Alternative Investing

How Do Investors Form Long-Run Return Expectations?

Understanding Return Expectations, Part 1

April 28, 2025

This paper is an overview of a forthcoming series which tries to understand how investors actually form long-run return expectations. It contrasts “objective” yield-based expected returns (which historically display some predictive ability) and “subjective” rearview-mirror expectations (which excessively extrapolate past 3-10 -year returns or growth).

Objectively feasible expected returns are low when market valuations are high and starting yields low. Yet, surveys reveal that the consensus expectations of some market participants (individual investors, equity analysts) can exhibit opposite behavior. The tension between objective and subjective expectations was most pronounced near market peaks (2000, 2021) and troughs (2009).

The story is nuanced. Academics and practitioners may mean different things when they talk about expected returns. Some subjective expectations appear more rational and less extrapolative, those of institutions and those on interest rates. Even rational predictions only work on average and can fail for a long time.

Rearview-mirror expectations have made many investors too optimistic on risky and private assets after the good times following the Global Financial Crisis, and too cautious on liquid diversifiers. The dangers of a rearview-mirror mindset are most pronounced in the case of US equities versus the rest of the world.

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