PFM's Capital Market Assumptions Process

Frequently Asked Questions

Q&A | January 2020

PFM recently released our Capital Market Assumptions (CMAs) for 2020. The CMAs reflect our projections for expected future returns and risk on a range of asset classes.

In an effort to provide insights into our CMA development process and answer frequently asked questions, we conducted a Q&A session with Biagio Manieri, Ph.D., CFA. Biagio is PFM's Head of Economic and Capital Markets Research and author of the annual CMAs.

How often do you update the Capital Market Assumptions?

Manieri: We update our CMAs annually. We do so because we find that while many of the underlying fundamental economic drivers such as expected growth and inflation do not vary significantly year-to-year, capital market drivers such as equity valuations, interest rates, and credit spreads can vary greatly and impact our forecast for future expected returns.

What factors are considered when formulating the CMAs?

Manieri: We consider both economic and capital market fundamental factors. Specifically, we consider and project real economic growth, inflation, interest rates, corporate revenue/profit growth, and trends in corporate profit margins. For credit-related CMAs, we also consider expected default and recovery rates. The capital market fundamental factors we consider and project include current equity valuations, credit spreads and expected share buybacks.

Why do you prepare two sets of CMAs: intermediate (next five years) and long-term (next 30 years)?

Manieri: We base our long-term CMAs on long-term underlying fundamental trends in economic and corporate profit growth, demographics, inflation, and historical valuation metrics for various asset classes. We produce intermediate CMAs that reflect expected returns over only the next five years because they can deviate significantly from expected long-term returns due to current market conditions, current valuations and recent performance. For example, the fixed-income asset class had a great year in 2019, but started 2020 with yields much lower than historical averages. Thus, it has lower prospects for the next few years.

Why are both the current intermediate and long-term CMAs lower than the historical returns?

Manieri: Going forward, we believe that U.S. and global economic growth will be slower than what we have experienced in the past. There are several reasons for this:

- The trend toward globalization and trade is slowing and may be reversing,
- High levels of debt throughout the global economy are burdensome,
- Aging and slower growing populations will be costly to certain economies,
- Productivity has been weaker than the historical average and lacks a catalyst for a near-term improvement, and
- Interest rates are low and expected to remain lower than historical averages, while at the same time credit spreads are fairly tight.

In the more intermediate term, the very strong returns of the past few years portend more modest returns for the next five years.

How should clients interpret the CMA returns?

Manieri: Our CMAs are an expected average or annualized return over the period specified. In technical terms: they are the geometric average and not the arithmetic average of what we expect capital markets to return. It is important to keep in mind that returns will be volatile year-to-year, and our CMAs are not likely to be accurate for any single year. However, over the period specified, we expect the annualized average return to approximate our CMAs.

Do you compare the CMAs with actual returns? What has been the relationship?

Manieri: Yes, we do compare our CMAs with actual returns over time. We show and discuss this on our annual client outlook webinar. While year-to-year actual returns may deviate from the CMAs, over time, the CMAs have matched actual returns reasonably well. In the case of fixed-income, for example, actual returns have been somewhat higher than our CMAs as interest rates have continued to decline over the past several years (e.g., 10-year Treasury yields have declined from 2.5% in early 2017 to a current 1.8%), which pulls forward the returns for fixed-income investments, but are likely to correct to our longer-term CMA estimates.

Any noteworthy trends in the CMAs?

Manieri: Over time, our CMAs have moderated somewhat. This is explained by the strong performance of both the equity and fixed-income markets in recent periods.

In the case of fixed-income, strong performance has been driven by declining interest rates and narrowing credit spreads. With low rates and tight spreads, forward looking returns are expected to be lower. With regard to equities, stretched valuations may be a headwind going forward.

Some believe that credit markets are in a bubble. Do you share that view and if so, why are the credit CMAs positive?

Manieri: We understand that corporate debt has increased significantly, however, we believe that most borrowers are generating sufficient cash flow to service that debt. We also concede that in some cases, credit conditions are stretched and that credit spreads are fairly tight. However, we do not believe that we are in a credit bubble akin to the sub-prime mortgage debacle that precipitated the 2007-2008 global financial crisis.

Furthermore, we expect interest rates to remain range-bound for an extended period of time and for inflation to remain tame. In such an environment, we think that credit spreads will remain fairly tight as investors continue to search for yields in a continuing low rate world.

Discuss the CMAs for alternative asset classes. What type of returns do you expect and what about the illiquidity premium?

Manieri: We do not believe that alternatives will generate returns in excess of public markets. In deriving our CMAs for alternative asset classes, we start with our public market CMAs and make the necessary adjustments to approximate typical investments made by alternative funds, such as the size of company in a typical buyout, leverage used, etc.

In the case of hedge funds, we use a weighted average of the asset classes that represents the universe of hedge funds. This assumes that, as a group, alternative funds do not deliver excess returns once we take into consideration the specific characteristics of these funds. Disappointing (recent) returns as well as academic research supports our approach.

We also do not see evidence of a material illiquidity premium; for example, in comparing private real estate with comparable publically-traded real estate investment trusts (REITs), we do not observe a return advantage from private real estate funds over time. Academic studies also conclude that private equity funds do not deliver excess returns over public equities, once adjusted for size, leverage, etc.[1, 2, 3]

1 Nicolas Rabener, "Private Equity: The Emperor Has No Clothes", *Factor Research*, https://www.factorresearch.com/research-private-equity-the-emperor-has-no-clothes.

2 Brian Chingono, *The University of Chicago Booth School of Business*, Daniel Rasmussen, Stanford Graduate School of Business, "LEVERAGED SMALL VALUE EQUITIES".

3 Cliff Asness, "The Illiquidity Discount?", *AQR*, https://www.aqr.com/Insights/Perspectives/The-Illiquidity-Discount.

Why are PFM's emerging markets CMAs more subdued than what some other firms are forecasting?

Manieri: We believe that some investors fail to take into consideration the higher political risk of emerging markets, which has a negative impact on returns over time. Traditional thinking is that the higher expected economic growth of emerging markets will translate into higher returns. However, this is not always the case. In addition, a good portion of the relative growth between emerging markets and developed markets is due to China, where economic growth has been slowing.

We think that the gap between emerging and developed economic growth will narrow. We see evidence that the path taken by some emerging markets to develop, starting with labor intensive industries that capitalize on low wages then moving to higher value-added industries, may be closing as technology is being used to perform labor-intensive tasks.

Based on the new CMAs, should investors change their investment philosophy or approach for 2020?

Manieri: At PFM, we believe that a well-informed investment philosophy is critical to long-term success. It should only be changed after thoughtful consideration; not in response to short-term market fluctuations. We continue to implement our investment philosophy, which relies on both strategic and tactical asset allocation, (research has shown these to be the primary driver of returns[4, 5]), and continue to use active investment managers and alternatives on a selective basis. Going into 2020, we are over-weight on equities and, on a selective basis, spread products, and under-weight on interest rate sensitive fixed-income. We believe this portfolio positioning is consistent with our 2020 CMAs. As always, we continually evaluate portfolio positioning based on economic and market conditions.

The CMAs are meant to be used only as part of an in-person discussion. For more information, please contact your PFM relationship manager.

4 Gary P. Brinson, L. Randolph Hood, Gilbert L. Beebower, "Determinants of Portfolio Performance", *Financial Analysts Journal*, https://www.cfainstitute.org/research/financial-analysts-journal/1995/determinants-of-portfolio-performance.

5 Gary P. Brinson, Brian D. Singer, Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update", *Financial Analysts Journal*, https://pdfs.semanticscholar.org/31e2/9ed3c6ca22d8e63f6fb328988121c5b12d74.pdf.

To learn more or discuss in greater detail, please contact us:

Biagio Manieri | Chief Multi-Asset Class Strategist
manierib@pfm.com | 215.567.6100

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