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INVESTMENT COUNSEL

Changing Expectations

Expectations for future market outcomes often are a blend of historical experience and more recent developments. Ever present is the admonishment that past returns are no guarantee of future results. Nevertheless, the past provides relevant ranges for investor consideration. Recent changes, whether or not sustainable, can weigh disproportionately on current expectations. Assigning greater weight to the recent rise in interest rates may be appropriate. Interest rates are meaningfully higher than the very low levels of the past decade but remain below historical averages. A review of changing expectations for all assets can provide perspective for achieving investor goals ahead.

PERSPECTIVE

The level of interest rates impacts directly prospective money market and bond market returns and indirectly the prospective returns from other assets including stocks and alternatives. In Chart I, pairings have been plotted of current, longer term return and risk projections for primary asset classes. In particular for money market and bond market returns, levels are higher than those of one year ago, reflecting the +450 basis point rise in short-term rates and the +170 basis point increase in bond yields. The traditional relationship prevails between risk taken and potential return opportunity, more of the former promises higher of the latter.

One important application of market projections is the determination of safe real (net of inflation) spending rates from a portfolio in retirement. A safe real spending rate is one for which there is an 80% probability of not running out of funds. Chart II shows current safe real spending rates relative to those of one year ago. Increasing levels of portfolio risk (measured by equity allocation) are plotted for a common 25-year horizon. Note that taking more risk beyond a point can diminish the safe spending rate. Spending rates for the oft-mentioned 60/40 U.S. stock/taxable U.S. bond portfolio are highlighted. The 2023 spending rate is applied to a portfolio value that would have declined by -17.3% in 2022. As a result, annual safe spending of $3,200 for a portfolio of $100,000 in 2022 would increase modestly to $3,300 for 2023.

The goal for investors supporting retirement living through portfolio withdrawals is to achieve a spending rate that neither falls short over time nor results in a reduced quality of life along the way. An 80% probability of success is considered a safe harbor for balancing these outcomes. Table I shows the trade-offs between the rates of spending and inflation over 25-year horizons for a 60/40 portfolio allocation between U.S. stocks and taxable U.S. bonds. Outcomes here are based on current return and risk expectations as shown in Chart I. An extended period of higher inflation and/or returns below expectations would reduce all safe-harbor spending rates.

CHART I

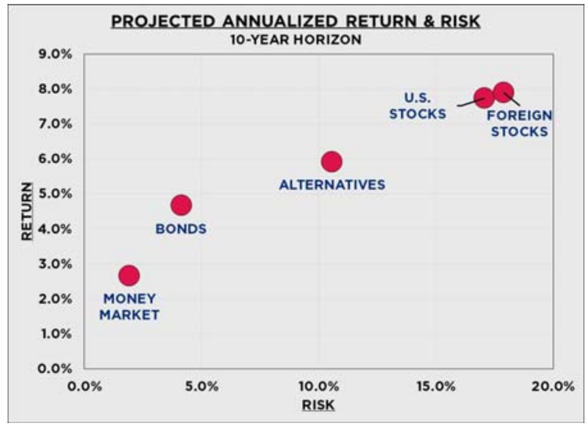

CHART II

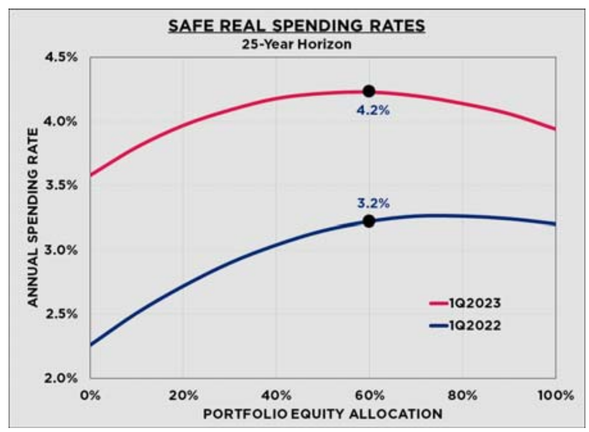

TABLE I

PROBABILITIES OF SUCCESS

25-YEAR HORIZON; 60/40 STOCK/BOND ALLOCATION

SPENDING RATE	CPI INFLATION 2%	3%	4%	5%
5%	76%	66%	55%	42%
4%	86%	79%	68%	56%
3%	94%	89%	82%	71%
2%	98%	96%	92%	86%

INVESTMENT IMPLICATIONS

Expectations for market returns and risks change over time. Such changes can necessitate adjustments to personal investment goals. Adjustments presuppose that goals are clearly identified at the outset along with time horizons and tolerance for risk. The most important risk is falling short of identified goals. Market risks cannot be eliminated and return expectations are subject to error. Nevertheless, application of a disciplined process that incorporates all the relevant inputs will enhance the potential for achieving desired outcomes.