Article from

Risks & Rewards

April 2020

2019 Investment Symposium—Session 3A: Real Returns and Risk Premia: What Are the Issues?

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Author's note: This article reflects the discussions during the 2019 investment symposium on Oct. 27. In my opinion, COVID-19's ravaging impact on health and economy worldwide will lead to a paradigm shift. Short-historical average or through-the-cycle average methods both seem inappropriate to set investment assumptions. The economic impact of lockdown and the interventions from multiple levels of government across many countries globally are more impactful than economic trends in the short-, medium- and long-term.

This session commenced by framing the debate over the setting of asset return assumptions. It addressed past history. The session later incorporated panel views on the current investment environment.

One of the aims of the presentation was to provide audience members with some additional thoughts on how "reasonable" expected return assumptions can be set.

The following summarizes several of the points discussed and questions raised during the session:

I. We have experienced many good years of investment performance. Is it reasonable to establish a long-term assumption by taking some sort of the recent average? Is it appropriate to assume that we will continue to have good years going forward?

II. Conversely, should we now anticipate some bad years (assuming mean reversion is still alive) and incorporate a belief that markets are too high already?

III. One approach to setting assumptions would be to pick round numbers around the average, say, for 10–15 asset classes (e.g., five equity classes, a few bonds, real estate, some structured assets, risk free assets, etc.). Should we alter these so that they represent a through-the-cycle assumption?

IV. Alternatively, the GMO real return forecast (not shown here) shows an at-the-cycle assumption. These are snapshots in time but would change depending on where in the cycle we are at.

V. Should we incorporate some "artful" changes to the assumptions, given that we know how the investment will be used? For example, bond cash flows are already set. Do we know that a particular nominal rate will be earned since the bond will not be sold (i.e., we should not incorporate any optimized trading)?

VI. Bias anyone? Of course, there are incentives to setting an assumption optimistically on the pension side. But the assumption should be linked to portfolio construction. A small variation in assumptions will lead to large impacts, due to the long-term nature of the investments but also the liabilities.

VII. Some consideration has to be given to the credibility of the current period (i.e., do we have a historical comparable period of low interest rates and high asset valuations, as we may have today?). This can add some weight to the assumptions we choose.

VIII. Reporting to various stakeholders and at the board level is often done in nominal terms. Therefore, stating expected returns nominally is still the more popular approach. But this does not preclude us from incorporating real term assumptions into models.

IX. You should have a rationale and a story to justify and sell expert judgments. This helps support the assumptions chosen.

X. Can we or should we hide behind the market efficient hypothesis? This would imply that observed market pricing is correct and hence no bad or good years should be anticipated.

XI. Should you link the asset returns to the liability? Do you invest in similar risky vehicles? This can also impact the assumptions we choose, but also helps us assess how concerned we should be over the reasonableness of the assumptions we select.

XII. Should the assumptions and expectations change based on market conditions? If equities are high and interest rates are low, does that affect the assumptions going forward? Again, this raises the old debate between using an at-the-cycle or through-the-cycle assumption.

XIII. What is the financial risk if the assumptions are not met? How sensitive are the liabilities to them? That is another measure of how reasonable our assumptions should be.

XIV. Are there ways to manage this financial risk underlying the choice of assumptions?

XV. Should we build-in some conservatism? Even though this has value as well, if our aim is to produce reasonable assumptions, then we should not seek to introduce bias in either direction.

Hope that some of these considerations are helpful in your assumption-setting process!

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