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**PROSPECTIVE RETURNS ON FINANCIAL ASSETS AND
WHY THE NEXT DECADE WILL BE DIFFERENT FROM THE PAST**

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MR. KENNETH W. STEWART: Our guest speaker, Edward H. Ladd, has a B.A. from Yale and a master's in business administration from Harvard. He went directly from Harvard in 1962 to join the investment counsel arbitration firm in Boston where he's now chairman and managing director. Standish, Ayer & Wood is a Boston-based independent investment counsel firm with assets under administration in excess of \$14 billion.

Ted Ladd's primary responsibilities there include, and this an impressive list, economic forecasting, fixed-income policy, administration, marketing, and development of strategies for financial institutions and selection family groups. Ted Ladd's a chartered financial analyst, a trade investment counsel member, and a member of the Boston Security Analyst Society and the Boston Economic Club. He's also a director of the Federal Reserve Bank of Boston, Graylock Management Corporation, Harvard Management Corporation, and the New England Electric System as well as finding time to be chairman of the board of trustees of Wheelock College.

MR. EDWARD H. LADD: I will be focusing primarily on the U.S. markets, although in a global context, but I will touch as well on Canada. Clearly there are many parallels between the U.S. and Canada. It's my intention in all of this to be provocative. You will not find that I am shy in my views. I hope that I will tempt your questions at the end. I would suggest to you that even if I am wrong in my projections, I think I am raising the basic issues that you should consider as you make financial projections in the future.

The outline of my presentation to you today is to start with the thought that the past, particularly the 1980s, is in many respects irrelevant in making projections of future returns from different sorts of financial assets. I have some thoughts in terms of projected real economic growth, projected inflation, projected real interest rates, and using that data to make some projections of returns from a whole variety of financial assets and then to talk about the risks and rewards that develop from them. That's a challenging task. Bear with me. I hope there will be ample opportunity for you to vent your frustrations in a question period.

The first subject. Why are the 1980s in particular a period that is not particularly relevant in projecting future returns? If you look at the U.S., the decade of the 1980s was, in my judgment, a nonrecurring and unsustainable period. We started in the U.S. at the beginning of the period with relatively low utilization of economic resources and ended up with relatively high utilization of economic resources both plant and labor. That is true despite the fact that we have now gone through a mild

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recession. We move from a relatively low federal government deficit to a staggeringly high federal government deficit.

We witnessed a debt explosion in both the corporate and household sectors, taking debt levels to extraordinarily high levels relative to the ability to service that debt. Externally we have moved from being a substantial net creditor to the rest of the world to being a very substantial net debtor to the rest of the world.

We have moved from a period in which financial institutions felt comfortable because of the strength of their capital and their earnings to make significant extensions of credit to a period in which many of them are in retreat. In combination with those items, we moved from a period in the U.S. and in Canada from relatively high inflation to low inflation and this permitted a dramatic decline in interest rates, producing spectacular returns from fixed-income securities with a high initial coupon followed by price appreciation, and the declining competition from interest rates allowed price earning ratios on stocks to expand producing 15%, 16%, 17% total returns depending on the time selected.

The returns from financial assets genuinely in the U.S. in the 1980s were conditioned, in my judgment, by a whole series of nonrecurring events and produced returns which were vastly higher than longer-term recorded history of the financial market. I would suggest that unless you think that we can continue to move forward at the same pace with a further explosion of debt increases in deficits, external borrowing, and declines in interest rates, it strikes me as extremely unlikely that the 1980s is going to be a particularly valid experience in projecting into the future.

Having hopefully raised some doubts about the 1980s, one almost has to start fresh in building financial returns for the future. I would start with the promise that future economic growth, and here I will focus primarily on the U.S., is likely to be relatively slow and disappointing for a variety of reasons.

In the near term we have had what I regard as an atypical recession and are experiencing a very atypical and lackluster recovery. As you look over not 1992, but the next three to five years, you are probably aware that there is a significant deceleration in the growth rate of the civilian labor force to something not much more than 1% per year. The participation rate of workers in the labor force has been very high and I don't see any evidence that supports a higher participation rate in the next five-year period. Therefore, if economic growth of necessity is the combination of the number of people at work and the output per person, the test then comes to productivity growth.

You are aware, I am sure, that the American and indeed the Canadian productivity experience in the last decade has been poor. I think it has been poor for a variety of reasons, but one important one has been inadequate investment in new technology and equipment. I am struck by some work that has been done by the bank for international settlements comparing the investment rates of G7 countries with economic performance over the decades. What you find from that analysis is that there is an extraordinary correlation between investment and economic performance and the investment levels in our countries have been relatively low. I would argue that there is nothing in the information we have at our disposal that would suggest

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that U.S. productivity growth will be more than 1% per year in the next five-year period. Let me take that combination then of growth in the labor force of 1% and productivity of 1% and add in something which is something more sociology than economics, but it's the whole issue of human capital. This has not received, in my judgment, a great deal of attention but probably should.

We have seen in the U.S. in the 1980s, in particular, a significant social deterioration and a reduction in education standards for many of the entrants to the labor force. Let me give you some statistics which I find quite alarming. By the end of the 1980s, a quarter of the babies born in the U.S. were illegitimate. The numbers have gone from about 5% in the 1960s to 15% in the 1970s to over 25% by the end of the 1980s. About a quarter of the children in the country (this is obviously an overlap) grow up in conditions of poverty, defined as a household income of less than \$13,000 a year.

The other day we found that 20% of the children in American high schools are carrying weapons to school. Twenty-five percent of the American population drop out of high school permanently. You take those numbers for the minority communities and in many cases they are materially higher. It is a massive problem, particularly in urban areas. What we have created then is a level of educational attainment which seems to me to be incompatible with the technical needs of our society and I'm not sure whether the implication will be slower growth in the labor force or weaker productivity, but one way or another, there has been a degradation of human capital which we have not addressed which is, I think, inevitably going to have an economic impact in the 1990s.

If that were not enough, there are some significant issues in terms of the availability of credit. We have seen financial institutions of all varieties that have been punished for bad lending and investing practices in the 1980s find their capital positions inadequate, a hospital regulatory environment, and a need to retreat. Then you come to the issue of governmental finance and most of us are aware of the ugly numbers. Our federal government is operating in a fiscal year that began October 1. The projected deficit is around \$350 billion. That is overstated to the degree that it includes savings and loan's clean-up costs. We will get to the bottom of that pit at some point and those numbers should be excluded from the true deficit. However, maybe less publicized, we are visibly spending what should be a Social Security surplus of about \$70 billion. The true deficit is in the area of \$320 billion. A considerable amount of money.

There is a discussion at the moment in Washington about how to produce a tax cut and as best as I can determine, the combined deficit of our state and local governments is in the area of about \$50 billion. One can assume that in the course of the 1990s, these deficits will continue, at which point we are going to have a very heavy burden for the subsequent decade or one can assume that those deficits will be gradually wound down, but there will be a cost in terms of economic stimulus to do that. You put all that together with a further assertion which I'll try and document later on, mainly relatively high real interest rates, and it seems to me that for the U.S., the best one can hope for in the next five years is economic growth of 1.5-2% per year. That does not suggest that we're going to be punished for the excesses of the 1980s but it will require a material period of time to grow into the fabric that we have

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created and the result is going to be substandard and somewhat disappointing economic growth.

The next question then would be the expected rate of inflation and here the news is halfway much better. Inflation has been rationing down. In the next 12 months in the U.S., it will be something in the order of 3.5%. I'm struck by the progress that Canada has made in inflation and my guess is that in 1992 Canadian inflation will be less than 3%. My assumption is that many of these gains are sustainable, but one should not discount altogether the future inflationary risks. We still have some major questions in terms of service sector, wages, and productivity. There is the overall productivity problem for the economy as a whole. We are not without food and energy priced risks. In the case of food, a near-term problem in particular may be the winter in the Soviet Union. In the case of energy, the best numbers we have are the free world. Oil demand is growing at about one million barrels a day per year and U.S. and Soviet oil production is shrinking at about one million barrels a day per year. You have about a two million barrels, per day, per year increment that has to be made up and if those numbers are correct, OPEC is going to be operating pretty close to full capacity shortly after the middle of the decade. I am not assuming that those are going to be major, near-term problems, but there is a risk.

Then there is the question of the classic response of governments encumbered with large amounts of debt. One way out is inflation and I would suggest, perhaps particularly in the U.S. but maybe in Canada, there are limits to the degree that central banks in particular can preserve an anti-inflationary policy if it produces a large amount of general economic distress. There is a political backlash. The Congress is clearly concerned about the structure of the federal reserve system. There may be interested issues in Canada as the country approaches its 1993 election as to whether the governor of the Bank of Canada should be reappointed in 1994. Beyond that I would suggest to you that in the U.S. in particular, we have a long history in the postwar years of being very intolerant of economic adversity; when we run into intractable economic or financial problems, we quickly look to the resources of the federal government and there is, in my judgment, an impressive social contract which means that inflation tends to be asymmetric. It is not likely to decline sharply. It can rise.

Putting that all together, my own assumptions are that for the next five years for planning purposes I am using a U.S. inflation rate of 4.5%. I've been using that for some time. If I were to redo all of the numbers now, maybe that would be a little on the pessimistic side, but I think somewhere in that 4-5% range is a reasonably good but perhaps conservative assumption. The next step then in this process is to try and add on to that inflation rate some sort of assumption for real interest rates and here I would make a vigorous argument important to all of us if it is correct that there is indeed a global capital shortage.

It seems to me that the evidence is quite compelling and the result of that will be a period of high real interest rates in the 1990s. We know that real interest rates have been increasing generally through the decades anyhow. My guess is that in the 1990s they will be higher than in the 1980s. The source of the problem is one, a general decline in world savings rates and some various substantial new demands for capital. Some of the new demands are coming out of the extraordinary political changes that are occurring, especially in Europe. I find it striking that when one looks

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back as recently as 1989, the world's capital flows, at least on a net basis, were very easy to analyze. The U.S. was absorbing a little over \$100 billion of capital. The Japanese were providing half. The Germans were providing half and the rest of the world was awry. The changes that have occurred since then are most easily documented in Germany and the cost of unification is extraordinarily high. There is no question in my mind that the Germans had to do it, but in my judgment they have not executed it well. The result of that is that Germany is currently a capital deficit country. I have visited it recently, and I am thoroughly persuaded that while it is making headway in the integration of East Germany, the cost is going to continue to be very high for a number of years in the future and Germany, at best, is likely to be capital neutral and probably a capital importer. In the meantime, Japan is having its own set of problems as the bubble economy goes away, and there is clearly a significant amount of retrenchment occurring, especially in the financial sector. It's not clear to me how this is going to work out, but I would argue very strenuously that the Japanese, in many respects having been the marginal investor in the U.S. markets in the 1980s, have been very badly beaten up and will not be so in the 1990s.

As you look elsewhere in the world, I think it's important to assess capital from a global standpoint. The international flows of funds are rising rapidly and are of immense importance. There are, in addition to East Germany itself, substantial additional capital needs that may come from eastern Europe and the Soviet Union. We cannot assess these now. Certainly there will be capital demands from those areas. Whether they will actually get capital is another consideration, but I was struck in visiting Germany at how concerned they are about the risks of migration from Eastern Europe to the Soviet Union. One person in the foreign office said to me very directly, "We have extremes for risk migration for the threat of communism it's a trade-off and the burdens could be quite considerable." He further said that he thought that borders were very porous and as the Americans have discovered in the case of Mexico, if there's a major economic incentive, it's difficult to keep those people out. There may be very substantial payments that have to be made to try and prevent major population flows.

In the case of the Persian Gulf, Kuwait has a massive rebuilding job. As one surveys the world, it's pretty clear that the sources of capital are imperiled. From the bottom up we're not going to expect additional capital for the world markets from Latin American or from Africa. With the German problems, not from Europe. With the U.S. and Canada, external deficits are not from North America. That leaves Asia. Even in Asia, some of the countries, most notably Taiwan, have embarked on major programs for internal remediation to environment and addressing infrastructure.

The conclusion of all of this is that only the Japanese are likely to generate material amounts of capital for export during the course of the 1990s and I think it is apparent to all of us that the rest of the world is very ambivalent as to whether it wishes Japan to have a large trade and capital surplus. This leaves us, I think, in the position of real interest rates being relatively high. If capital is in short supply, the price of capital will have to be quite high and I don't know how high is high, but it would not be a surprise if in the U.S., as an example, real interest rates were to average in the area of 4.5-5%. As we look around the world today, that is indeed the norm rather

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than the exception. Here in Canada we have 9.5% government bonds with an inflationary environment which is widely expected to be below 3%.

There are countries in Europe, most notably Denmark, 9% yields 2% inflation. The U.S. real rates of return are lower than that at the moment, but if I am correct in this assessment, it has some major dimensions in terms of planning for financial returns as well as impact on the economic arena. If one takes all of this information and let us assume for the moment that I am correct and that we're dealing in the U.S. with roughly a 4.5% inflation rate and a 4.5% or 5% real interest rate level. One ends up with bond returns which are somewhat in excess of what we see at the moment although not dramatically.

My best judgment is depending on the type of high-grade bond that you're using, a reasonable projected expected rate of return is somewhere in the area of 8-10%. Then the interesting question is can you reasonably expect a higher rate of return from that from U.S. common stocks? I don't believe that a hard look at the statistical evidence gives you much comfort in that area. The underlying earnings and dividend growth from American corporations are not, I would submit to you, more than 6.5-7% per year. People have a sense that it is much greater than that, but reality says that it is not. To that you must add a current yield of something in the area of less than 3%. You're talking about a 9% overall return subject to the question of whether you think stocks are fairly undervalued or overvalued at the inception date of your forecast and the vast majority of evidence I have is that U.S. stocks are at least modestly overvalued relative to inflation of interest rates.

We end up with the thought that U.S. common stocks are very much in the same range in terms of prospective rate of return as your U.S. bonds. How in this area do we get additional return from other areas? The mortgage market has been very fruitful in the U.S. and in our judgment will continue if there are high-quality government-guaranteed mortgages to produce returns about 1% in excess of the bond area. Smaller capitalization common stocks which have underperformed for a very long time until quite recently may have better opportunities and I would suggest that generally speaking, investment returns on both stocks and bonds may be better outside of North America than within. I expect Europe and Asia to do relatively well. Areas of disappointing investment returns would, in my judgment, be commercial real estate. I know that as a horse that has been badly salvaged already and I would quickly confess that at current price levels a lot of the damage has been done. As one looks ahead for North America, at least we probably have enough commercial real estate to last us for the better part of the decade, if not, well into the next century. Beyond that the other dynamics are almost all negative in terms of demographics, service industry absorption, the dedication of financial institutions to support the commercial real estate market, and particularly the level of real interest rates that I am projecting. I wish I could get better statistical information on it, but it is my impression that unleveraged returns from commercial real estate have been quite mediocre and in the heyday of commercial real estate, the opportunities came through leverage and in many occasions there was the opportunity to borrow relatively large amounts of long-term fixed-rate money at very low interest rates. That is now all behind us.

Other areas that are a source of concern to me and I suspect will produce below-average returns will be junk bonds and commodities. In the case of junk bonds, most

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of us are aware of the studies that were conducted in the late 1980s which alleged to prove that you got enough additional income to offset the credit risk. In my judgment, those studies were absolute nonsense. They were all conducted during a period of continuous prosperity with far less leverage than existed at the end of the period and they are not worth a serious look. As one looks ahead with corporate leverage being extremely high, it seems to me that the risks are materially greater and at least under current circumstances the incremental income that one gets is not particularly awesome. In the instance of gold, again that ties into my real interest rate forecast. If real interest rates are high, the costs of holding a nonearning asset will be quite expensive, at least in terms of opportunity. As I put this all together and I haven't given you more specifics about it, but it seems to me highly likely than in the 1990s we are going to see a massive converge of returns from financial assets in the area of 8-10% in nominal terms, 4-5% in real terms and unlike the recent periods there will be relatively few outliers.

Now what can change this forecast? What are the major dimensions? One possibility is a reassertion of U.S. economic policy leadership. I wish I could tell you I saw evidence of that at the moment. Another consideration, a positive consideration, might be if you thought that the central banks and their noninflationary philosophy were to remain a very dominant feature and would not be overwhelmed by political reverberations. I think that is a question. I would suggest that one of the positives in this picture is the ongoing globalization of trade of financial markets. I think this tends to enhance competition, restrict inflation, and create economic opportunities. The major risks. What could go wrong that could make my forecast too optimistic? One major exposure near term is the risk of accelerated disintegration of the Soviet and Eastern European economies and all of the implications of that.

Another worry would be the fear of protectionism. A particularly sensitive issue may arise in 1992 as the Japanese trade surplus temporarily expands. This may be unfortunate timing during a U.S. presidential election and lastly and maybe most importantly the financial risks that we have. There are lots of very fragile financial institutions that exist and the fact that real interest rates are likely to be high, in my judgment, represents a problem. This is a problem that will be difficult to solve because under my forecast if it's correct, real interest rates will be higher than the underlying real economic growth which implies that in the long run, real debt burdens will be rising rather than falling.

My conclusions in all of this would be one, the 1980s are all over. Both chronologically and financially this is a period that has passed. It was interesting while it lasted. It was euphoric, but it's all gone and it is not to be repeated and the 1990s will be significantly different. I realize that makes the task harder in projecting future rates of return, but I think that is imperative.

The second conclusion is, in my judgment, there will be a conversion in the return for most financial assets thinking, particularly in the U.S., in the 8-10% range. I would point out to you that 8-10% sounds as if it's unpleasant, but it's very much in line with history. This does not suggest that one is going to be punished for the excesses of the 1980s, merely that we're going to come back to reality. I think one of the tough parts of this period is the necessity of downshifting our expectations after the

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heydays of the 1980s even if we know in our minds that those periods were unsustainable.

We have been through, in my judgment, a bizarre period. We need the wisdom to assess what happened in the 1980s. We have a vast amount of information available as to what happened, but it is clearly that many institutions, many economic policymakers, got carried away by the experience that data alone are insufficient. What we need, I think, is some very good judgment as to how to assess all of this. I hope I have made some small contribution to your collective wisdom. If not giving you my answers at least raising the issues which I think seriously deserve your consideration.

Let me stop there and I hope there will be ample opportunity for those of you seething with this concept to voice your frustrations and tell me I'm wrong.

FROM THE FLOOR: I was wondering if there are some other considerations that could suggest that the forecast would actually be better. For example, you didn't touch on the demographic considerations, the baby boomer generation saving more for retirement. Just a suggestion but given that the Cold War has now ended and that there seems less need for defense spending, could it be the diversion of those government spending away from defense into perhaps human capital may make things better?

MR. LADD: Those are two good questions. Let me try and respond and I think in each case there is the opportunity for some positive development, although relatively small. With regard to the demographics and saving, we don't have, in my judgment, very good information on this, but the best statistics I have indicate that there is not a significant disparity in savings rates among the various demographic groupings. There is not much evidence that when people get into their 40s they save a lot more than people in their 20s or 30s. The population with the fastest growth is the very elderly and they are saving to some degree and there has been some work done that suggests that even if you thought that the demographics were important, the sort of 10% savings rates are statistically impossible given the modest changes in the demographic profile. Nevertheless, I am inclined to think that the savings rate will increase in the U.S. and the reason may be, in my judgment, that since savings is the net of the increase in financial assets less the increase in financial liabilities, we are collectively so debt burdened and the leaders are significantly risk averse and the real interest rates are sufficiently high that I think our collective growth and our borrowing will be materially lower than in the past, but a lot has to be done in this area and we're starting from such a low base that it will require some substantial increases.

Let me give you just some quick figures on this which may be a little rough, but I referred in my remarks to an adjusted federal deficit of \$325 billion plus \$50 billion of government (state and local) deficits. The personal savings rate in the U.S. is at \$160 billion. The corporate-retained earnings are now \$10 billion. Now the latter is secretly depressed but the comparison of the size of what the government is taking versus what is being generated from the household and corporate sectors tells me that we have a very long way to go.

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On your second point, the Cold War is over I think and hope and I do see an opportunity for some reductions in defense expenditures but the evidence to date is that it's tough to come by and indeed it may come later rather than sooner. One of the items that seems to be surfacing at the moment is that the cost of destroying the nuclear stock piles is going to add to the near-term cost. Having said that, I think there will be breakthroughs. There is the issue of what will we do with that and I am disheartened that this last we have proposals from the U.S. Congress that we should spend those projected savings from a defense budget in a tax cut at a time when we we're dealing with a \$325 billion federal deficit. I think it is a positive and should have been mentioned. I'm concerned the effect won't be that large. Other questions.

FROM THE FLOOR: A couple of questions that are related. We speak of conversion for return. Do you mean conversion of return after adjustment for risk or before, and the second part of the question is that if you see a conversion of return, that at least raises the possibility of a diminish in need for diversification. Is that true?

MR. LADD: Again two good questions. The returns that I was providing for you, 8-10%, are before any adjustment for risk. It would be nice to have a more specific risk adjustment, although I find myself very ambivalent as to what those risk levels are going to be. You should certainly receive a higher level of return from common stocks, for example, versus high-grade bonds, but that has not been the case in my projections.

In the case of diversification, I don't think that does mean a reduced means for diversification. For a variety of reasons it seems to me there are more than ample investment risks. We have, I think, great difficulty in trying to make good investment judgments. We are overwhelmed with data. There is likely to be, in my judgment, a continued high level of volatility in investment returns in the short run. I am staggered at how well-linked the communications networks are. The performance orientation, short-term performance orientation of many investors, and the whole global organization of capital flows with all of this liquidity slushing around tells me that there will still be a high level of volatility. Now you can tell without difficulty from my remarks that I am a risk averse investor, but one of the ways of trying to temper that risk is through diversification and I think in some respects some of the errors of the 1980s have come from inadequate diversification. I would be a strong proponent of spreading the net very broadly. I think it's important to recognize in many senses what we don't know and how difficult it is to forecast.

MR. DENNIS P. LAUZON: I'd like to know if you think the dollar is currently fairly valued and if it did appreciate, let's say by 50% over the next five years, how would that impact your forecast?

MR. LADD: One of the objectives of my investment career has been to avoid forecasting currencies if I can so I will try and waffle a little bit on the issue. My sense is that the dollar is somewhat in a range of fair value at the moment, but I am concerned that interest levels are not particularly competitive. We are somewhat less disciplined in our economic policies than others. I think it is likely over the course of the 1990s that the U.S. will continue to have a current account deficit and be a capital importer and be a rising international debtor, although not at the pace of the late 1980s.

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One of the basic issues for the U.S., I think, is the oil question. To translate the daily import rate to an annual rate, we are importing about three billion barrels of oil per year. Now you can place whatever assumption you want on that in terms of what you think the oil price is likely to be. My own judgment is flat in real terms rising in nominal terms, but that is an annual cost that may approach as our production ramps down \$90-100 billion per year by the mid to late 1990s. If that's the case it will require, I think, a very substantial surplus on our other transactions to keep the overall current account approaching balance. I would argue from that the path of least resistance is probably toward a somewhat lower dollar, but then as I make analysis of the competitiveness of our manufacturing and as a tourist or business traveler I'd look at price levels in other countries I am staggered at what they are. My sense is that a lot of this is already discounted at a level of currencies. The thrust of that is I am assuming for investment planning purposes not to have a gain or a loss from the exchange risk out of U.S. dollars.

FROM THE FLOOR: What kind of possibility would you attach to governments not being able to curtail spending and not being able to raise taxation and, therefore, deal with deficit inflation? It appears that you don't think inflation is going to be increasing in the future. Maybe indirectly it appears you don't think it's going to happen. Could you follow up on that a little bit?

MR. LADD: That's a very good question. I hope eventually that we will be forced to see more action on the governmental deficits.

It is very difficult to control expenses, entitlement programs in particular. The social disintegration that I anguished about earlier in my remarks is potentially very costly. I think it's going to be tough to ratchet down those deficits. I am struck that in the case of Canada where the annual current account deficit is about \$25 billion or 3% of GDT. This is about the amount that the Canadians are paying for interest on their past debt and it keeps accumulating and you can do it for awhile but at some point it produces a lot of problems.

I think the natural reaction of the political community in a democracy is to try and reflate and I would be more discouraged about it if I didn't think that the markets would have great difficulty accommodating that. It's interesting to me that just recently the tax cut issue has surfaced in the U.S. as a symbol of lack of fiscal discipline. The bond markets have taken that very badly. I think that will continue to be the case and as it drives interest rates higher, I think that tends to limit the degree of inflationary damage that can be done by other fiscal policies.

MR. ALAN J. ROUTHENSTEIN: I think what you were stating is that the equity market right now disagrees with your forecast. Do you see the equity market turning around quickly or do you see it turning around slowly to agree with your forecast and if so, what are the implications of the debt market and volatility of interest rates?

MR. LADD: Let me try and answer all of those questions. First I think that my expectations are below those of market participants in terms of U.S. equities. I go out and ask people what they expect or do they think my 8-10% is too low. There is a common belief, I can't substantiate this statistically but returns on equities ought to be 11%, 12%, 13%. I see that myself as a delay in downshifting from the 1980s

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when the returns were spectacular and I think the hard evidence suggests that the returns are more likely to be 8-10. Why in the face of this are common stock markets behaving so well? I would quickly submit that it is not earnings and dividends that are the current preoccupation.

The simple issue today is that one's money market fund yields five. That is a disappointment. What else are you to do with the money? You're not going to invest it in real estate given what has happened recently. Some of it will go into bonds, but a lot of it will go into common stock. There are lots of past correlations which say that common stocks do well when interest rates are relative low. This is a worldwide phenomenon. Nothing seems to stir the Japanese market more than the possibility that the bank of Japan will cut short-term interest rates. I don't see any near-term change in this picture, but I would quickly confess that one of my desires also is to avoid forecasting interest rates. It seems to me that we're on sort of fragile ground of everybody being enthusiastic about stocks not because of the fundamentals but sort of a purchase by default. Does this mean more volatility? Yes, I suspect it does and probably more volatility in terms of assets on interest rates as well. There is certainly a great willingness with our fairly short-term focus in the investment community to switch around and engage in a lot of asset allocation. I think the key is probably when central banks find that they can no longer reduce interest rates or when it doesn't seem to be doing any good. At that point I think we'll find that stocks are somewhat on the high side but not violently.

FROM THE FLOOR: I have two questions. One, if you could comment on infrastructure issues. Specifically not national but regional in local community issues and I'm from the New York area so I'd be extremely interested in that and second, do you see any emerging technologies that are likely to have a significant impact in improvement in your forecast? You mentioned small cap stocks. I'm wondering if there were certain types of industries or technologies that might have a significant opportunity.

MR. LADD: From a national picture there is some evidence that inadequate infrastructure spending does hamper productivity growth and does limit returns from private investment so it is a depressant to economic growth and general productivity growth in particular. I don't know any good statistical information about New York, although I have talked with the head of the New York State Department of Transportation who assures me that there is a general deterioration in roads. A big part of infrastructure spending is basically roads and highways. Certainly the anecdotal evidence suggests that New York, among other areas, has a problem, but these difficulties are confined, I think, importantly to urban areas that have extra pressures as sort of the dumping grounds of our social distress and a compounding problem that the northeastern U.S. is the weakest area economically. My own guess is that we are in an elongated soccer economic shape in the Northeast and that these problems having started earlier than the nation as a whole is likely to last a little bit longer.

It is reassuring to me and, maybe to you, that there are many areas in the U.S. that are doing much better. It's always a happy experience for me to go to Kansas City or to places in the agriculture zone or the Upper Midwest. Those communities are manufacturing/export oriented. In the Rocky Mountain area, there aren't many people, but the growth is pretty good in Seattle. We have, I think, the worst of it in

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New England and the Middle Atlantic states. In terms of emerging technologies, so many areas that are working and I think one of the pluses for the U.S. is the amount of entrepreneurship which is going on. While the incentives in terms of taxation are not all that they might be, there is an extraordinary fervor which I think is a decided plus and is one of our great strengths versus other areas of the world.

It is regrettably not that big. For those of us who worry about Massachusetts as an example you try and look at the jobs that are to be created by biotech and software and environmental controls and medical technology. There are jobs there and things are coming along, but we have lost a staggering number of basic manufacturing jobs and it's not going to rectify the damage. I think the technological area is a positive but probably not going to have enough of an offset to overall economic growth to be as important as we would like.

MR. STEWART: Sorry. I don't think we have time for any more questions. I'd like to call on Eric Lofgren, vice chairperson of the Section to come up and personally thank our speaker.

MR. ERIC P. LOFGREN: If risk is defined from deviation from stated expectations, certainly economic forecasting is a risky business. It helps to be visionary. I'm sure I've learned a lot here and hopefully I'll see more clearly into the future.

MR. STEWART: One small financial housekeeping item that I forgot to mention at the council meeting was it was decided to freeze dues for the Investment Section at the current level of \$10 the following section year. I would now like to call on Mark Griffin to come up and give us a very brief overview of the membership survey that was conducted earlier this year to get feedback from the section.

MR. MARK W. GRIFFIN. There was a survey that was conducted earlier this year. First of all from the prospective of the council, it was good news to find out that the very vast majority think that we are doing a good job and we're living up to your expectations. The bad news was that only one person out of approximately six returned the survey. I'm not sure what the other five think. Nevertheless, we will assume, being actuaries, that we can just extrapolate. We learned a few interesting things and we will have some more analysis to do on these results. I found one of the more interesting things was the breakdown of people's primary responsibilities. One of our first questions in this survey was what best characterizes your professional investment responsibilities? You can only choose one here. The first choice was I'm primarily involved in investment issues. Only 14% responded to that one. The second possible choice was investment issues have a high impact on my work. My primary responsibilities are not investment oriented. That was 64%. Twenty percent felt that investment issues are only minimally related to my professional responsibilities, and 2% said they had essentially no bearing.

With respect to the newsletter here's where you get an idea of what some of these responses were like. We had listed a number of features and wanted to indicate whether you found them interesting or not interesting. The most interesting was technical articles. The next most interesting was nontechnical articles. I'm not sure what conclusion to draw from that. We did learn a lot about the newsletter and the responses to the newsletter were very good. One of the other things I want to touch

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on is finances. As Ken mentioned earlier, there is a surplus nowadays within our budget. We want to get some sense for how you felt we should spend that budget. The most popular response was to financially sponsor research projects. We have some plans to do that. The second most popular was, remember this survey was taken a little while ago, retain higher-profile speakers at meetings/seminars. I'm sure you'd respond differently in your exit survey. Third, subsidize seminars that might lack widespread appeal. Fourth, distribute summaries of economic statistics. Fifth, offer prize money for investment papers, which we do. Number six was reduce annual dues which we choose not to do. Number seven of which zero people responded was mail the newsletter first class.

The only other questions that I really want to comment on in any detail are the ones with respect to the expand process and, of course, the advisability of beginning an investment track and this is certainly the hot issue. One of the questions was which statement best describes your opinion on the advisability of developing an investment exam track? The first possible choice was there is no need for an investment track to which 11% responded. The next choice was first investment course material should be strengthened and expanded. It is premature to decide about the need for an exam track until this is done. That was 47%. Forty-two responded the council should actively promote the development of an investment track. I think, that is, in fact, the next item on our agenda.

MR. STEWART: I'd like to call on Pete Hepokoski to speak about the investment track question. Pete is wearing two hats. He is the member of council with the portfolio for basic education and he is also a member of a special task force on the investment track which, and I quote, "has as its mission from the Society to recommend whether or not the Society of Actuaries should adopt an investment fellowship track."

MR. PETER HEPOKOSKI: Before I comment on the track specifically, I want to clarify one item. The next item on the agenda is to talk about the investment course content committee. The work of that committee, which has been considerable over the last two years and is ongoing, has another couple of years to go and is separate from the investment track concept. That's in progress. It's happening. It doesn't depend upon the track or vice a versa at this point. With respect to the investment track, there are two areas I'd like to update you on at this point.

You heard Don Sondergeld mention the task force that has been established to address the issue. The task force is being chaired by Bruce Moore of the E&E Committee and members in the task force include representatives of the board, the actuary of the future task force, the investment course content committee, this council, the CIA committee on investments. There's a member of the Institute who works in the U.S. primarily on investments but has the prospective of the Institute of Actuaries and the Society staff representation. That group had its first meeting last month. Its second meeting will be later. Our assignment is to address the question, should there be an investment track? The other item I'm going to be updating you on is the investment section council which began development of a position paper actually shortly before the establishment of the task force. Mark Griffin heads this effort within the section council.

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When I describe to you where we're at, recognize that this is a preliminary report and since there is not an official document out of either group, it may be biased by some of my feelings or observations but I'll try to best characterize where each of those efforts is at. With respect to the preliminary conclusions of the Sondergeld-appointed task force, I jotted down four or five items that I saw as preliminary conclusions. One is that our most pressing need with respect to investment education is to assure that the work of the Investment Course Content Committee proceeds and that the new courses are added as scheduled.

The next priority is to address the increase required investment courses for all actuaries and tracks on the examination syllabus. With respect to the investment track per se, I think there's clearly not a sentiment in the task force to reject it. The answer no to the investment track is not one that we're considering. There are more objections than just saying yes and I think maybe the three objections that occur to me characterize what we'll be talking about. One option is commit to an investment track at this point. Another is to defer the decision until we can resolve several issues. At our first meeting we developed a list of approximately 15 pros and 15 cons with respect to the investment track. There's a third issue which is to extend the consideration to broader investment financial track as suggested or to fit in with the report of the actuary of the future. As I say, we're meeting later, but that's where that stands now. With respect to the position paper of the Section Council, we've tried to incorporate your comments from the membership survey so that we think it's broader than just the council.

I could characterize by about three or four statements where we're at in the development of our position paper. One is that we prefer the evolutionary approach. We think that committing now to an investment track will not accelerate the earliest availability for such a track. We agree with the preliminary conclusions of the task force to emphasize the new courses, the new electives that are coming on and to emphasize more required courses for all tracks. The need is greater for more investment education for all actuaries, in our opinion, than a lot of investment education for a few actuaries.

The other point is that what other structure results should have more of an asset liability focus to it than a purely asset focus as a council. We have agreed, regardless of any differences that may result from our position paper and the task force result, that we do intend to support the decision of the task force and ultimately the board decision on this issue.