WELLS FARGO ADVISORS

The Week

Gary Thayer, Chief Macro Strategist

What if returns are lower?

- Earlier this month, *The Wall Street Journal* carried a story saying that Calpers, the California Public Employee Retirement System, is considering reducing its projected rate of return on the assets that it manages in its pension funds. A change in the assumed rate of return is important for California government finances but also important to investors generally.
- During the past seven years, Calpers has assumed that the combined return on assets that it manages, including stocks, bonds and other assets, would average 7.75% per year. Looking ahead, Calpers is discussing whether returns could be more modest because the global economy may be in an extended period of slower growth.
- The story focused on the possibility that a lower assumed rate of return would make it more difficult for the pension fund to cover the payouts that it is committed to make to retirees and beneficiaries. Consequently, current California government employees and local governments might need to contribute more to ensure the fund meets its projected payments.
- *The Wall Street Journal* article said that Calpers' rate of return assumption would probably be under review this year, and a decision may not be made until early 2011. In other words, Calpers is considering changing its rate of return assumption but no specific alternative targets have been discussed.
- This discussion raises an important issue for all investors. If rates of return are lower in the future than previously assumed, it will be harder for investors to meet their investment objectives. Consequently, investors may need to save more, work longer or reduce expectations in order to adjust to a world of more modest returns.
- To illustrate the impact of lower projected returns, it may be useful to look at an issue important to stock market investors. How long will it take for the stock market to return to the peak prices in 2007? As you might expect, the lower the projected rate of return, the longer it will take to get back to the old highs.
- During the past 12 months, the U.S. stock market, as measured by the S&P 500, has recovered more than 50% of its losses incurred during the 17-month decline from October 2007 to March 2009. This has been an impressive 70% increase in just one year. This is substantially better than the 7.0% average annual increase in the S&P 500 since World War II.
- In our 2010 outlook, we showed that the stock market often achieves outsized gains in the first year of recovery from recession lows. However, in the second year of recovery, the gains are usually more modest and volatility is frequently greater. Of course, past performance does not guarantee similar future results. Nevertheless, we expect more modest gains in the stock market this year.
- Looking back, the 7.0% average annual increase in the S&P 500 from 1945 through 2009 includes several strong recoveries after recessions but also many steep declines during recessions. Thus the average annual gain is not what investors should expect the market to do every year. Nonetheless, it is useful to look at market performance around this average when discussing the potential going forward.

- Looking ahead, if the stock market increases at a steady 10% annual rate from the current level, it would take approximately three years and two months for the S&P 500 to increase back to its old highs. If the market grows at half that rate, it would take slightly less than twice as long or six years and three months for the market to get back to the previous peak.
- Another way to look at the potential impact of lower rates of return is to calculate how long it would take for a portfolio to double in value under various return scenarios. This can be done easily using the "rule of 72". To find the time it takes an asset to double in value, you divide the number 72 by the assumed rate of return over the holding period. For example, if the rate of return is 10%, it would take 7.2 years (72 divided by 10) for that asset to double in value. If the rate of return is only 6%, it would take 12 years (72 divided by 6) to double in value.
- Finally, the two illustrations discussed above do not to include an important element of investing, namely additional contributions from increased savings. If rates of return are lower in the future, investors can still achieve their investment objectives by adjusting the amount of money that they contribute to their portfolio. If investors increase the annual contribution to their portfolio, then the time needed to meet their investment objectives need not increase even though returns may be lower.
- The following table looks at three alternative investment scenarios. The first assumes that a $100,000 investment grows at a 10% annual return through market appreciation alone with no additional contributions or reinvested dividends, hitting the investment objective of $259,000 after 10 years. The second scenario assumes that a $100,000 investment grows at a 7% annual return through market appreciation alone. In this case, investors, relying just on market performance miss their goal of $259,000 after 10 years. The third scenario assumes a 7% market return, but investors contribute an extra 3% per year to offset the lower market return. This allows the asset to have the same ending value after 10 years as the 10% return with no contributions. In other words, in a lower return world, investors can still achieve their financial objectives but may need to offset lower returns with increased contributions.

Year	Scenario 1 10% market return	Scenario 2 7% market return	Scenario 3 7% market return plus 3% contribution
Starting Amount in thousands	$100.00	$100.00	$100.00
+1	110.00	107.00	110.00
+2	121.00	114.49	121.00
+3	133.10	122.50	133.10
+4	146.41	131.08	146.41
+5	161.05	140.26	161.05
+6	177.16	150.07	177.16
+7	194.87	160.58	194.87
+8	214.36	171.82	214.36
+9	235.79	183.85	235.79
+10	259.37	196.72	259.37

The above figures are used for illustrative purposes only and do not reflect any current rate of return available through Wells Fargo Advisors. Figures do not include fees, commissions or taxes, all of which would have a negative impact on results. Investments will fluctuate in price so it is possible to receive more, less or the same as the original investment when sold.

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