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The Performance Expectation Gap

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Research shows that US investors expect real annual investment returns of more than double what financial professionals expect. In the short run, this is a recipe for unhappy investors as short-term returns rarely meet expectations. Eventually, this gap leads to even greater misalignment and deep dissatisfaction.

LONG-TERM US INVESTMENT PORTFOLIO REAL RETURN EXPECTATIONS (2022-2023 SURVEY RESULTS)

Source: 2023 Natixis Global Survey of Individual Investors, Natixis Investment Managers, Global Survey of Financial Professionals conducted by CoreData Research in March and April 2022.

Financial professionals expect long-term portfolios to generate 7.0% annually after inflation. As of January 2024, inflation as measured by the Consumer Price Index was 3.4%, so this expectation is roughly in line with the average annual return of the S&P 500 index at 10%. Investors, on the other hand, expect to see 19% nominal returns annually from their long-term portfolios.

To put this into perspective, the S&P 500 has generated annual returns of more than 19% in 37 of the past 95 years, or about 39% of years. But the S&P 500 has also generated 26 years of negative annual returns over that same period, about 27% of years, which is why the long-term average ends up being around 10%.

For investors owning a 100% equity portfolio, the financial professional return expectation is reasonable over longer time horizons. But most investors do not own 100% equities, and have allocations to bonds, real estate, commodities, and other asset classes that drive down the 7% return expectation into the 3-4% range. To generate a 19% annual return over time, investors would have to consistently invest their entire portfolio in highly volatile and speculative investments, a sure recipe for disaster.

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From the Behavioral Viewpoint

What is going on?

1. Investors have **Unrealistic Expectations** based on limited and **Anecdotal Information**. Often cherry picking favorable one-off examples or using unreliable information. Anyone looks smart selectively after the fact.

2. Investors are subject to **Myopic Loss Aversion,** they feel losses more strongly than gains and want consistent returns in every period. The difficult truth is that investment returns are choppy and uncertain, with losses and gains in any period.

3. Investors use **Heuristics** or mental shortcuts and **Fallacy of Control** to overestimate their ability and level of control. We conclude investing is easy and financial professionals should deliver consistent double digit returns year in and year out.

What can we do?

1. Tune out the noise and cocktail talk about great investments. Do not kid yourself about how easy successful investing is. It takes time, skill, and discipline.

2. Reframe your focus to achieving plans and goals over years and decades, rather than abstract and meaningless recent performance numbers.

3. Learn to understand markets as a long-term return distribution. The more draws from the distribution, the better the outcome. Develop realistic expectations and accept that both positive and negative returns will inevitably occur.

4. Develop a needs-based plan that separates short-term and long-term investments and stay fully invested over time. Build a strategy-diverse equity portfolio that can be resilient in a variety of market conditions and designed for the long-run.

5. Work with an experienced financial advisor for coaching to stay on track and to remain focused on long-term goals.

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