

## INVESTING SPECIALISTS

# Experts Forecast Long-Term Stock and Bond Returns: 2017 Edition

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**Christine Benz** 12 Jan 2017

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In Focus

 **PASAX** **PAUAX** **WARAX**

Even the most basic financial plan calls upon you to make your best guess about a few key facts: how much you can kick in on an ongoing basis; how much time you have to invest; what combination of stocks and bonds you employ; and finally, the rate of return you can expect to earn on your investments.

The first three fall into the realm of "somewhat knowable," and you exert at least some control over them. But forecasting returns is a trickier business.

Many investors turn to long-term market averages--dating to the late 1920s, for example--to help shape their return projections, but they're not perfect gauges. For one, most investors don't have 90 years to invest, they have more like 40 or 50 years; the shorter the time period (and the better or worse the starting and ending points), the more returns over that period are apt to vary from historic norms.

So what's a well-meaning investor to do? I think it's reasonable to use the long-run averages as a starting point--8%-10% for stocks and 5% for bonds--then tweak up or down based on experts' opinions about current valuations and the investor's own time horizon. Given today's low yields on both stocks and bonds and not-cheap equity prices following U.S. stocks' extended run, it's only reasonable for U.S. investors to adjust their return assumptions downward from those long-term averages. But how far?

As I did last year, I've compiled insights from a range of market experts--both inside and outside of Morningstar--to help you draw meaningful conclusions. Note that these expert forecasts vary in their time horizons as well as in whether they factor in inflation and currency effects.

### **John C. Bogle, founder of Vanguard Group**

*Highlights:* 4%-5% equity returns, 2.5% bond returns (September 2016)

In an interview in late September 2016, the Vanguard founder said he was expecting muted returns for both stocks and bonds. Bogle's intuitive formula starts with the equity market's dividend yield, then factors in expected earnings growth and the potential for P/E multiple expansion or contraction. Based on his inputs--a 2% dividend yield, 5% earnings-growth rate, and a 3% haircut for P/E contraction due to high starting price multiples--Bogle said it was likely stocks would return 4% or 5% over the next decade, and that figure would shrivel further once inflation, taxes, and investment fees are taken into account. Like most market experts, Bogle isn't expecting robust returns from bonds, either. He said in the September interview that he thinks a 2.5% return is reasonable for investors who are willing to venture beyond Treasuries, as starting bond yields have historically been a good predictor of what bonds will earn over the subsequent decade.

### **Grantham Mayo Van Otterloo (GMO)**

*Highlights:* -3% real (inflation-adjusted) returns for U.S. large caps over the next seven years; -0.8% real (inflation-adjusted) returns for U.S. bonds (Nov. 30, 2016).

The valuation-conscious team at GMO is frequently pessimistic in its seven-year forecasts (login required), and its latest dispatch is no exception. Owing to low yields and high valuations, the firm is forecasting negative real returns from the U.S. stock and bond markets over the next seven years. (The subset of high-quality U.S. companies should break into the black, on an inflation-adjusted basis, in GMO's view.) Meanwhile, the firm is more sanguine about non-U.S. equities. It's forecasting mildly positive real returns from international

equities and the strongest gains (a 4.4% real return) from emerging-markets equities. It's worth noting that the firm's pessimism on the U.S. market has cost it on the return front over the past several years: Wells Fargo Absolute Return (WARAX), which is managed by the same team that formulates the seven-year asset-class forecasts, has recently struggled. As analyst Leo Acheson points in his most recent review of the fund, GMO has recently experienced some changes in its management ranks, too, as Sam Wilderman, co-head of asset allocation for the firm, departed at year end 2016.

### **Morningstar Investment Management**

*Highlights:* 3.1% 10-year nominal returns for U.S. stocks; 2.7% 10-year nominal returns for U.S. bonds (Dec. 31, 2016).

Like GMO and Research Affiliates (below), Morningstar Investment Management's return expectations for U.S. stocks and bonds are low, if not downright discouraging, especially when you factor in inflation. But the outlook is more optimistic for foreign equities: MIM expects U.S. holders of international developed equities to earn 6% on a nominal basis, and U.S. holders of emerging-markets equities to earn 9% nominally. MIM's forecasts are lower once inflation and currency effects are factored in; for example, the return on international developed markets equities drops to 2.8% and emerging-markets equities to 4.8%. Morningstar Investment Management provides its latest return expectations in *Morningstar Markets Observer*; investors can download the most recently available version [here](#).

### **Research Affiliates**

*Highlights:* 0.8% real returns for U.S. large caps (the S&P 500) during the next 10 years; 0.8% real returns for the Barclays U.S. Aggregate Bond Index (Dec. 31, 2016).

The graph depicting Research Affiliates' return expectations for various asset classes is fun and easy to use. While the firm is even more downbeat about the prospect for U.S. stock and bond market returns over the next decade than it was a year

ago, it's still optimistic about investing overseas. At year-end, the firm was expecting a nearly 6% real return from developed markets equities and a 7.5% real return from developing markets stocks. Like GMO, the firm is also relatively positive on the prospects for emerging-markets bonds, especially those denominated in local currencies; it's forecasting a 4% real return from such bonds over the next decade. Research Affiliates has steered PIMCO All Asset (PASAX) and PIMCO All Asset All Authority (PAUAX) to mixed results: While both funds fared well during the bear market and have snapped back recently, their emphasis on emerging markets has hindered their results over the past few years. However, All Asset retains a Gold rating, while All Asset All Authority is rated Bronze.

### **Vanguard**

*Highlights:* Nominal global equity-market returns of 5% to 8% during the next decade; 1.5% to 2.5% expected returns for global fixed-income markets (December 2016).

In its 2017 Economic and Market Outlook, Vanguard's economic team describes its outlook for global equities as "guarded but not bearish." Vanguard's Capital Markets Model provides a range of probabilities for returns from various asset classes. For global equities, the firm's model places the highest probability of nominal returns in the 5% to 8% range for the next 10 years. The firm's research also suggests that investors in foreign stocks that are not hedged into the dollar could outperform the U.S. market in the next decade. "The expected return outlook for non-U.S. equity markets is modestly higher from a U.S. investor's perspective," the firm's economic experts wrote. However, in contrast with the researchers at Research Affiliates and GMO, the Vanguard team doesn't consider emerging-markets equities to be cheap. "Emerging-market valuations are low relative to developed markets, but this phenomenon is typical of riskier markets," the firm's economists wrote.

Christine Benz does not own shares in any of the securities mentioned above. Find out about Morningstar's editorial policies.

