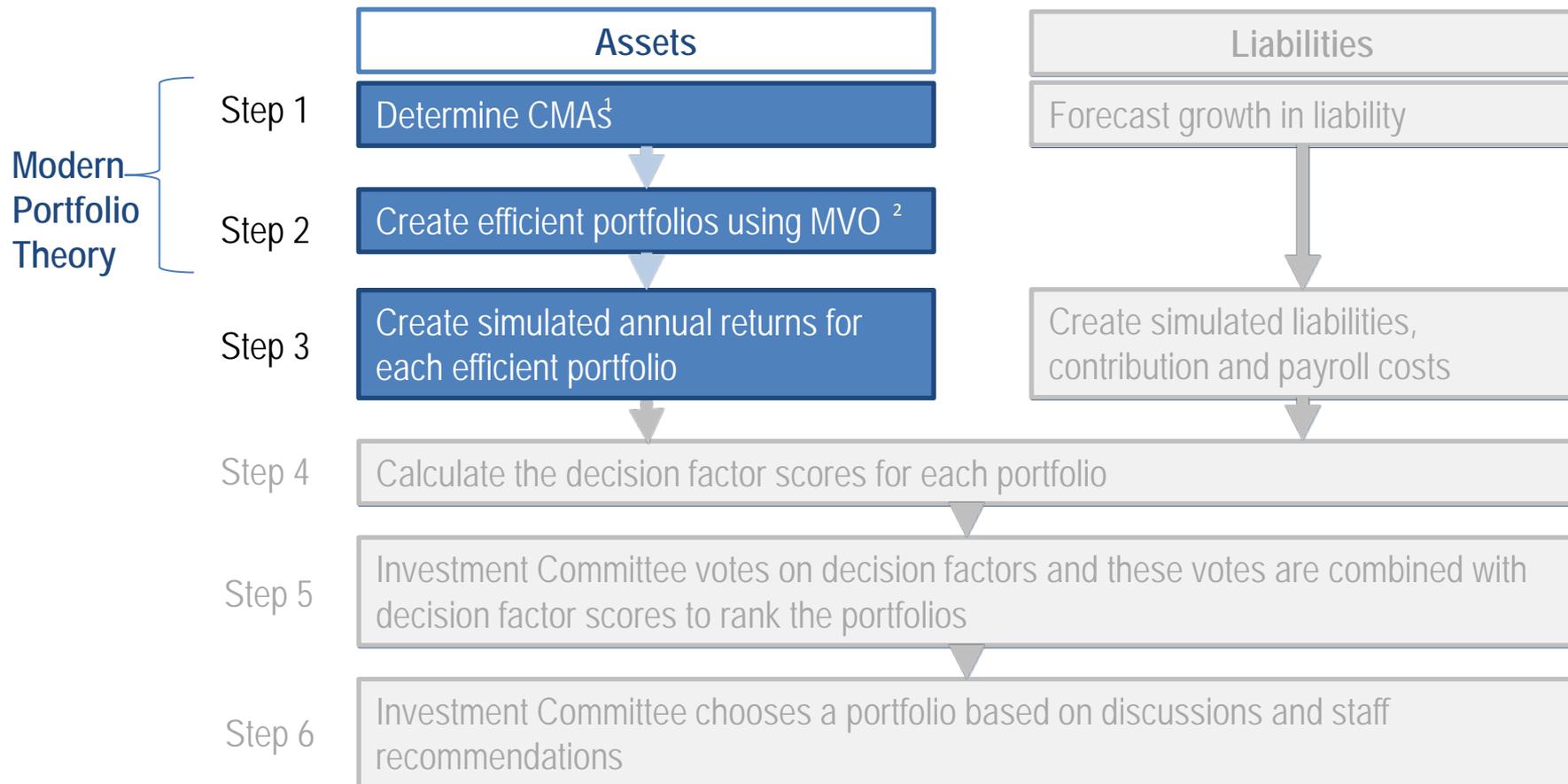
- II. Capital Market Assumptions – A Basic Primer
 - Allan Emkin, Pension Consulting Alliance

- III. Asset Forecasting Uncertainty
 - Steve Foresti and Michael Schlachter, Wilshire Associates

I. Brief Overview of Capital Market Assumptions

Eric Baggesen, Ben Meng

Steps to Obtain Policy Portfolio in Past ALM Workshops



Three Components of CMAs

- Expected returns
- Expected volatility
- Expected correlations between asset classes

Methodology for Expected Returns

- Various Fundamental Valuations Models
- Predictions on valuation metrics, such as earnings yield, credit spread and capitalization rate
- Industry survey

Expected Returns (Examples)

Public Equity

- Dividend Discount Model
- Income + Growth + Valuation
- Inflation + Real Risk Free Rate of Cash + Risk Premium

Private Equity

- Public Equity plus illiquidity premium and other adjustment

Fixed Income

- Yield-to-maturity plus spread adjustment

Real Estate

- Cash Flow forecast plus capitalization rate forecast
- Risk premium between Equity and Fixed Income

Risks and Correlations Estimation

- Is largely based on observed historical asset class behavior and an understanding of the response of individual asset classes to changes in economic factors
- Adjusts the historical asset class behavior to account for evident trends and recent abnormalities of discrete 5-year data periods

II. Capital Market Assumptions – A Basic Primer

Allan Emkin, Pension Consulting Alliance

Purpose

- We use quantitative models to develop intuition about the future
- All models and modeling require assumptions
- Everyday example: the weather forecast (today, tomorrow, 5-day)
- Weather forecasting is sophisticated and necessary, but is often erroneous
- Forecasting for investments begins with capital market assumptions (CMAs)
- CMAs express views about future growth and risk of major market segments

Purpose – General CMA Characteristics

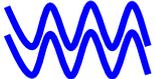
Capital market assumptions are organized by types of investment assets

- e.g., equities, fixed income, real estate, cash, etc.
- Public vs. private, domestic vs. international
- Typically kept at high-level to reflect most dominant market and/or risk segments

Many practitioners over-model dozens of market categories

- Should focus on no more than the top 6-to-8 categories

For each asset, an assumption about:

- Expected growth (typically: 10-year annualized return) 
- Expected risk (standard deviation – i.e., average per year volatility) 
- Expected relationship with other assets (correlation)  vs. 

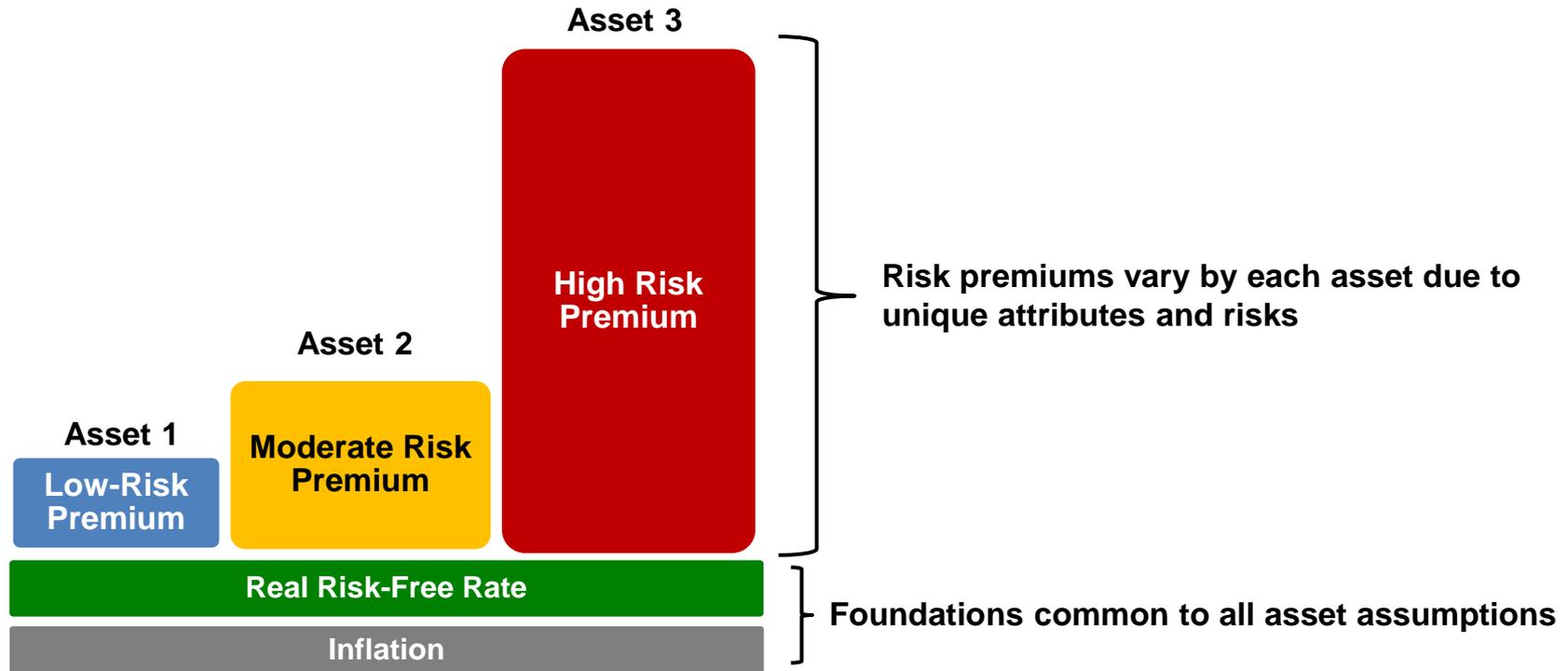
Caveats

- **Precision is not accuracy**
- **Assumptions indicate *tendencies*, not pinpoint forecasts**
- **Basic return, risk, and correlation assumptions assume a special-case world:**
 - Normal distributions (i.e., crises should occur less often than really they do)
 - A certain level of stability (entropy and chaos are not assumed)
 - Randomness (the future is never influenced by the past)

Determining Expected Growth – Building Blocks

Each asset is viewed by its ability to:

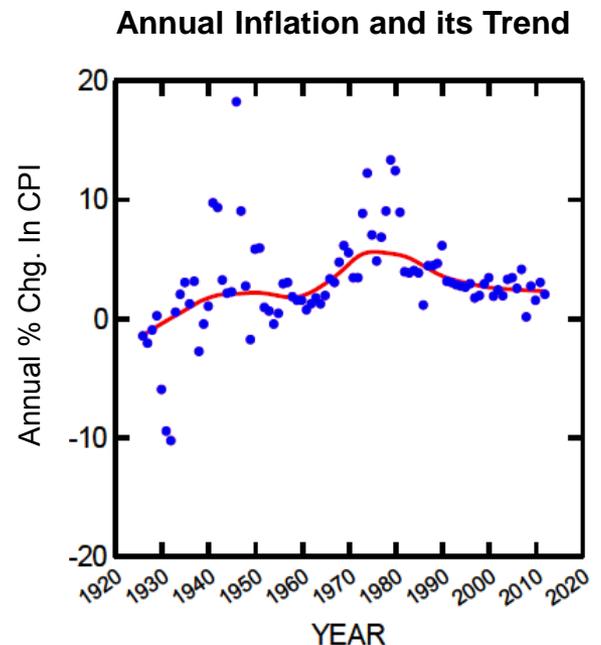
- Grow with inflation
- Provide growth relative to inflation: (i) a “risk-free” lending rate, (ii) a premium for additional risk



Determining Expected Growth – Building Blocks

Inflation

- Since inflation is a foundational building block, each asset is expected to compensate for inflation over the long-term
- Over the last 20 years, inflation has been relatively easy to model
- Inflation levels forecasted using:
 - 10-year TIPS/10-year Treasury differentials
 - Consensus economic forecasts
 - General view about Federal Reserve Bank policy
- Recent inflation has been relatively stable, but volatility is increasing

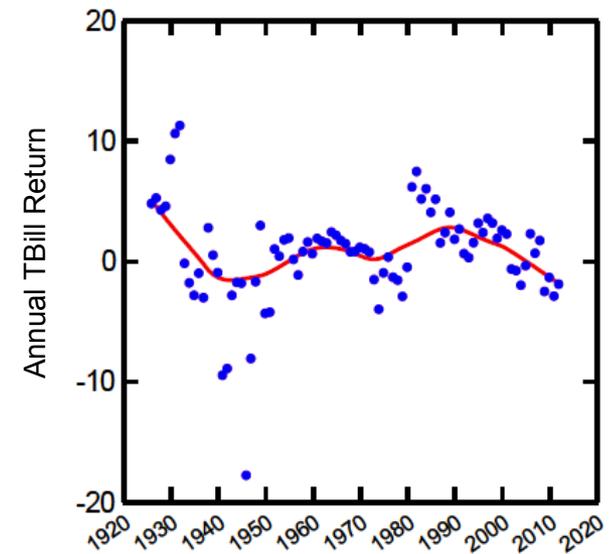


Determining Expected Growth – Building Blocks

Real “Risk-Free” Rate

- Typically, the short-term default-free lending rate in excess of inflation*
- The “risk-free” rate has experienced cyclical volatility; today it is negative
- Short-term lending rate forecasted using:
 - Current and historical levels of T Bills
 - General view about Federal Reserve Bank policy
- Key assumptions:
 - Accommodation now
 - “Catching up” later

Short-term TBill Return and its Trend



*PCA also examines the longer-term expected return of 10-year TIPS

Determining Expected Growth – Building Blocks

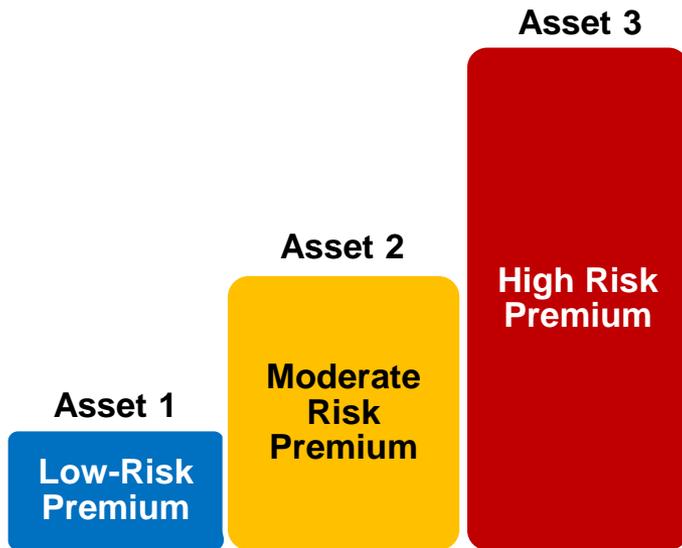
PCA Assumptions and Actual Results: Inflation & Real Risk-Free Returns

Foundational Building Blocks	In 2003	Today
Expected Results		
Inflation	2.50	3.00
Real Risk-Free Rate	1.50	-0.75
Total Nominal Risk-Free Return	4.00	2.25
Actual Results		
Inflation (ten years hence)	2.40	??
Risk-Free Return (ten years hence)	-0.70	??
Nominal Risk-Free Return	1.70	??

- Inflation expectations could be considered reasonably accurate
- Even the short-term “risk-free” rate is difficult to predict; PCA expects it to remain negative

Determining Expected Growth – Building Blocks

Individual Class Risk Premiums:



- Size of premium typically linked directly to amount of risk taken
- Return/risk tradeoff declines the more risk you take
- Level of precision difficult to nail down, particularly with more private markets
- Wilshire Associates will discuss specific risk premiums in more detail

Arithmetic vs. Geometric (Compound) Returns

- Different practitioners apply different building-block approaches
 - Arithmetic Return estimates (what will happen in any one year)
 - Compound Return estimates (what will accrue over an entire horizon)
- Compound return = (arithmetic return – penalty for bearing risk overtime)
- Arithmetic returns have attractive statistical properties
- Compound returns matter the most

III. Asset Forecasting Uncertainty

Steve Foresti, Wilshire Associates

Michael Schlachter, Wilshire Associates

Agenda

- Review basic approaches to asset class modeling
 - i.e. what are we attempting to measure?

- Discuss predictive accuracy across major asset class categories
 - Bonds
 - Stocks
 - Commodities

- Observations on the impact of forecasting uncertainty

- Conclusions / Q&A

General Approaches to Forecasting Investment Returns

Equities (Stocks, Real Estate, etc.)

- DDM (Dividend-Discount Model)
- Component Model (Income + Growth + Valuation)

Fixed Income

- Yield driven (current & expected)
- Defaults & recoveries

Commodities

- Inflation-plus

Private Markets

- Adjust public market proxy assumptions for appropriate level of financial leverage

General Approaches to Forecasting Investment Returns

- While there are various modeling techniques, all asset classes can be viewed from the prism of a components model
 - Income + Growth + Valuation Change
- Importance of contributors

	Income	Growth	Valuation
Equity	X	X	X
Fixed Income	X		X
Commodities			X

- Some components are more challenging to forecast

Fixed Income Components

Income

- Yield-to-maturity is a reliable starting point for forecasting bond returns (especially high quality bonds)
- Interest rate changes will impact the reinvestment yield (i.e. income in future years)

Growth

- No contribution from growth (other than default, cash flows are known in advance)

Valuation

- Interest rate changes will impact price levels (though bonds held to maturity will provide an agreed upon settlement price)

U.S. Core Bonds

Current yield vs. subsequent 10-year return



Equity Components

Income

- Dividend yields
- Relatively stable and predictable over time

Growth

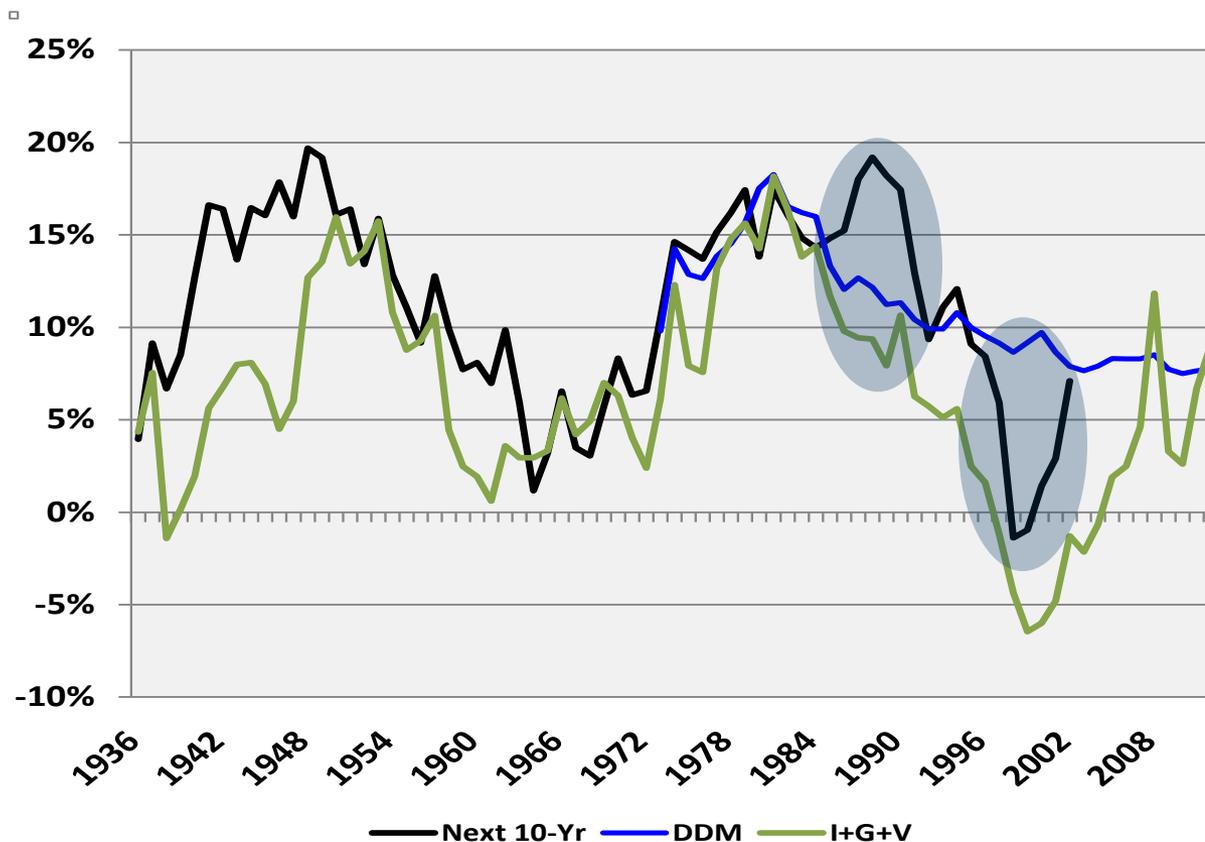
- Increases in corporate earnings and/or dividends
- Short-term swings can be difficult to project

Valuation

- Price multiples: how much investors are willing to pay for each \$1 of earnings/dividends (i.e. changes in P/E and P/D ratios overtime)
- Volatile and extremely difficult (i.e. impossible) to accurately forecast over the short-term (even the long-term can be difficult)

U.S. Stocks: Model Forecasting

Dividend Discount Model (DDM) and Income + Growth + Valuation Model (IGV) Accuracy



Component Contributions by Decade

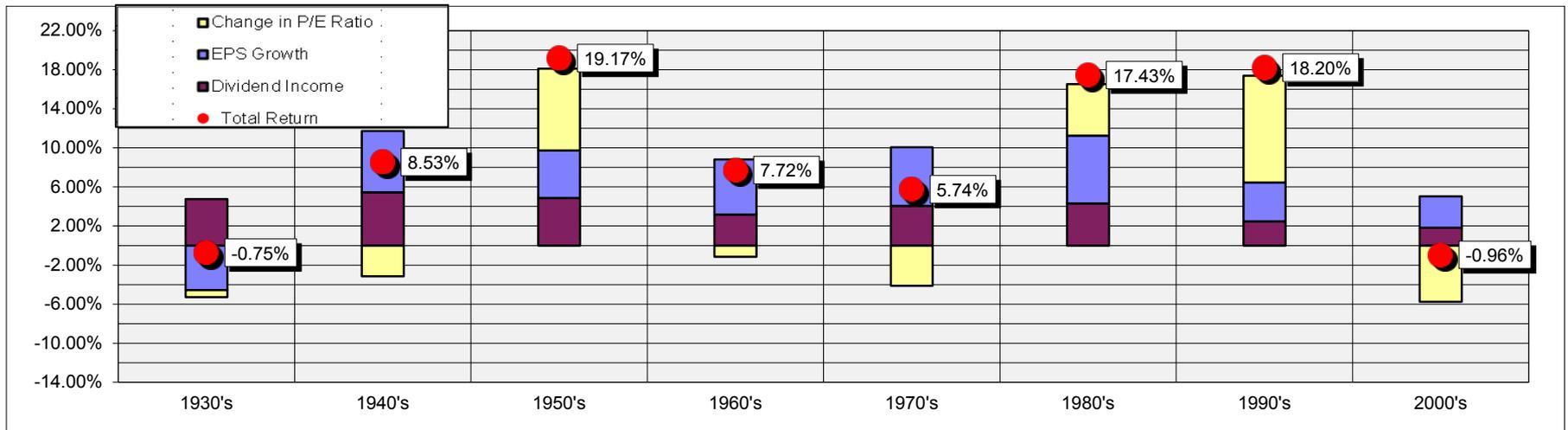
Income (I): Positive contributor in all 8 decades

Growth (G): Positive contributor in 7 of 8 decades

- Negative contributor (contraction) in the 1930's

Valuation (V): Positive contributor in 3 of 8 decades

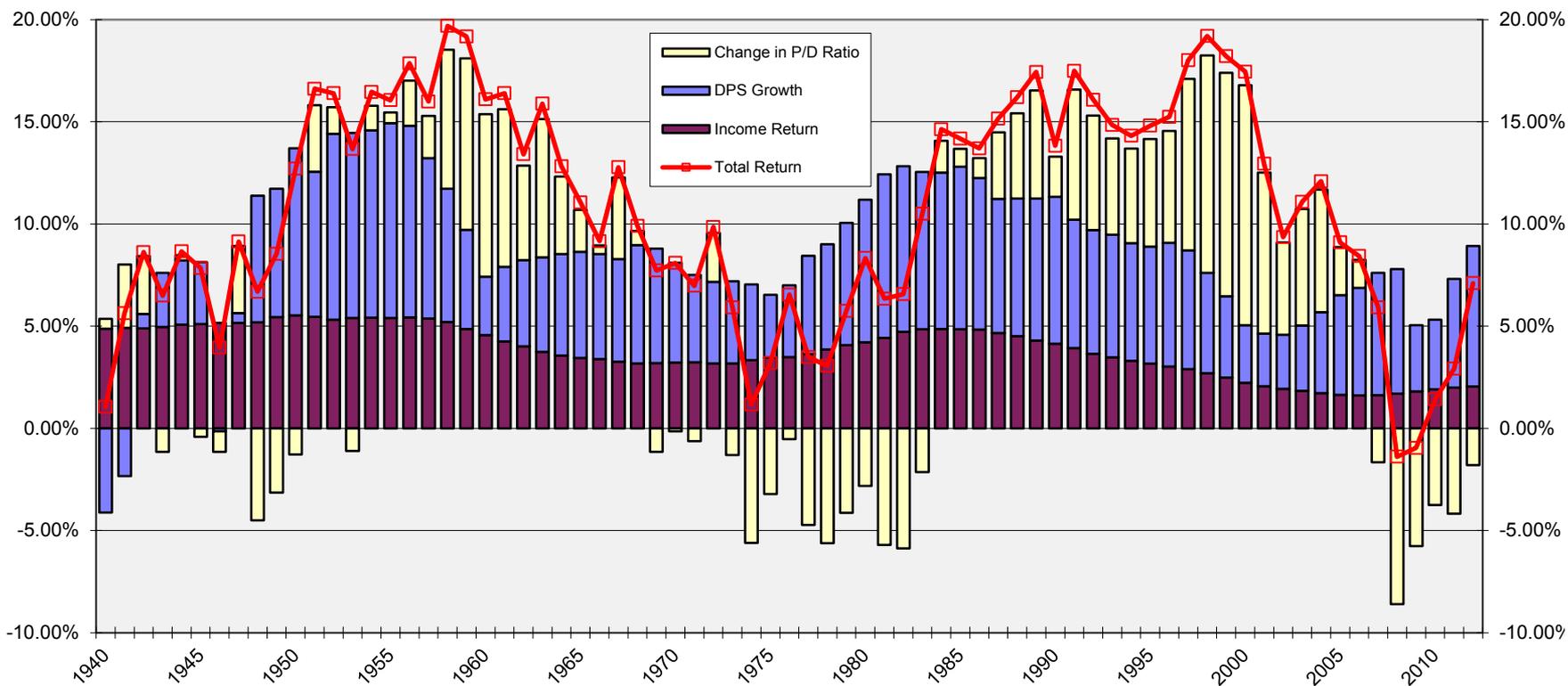
- Huge contributor in the 1980's and 1990's



10-Year Rolling Component Contributions

The valuation component is a dominant (and volatile) contributor to realized returns

10 Year Trailing S&P500 Return Components

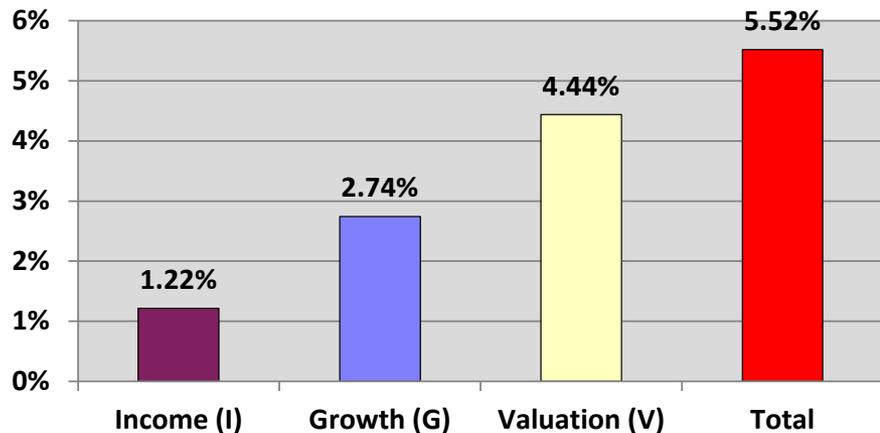


10-Year Rolling Component Contributions

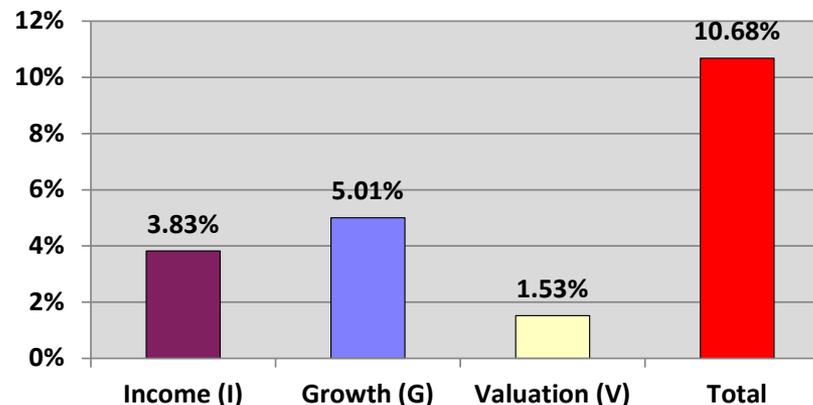
Contribution statistics over 73 distinct 10-year periods

- Income (I)
- Growth (G)
- Valuation (V)

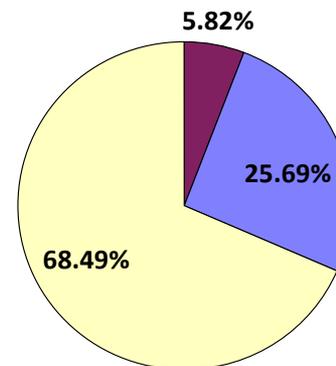
St. Dev. of Return Contributions



Avg. Return Contributions



% Contribution to Risk



Commodities Components

Income

- None (other than from the underlying collateral held in conjunction with exposure via futures contracts)

Growth

- None
- No direct cash flows from which to grow

Valuation

- Price fluctuations
- Volatile and difficult to forecast accurately

Commodities Futures: Model Forecasting

Inflation-plus vs. subsequent 10-year return



Source: Gary Gorton and K. Geert Rouwenhorst "Facts and Fantasies about Commodity Futures," (February, 2005), Wilshire CompassSM

Observations: Forecasting Uncertainty

“What Could Possibly go wrong?”

Macroeconomic shock to...

- Inflation (spikes or deflation)
- Interest rates/Access to capital (or spreads)
- Growth rates (GDP, corporate earnings, etc.)
- Market levels (“popping of a bubble”)

Geopolitical shocks

- War/ Terrorism/ National unrest
- Could serve as a trigger to the macroeconomic shocks above

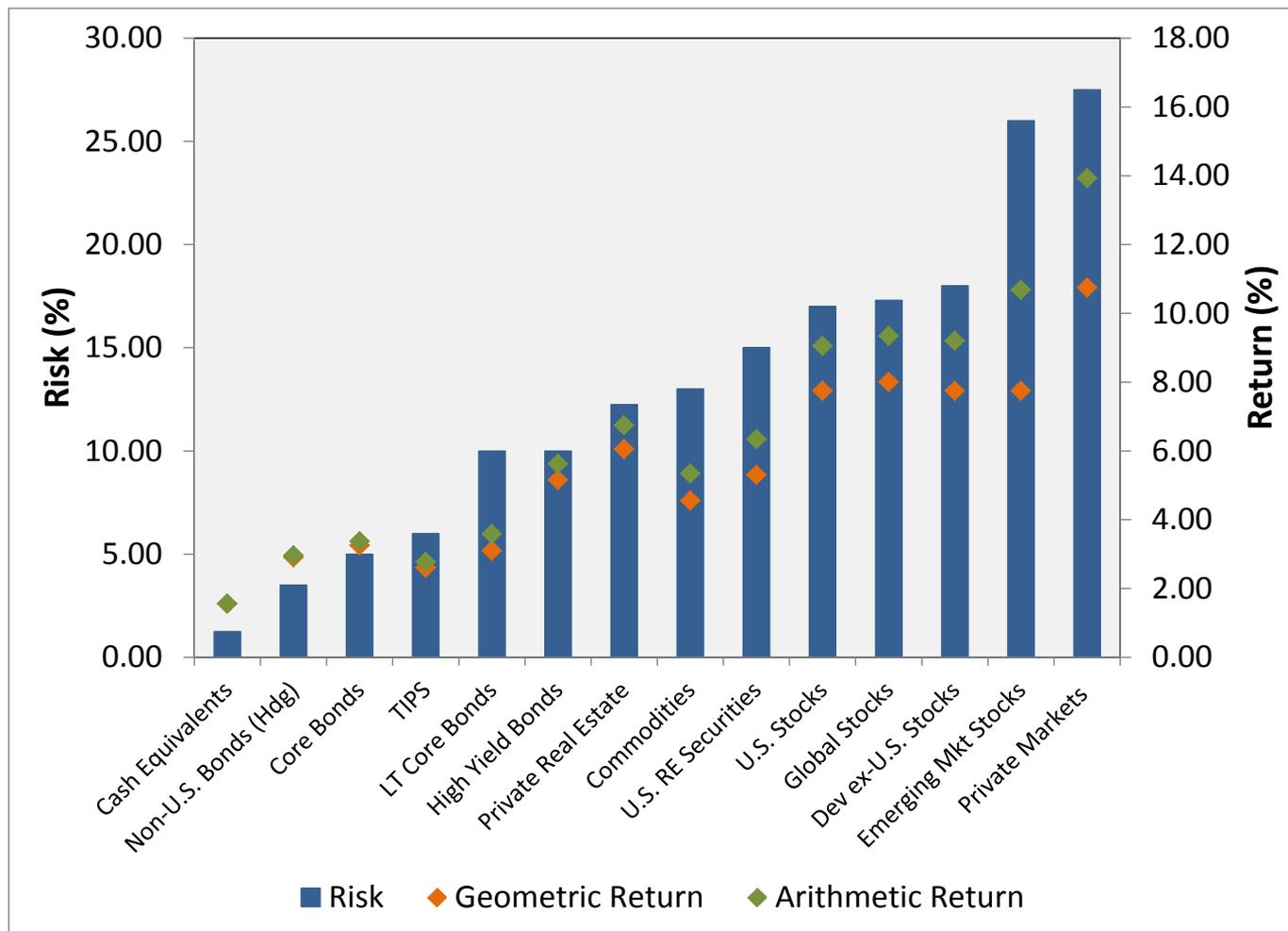
And then there are the unknown risks

- TBD

Observations: Forecasting Uncertainty

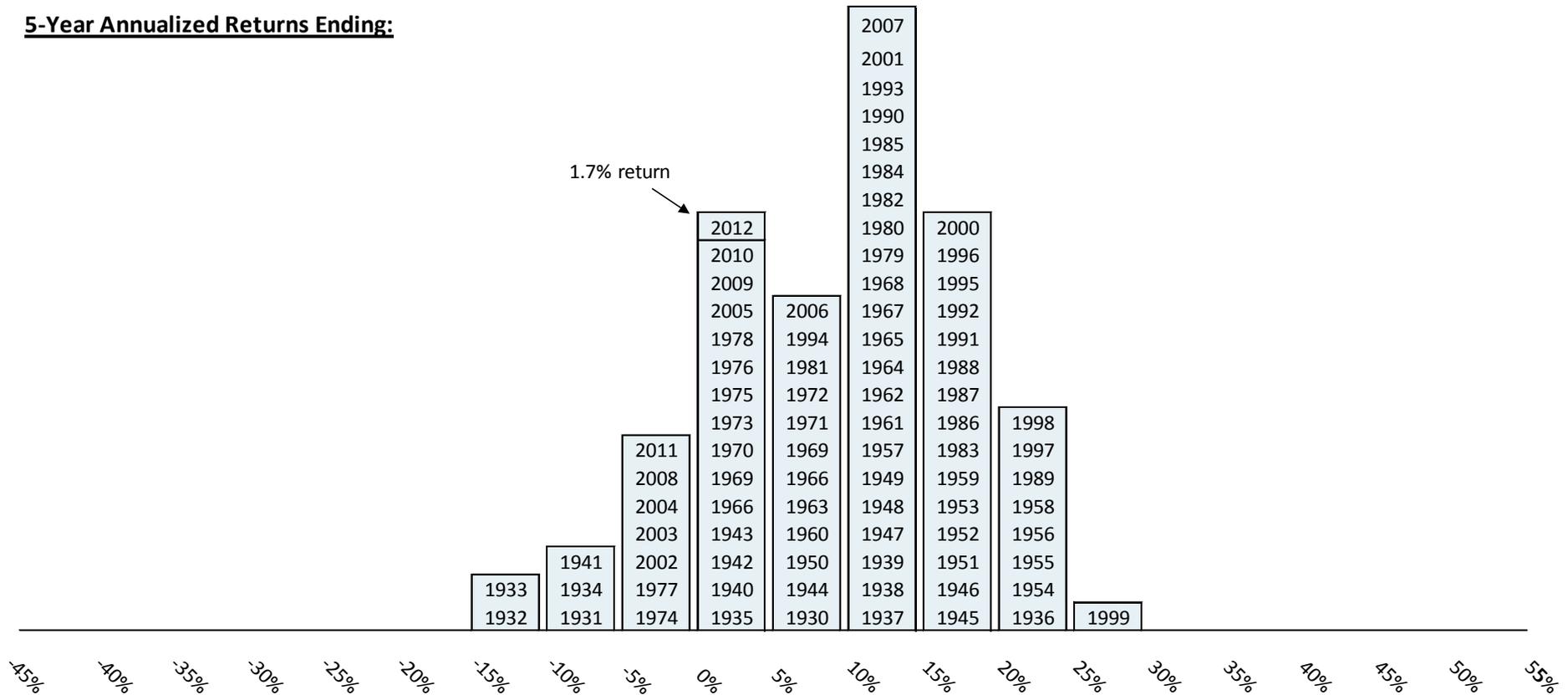
- Internal consistency of inputs is critical
 - Forecasting errors in a specific input can then uniformly impact various asset classes (potentially maintaining their relative relationship)
- In general, the more volatile the asset class, the more difficult it is to forecast accurately (often because the valuation component is a significant contributor)
- Longer term forecasts can have greater predictive accuracy
 - Long-term investors can benefit from a more dependable relationship between asset classes over extended holding periods

Wilshire's 2013 Return and Risk Assumptions



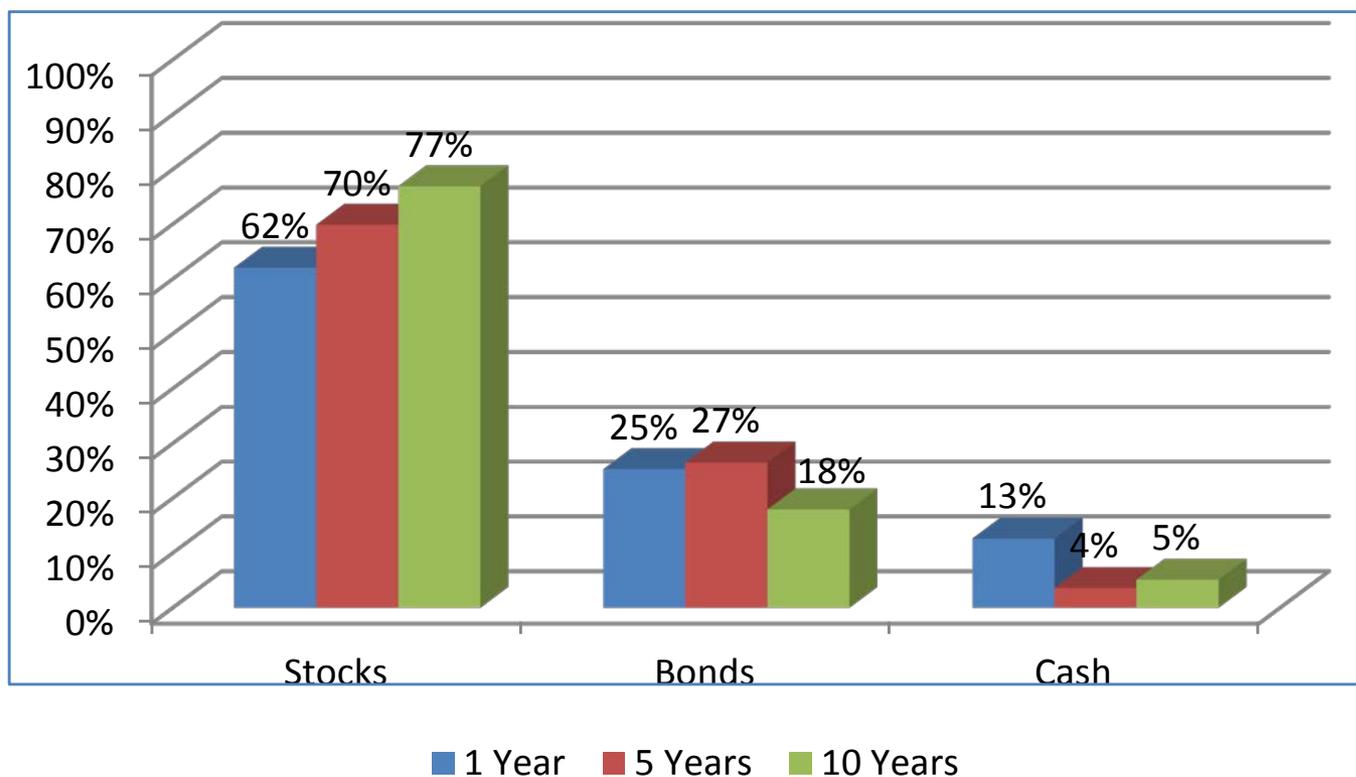
Histogram of 5-Year S&P 500 Returns

5-Year Annualized Returns Ending:



Market Leadership by Holding Periods

- The probability of receiving an equity risk premium increases with longer holding periods
- Winning percentages of stocks, bonds, and cash (annual data from 1926-2012)



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Wrap Up

- Questions
- Next Steps
- Adjourn