

Capital Markets Brief

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Some Effects of Lower Capital Market Returns

Over the last several months, I have written several times about why I believe that, in the future, investors are more likely to experience 8.5%-9.0% annual returns for stocks rather than the 10% returns that many have learned to expect. This expectation is the result of the extraordinary performance that many enjoyed in the 1980s and 1990s. Most of these investors were not around, or were not invested in the stock market, during the early to mid-1970s when stocks declined for two consecutive years.

If investors accept the thesis that future stock returns will be lower than the historical average, then it is crucial that they re-evaluate their overall investment objectives and attitude toward risk, and determine if they are still on track to meet their objectives. Lower capital market returns affect everyone from the CFO, who needs to forecast the appropriate cost of capital in order to make crucial corporate financial decisions, to the individual investor, who is planning for retirement.

- In the household sector, lower returns on assets mean that investment and financial plans, including retirement plans, must be reviewed and, in some cases, re-worked. Prudent planning for lifetime income may require an increased commitment to investing, delayed retirement and/or accepting a reduced income level.
- In the public and corporate sectors, the expectation of lower capital market returns adversely impacts capital budgeting plans, pension liability assumptions and annual spending targets.

The effect on pension plans can extend beyond calling into question a company's ability to fund future liabilities. In the corporate sector, pension fund assets can represent a significant percentage of total operating assets. For many of these companies, pension asset growth assumptions have been based on return forecasts that are optimistic, if not unrealistic. At the same time, the value of pension fund liabilities has been rising as interest rates have fallen. Many pension funds have quickly gone from a healthy surplus (where assets exceeded future liabilities) to a deficit (shortfall) position. Migrating to unfunded status can prove expensive to the corporation, resulting in a direct hit to future corporate earnings.

General Electric (GE) recently announced that next year they intend to write off between 5 and 7 cents per share of after-tax earnings due to their current pension fund shortfall. GE recently lowered their return assumptions on pension assets from 9.5% to 8.5%. According to Goldman Sachs, 35 of the S&P 500 companies derive more than 10% of earnings from the performance of their pension funds. GE's pension fund assets represent nearly 25% of total operating assets. The percentage is even higher for companies such as Boeing (102%), Unisys (101%), Lucent (93%) and IBM (79%).

Unlike GE, many corporate pension funds continue to use optimistic return assumptions and, in some cases, are actually raising estimates. In 2000 and 2001, pension fund assets of several large companies dramatically underperformed their original return expectations. In 2000 alone, the difference between expected and actual returns for GM was -6.8%, IBM (-4.7%) and Verizon (-3.4%). While pension assets have been deteriorating, interest rates have been falling. Accounting standards require pension funds to discount future pension obligations (liabilities) at current interest rates. Thus, as asset values and interest rates fell, the value of these future obligations rose, resulting in large pension fund shortfalls and a probable hit to future earnings.

We continue to expect capital market returns to be far below those achieved in the 1980s and 1990s (18%) and even somewhat below the long-term, 60-year average (10%-12%). We believe, however, that stocks will continue to outperform bonds by an average of 3%-4% per year over the longer term. More importantly, we believe this outperformance will occur in an environment where inflation will run at a low, 1.5% -2.0%. In such an environment, the purchasing power of even these less spectacular investment returns should continue to outpace increases in the cost of living index.

It is these real (inflation-adjusted) returns that will ultimately define the corporate investor's capacity for growth and the individual investor's purchasing power over time.