ACG Insights: 2023 Capital Market Assumptions

Executive Summary

- **The market reset from peak levels in early 2022 has meaningfully increased forward return assumptions as firms publish 2023 Capital Market Assumptions (Exhibit 1)**
- **One of the most important inputs when projecting forward returns is an assumption of the current risk-free rate of return (Exhibit 2)**
- **Much of the increase in 10-year return expectations can be attributed to a higher risk-free rate as fixed income yields have increased significantly from last year (Exhibits 3 & 4)**

Background

Many investment firms go through an annual exercise of forecasting long-term returns for various asset classes. These assumptions, often 10-year forward looking, serve the dual purpose of helping investors set strategic asset allocations and think about the interplay between risk and return on a long-term horizon. Capital Market Assumptions (CMA's) tend to be a routine exercise in many cases in that not much will meaningfully change from year to year. 2022 provided an exception to the routine. As ACG and other research groups publish 2023 assumptions, there have been significant upward revisions to return expectations across asset classes due primarily to substantial resets in valuations and interest rates in 2022.

Market Reset Lifts Forward Return Expectations

Exhibit 1 below illustrates the magnitude of the shift from last year using ACG's CMA's alongside two prominent Wall Street firms (JPMorgan and Invesco). All major asset classes have been revised higher, some by 2-3% or more annualized, which can potentially mean elevated returns when extrapolated over 10 years. There is a considerable degree of uncertainty inherent to long-term forecasts that is visible in the wide range of numbers in Exhibit 1. Different models will yield different results year-to-year, but a consensus of results over long periods tend to converge toward similar predictions.

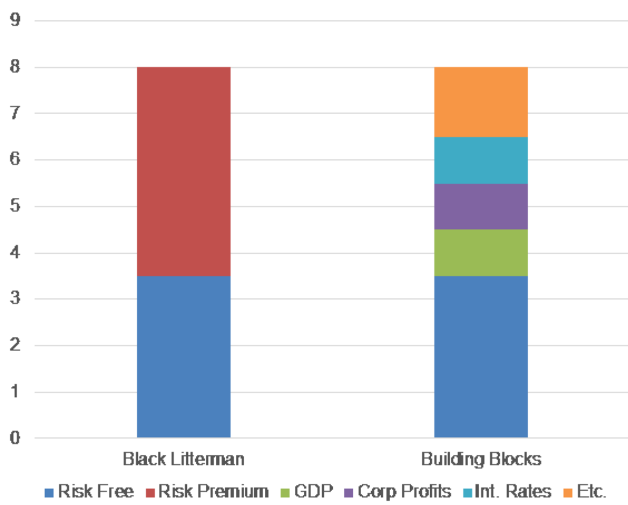
Exhibit 1: Comparison of Year/Year CMA's [1]

Asset Class	2023 ACG	2023 JPMorgan	2023 Invesco	2022 ACG	2022 JPMorgan	2022 Invesco	Year over Year Change ACG	Year over Year Change JPMorgan	Year over Year Change Invesco
Large Cap Equity	7.26	9.07	9.00	5.36	5.16	8.00	***1.90***	***3.91***	***1.00***
Small Cap Equity	8.52	9.94	12.30	6.17	6.17	11.60	***2.35***	***3.77***	***0.70***
International Equity	8.33	11.14	9.20	6.02	7.82	8.80	***2.31***	***3.32***	***0.40***
Emerging Markets Equity	10.33	11.96	12.40	8.02	8.86	11.90	***2.31***	***3.10***	***0.50***
Core Plus Fixed Income	4.52	4.68	4.50	2.51	2.66	2.00	***2.01***	***2.02***	***2.50***
Long Duration Fixed Income	5.27	5.72	3.70	3.26	2.74	2.00	***2.01***	***2.98***	***1.70***
Cash (Tbills)	3.53	2.40	3.70	1.51	1.30	0.90	***2.01***	***1.10***	***2.80***

What Explains the Upward Revisions?

There are different ways to generate CMA's and most methods incorporate qualitative elements on top of the quantitative aspects of the exercise, but a common starting point is an assumption for a risk-free rate of return (Exhibit 2). Expected returns for risk assets are then calculated based on a spread above the risk-free rate.

Exhibit 2: Illustrative Example of the Importance of Risk-Free Rate [2]



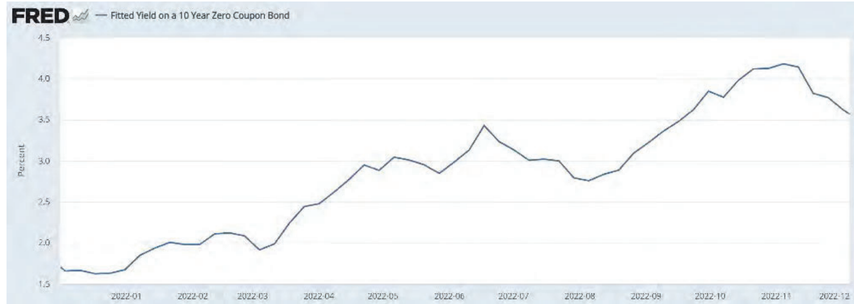
ACG utilizes the Black-Litterman model as the foundation of our assumptions. The model uses historical correlation and volatility data along with current market weights and an estimate of a market risk premium to optimize for expected asset class returns. Holding all else constant, changes in the risk-free rate can have an outsized impact on final return assumptions. Isolating the risk-free rate and ignoring everything else that changed during 2022 in markets is an easy explanation for a large portion of the increase in most asset class expectations, especially fixed income.

Silver Lining of Higher Yields

The past year was a difficult one for bond investors as the U.S. Federal Reserve embarked on a path of higher interest rates to fight inflation. The yield curve shifted upward across maturities in response to tighter monetary policy. ACG has historically used a rolling average of the 10-year treasury yield as a proxy of the risk-free rate to smooth the impact of short-term volatility. In response to the shift away from a zero-interest rate policy, where the Fed has raised rates at the fastest pace in history, we re-examined the risk-free rate assumption to better incorporate the new regime. Shown graphically in Exhibit 3, the government 10-year Zero Coupon Bond provides a good point-in-time estimate for what can be considered a riskless 10-year forward return. Also in Exhibit 3, the yield on the 10-year Zero rose from approximately 1.5% to begin the year to around 3.5% in December. Starting yield tends to be an excellent predictor of return for a bond over a 10-year period (Exhibit 4). Therefore,

[1] Source: ACG, JPMorgan, Invesco. All returns are arithmetic and annualized 10-year forward expectations.
[2] Source: ACG

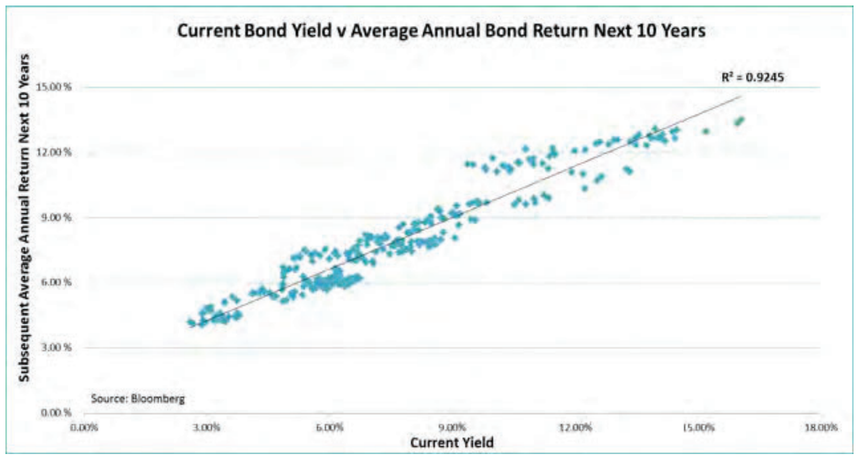
Exhibit 3: Yield on a 10-year Zero Coupon Bond [3]



we can make a reasonable assumption of the risk-free rate of return by using a 10-year yield observation from the same point in time that we are generating updated CMA's.

Using a risk-free rate of 3.5% as opposed to 1.5% a year ago lifts all assumptions, all else equal. Most forecasts have an element of subjectivity that will heighten or dampen the premium above the risk-free rate for specific asset classes. As an example, someone using a building blocks approach for equities might not change assumptions much if they believe slowed earnings and GDP growth will offset lower starting valuations.

Exhibit 4: Correlation Between Current Yield and Bond Returns [4]



Conclusion

2022 was extremely difficult for diversified portfolios as both stocks and bonds reacted to a new market regime. The flip side of a market reset from peak levels is that the outlook for forward returns has improved significantly. One of the main drivers for improved long-term expectations is that the risk-free rate has moved meaningfully higher. Especially for bonds, simply starting from a higher yield portends higher 10-year return assumptions (Exhibit 4). Capital Market Assumptions are never a perfect predictor of future returns, but investors can incorporate CMA's to help think about long-term portfolio allocations given ever-changing market conditions. ACG, for example, uses Monte Carlo simulation to account for some of the uncertainty inherent to projecting returns, which adds a layer of probability on the range of outcomes in long-term assumptions.

[3] Source: St. Louis Federal Reserve (FRED)
[4] Source: *Bloomberg*

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