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Expected Returns 2008

Asset Allocation

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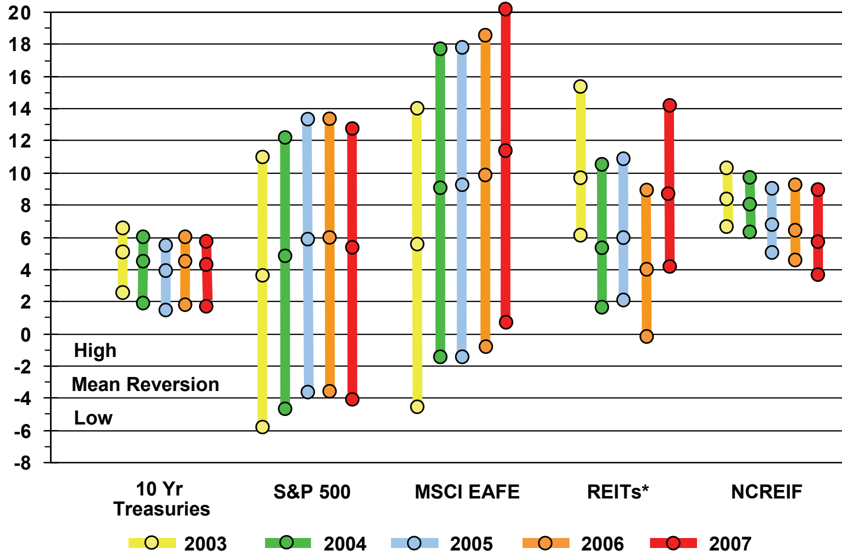
We have updated our analysis of potential 10-year returns from various asset classes. The chart below depicts the range of potential outcomes of investing in different asset classes based upon a reversion to certain valuation measures. The range of potential returns is calculated using the return required to reach the historic high, low, and average valuation for the asset class. (For a more complete explanation, please see the Appendix.)

Evolution of 10-Year Expected Returns



* Calculated using data from SNL and NAREIT

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While acknowledging the challenging markets that we experienced in the latter half of last year and certainly the first three months of this year, it is possible to make a few observations that may prove to be useful in the current environment.

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Observations:

- Higher P/E multiples make US equities slightly less attractive as of year-end 2007. This reverses a four-year trend during which expectations for stocks have been higher year over year. Despite modestly positive returns in 2007, negative earnings growth in the second half led to higher multiples. Based on their valuations at year-end 2007, US stocks could face serious headwinds if the economy suffers a deep or prolonged slowdown. For stocks to deliver returns over the next ten years in the upper end of the range, earnings would need to rebound strongly.
- As we stated last year, long-term Treasuries remain range bound, given the low yields and the resulting narrow band of possible outcomes that can be derived from our calculations. Having said this, Treasuries look slightly less attractive at the end of 2007, as investors poured into them as a safe haven to the uncertainty in the credit markets. While this analysis does not look at relative value across the broader fixed-income markets, with credit spreads nearing historically wide levels in some cases, opportunistic investors might find more favorable risk-reward trade-off elsewhere in the fixed income market.
- REIT prices tumbled last year, partly as a result of fears that earnings and values in the real estate markets would be considerably lower in the upcoming year and partly due to a pronounced capital rotation out of the financial sector. Concerns that a softening economy and a lack of available debt capital would begin to take a toll on real estate fundamentals and pricing respectively led to a sell off in the REIT market. The significant decline in share prices has bolstered the relative attractiveness of the public real estate markets on a prospective basis, as can be seen in the large jump in future potential returns.
- As we noted last year, appraisal lags did leave some wind in the sails of real estate values, resulting in slight gains in real estate pricing. These modest gains (on average) resulted in total returns that were slightly lower than in years past, but were still well above the long-term average for the asset class. However, there is now more downside risk than upside potential, as demonstrated by where the mean-reversion scenario (the middle dot) lies on the line, given the continued high pricing of commercial real estate. We have seen some weakness in NCREIF's results, indicating that the peak that we discussed in last year's piece does indeed seem to be firmly behind us at this point.

We continue to publish this piece in the context of 2008's increased levels of volatility for the simple reason that a view towards the longer term is often lost in such turbulent times. Currently, technicals appear to trump fundamentals and markets seem to trade on rumors that can be self-fulfilling. To weather the current storm we must continue to keep long-term history as an anchor. In this context, we hope this piece provides useful information for you. As always, this analysis does not provide data on projected correlations – essential to any asset allocation analysis. Also, given the wide range of potential returns, additional analysis and research could help narrow the range a bit, moving from what is possible based on history to what is more likely based on the present.

Appendix

Methodology for Range of Returns

Range of return calculations use historical valuations as a guide for expected returns. Given today's valuation for each asset class, high, low, and average expected returns are calculated assuming the asset class reaches its historic high, low, or average valuation in 10 years. This is not a forecast of the probability of these outcomes. It is the arithmetic result of what would happen if each asset class reverted to mean, high or low multiples.

Each bar represents the range of potential 10-year returns for that asset class as of the referenced calendar year. With the referenced calendar year as the starting point, the top of the bar represents the return if the asset class reaches the highest historic valuation in 10 years. The bottom of the bar represents the return if the asset class reaches the lowest historic valuation in 10 years. The middle point on the bar represents the return if the asset class reaches the average historic valuation in 10 years.

Earnings growth rates are assumed to be 5% for U.S. Equities, International Equities and REITs. Income growth for real estate is projected based on current market conditions using projected growth for NCREIF.

Valuation measures for each asset class are as follows:

U.S. Bonds	10-Year Treasury Yield	(Apr. 1953 – Present)
U.S. Equities	S&P 500 P/E	(Jan. 1926 – Present)
International Equities	MSCI EAFE P/E	(Dec. 1972 – Present)
REITs	NAREIT P/FFO	(Jan. 1993 – Present)
Real Estate	NCREIF Cap Rates	(Jan. 1979 – Present)

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The information expressed sets forth our views as of this date. The underlying assumptions and these views are subject to change.