

Framework for Developing CME

In a universe with only two asset classes (i.e., stocks and bonds), capital market expectations (CME) would include the expected returns and volatility for each asset class as well as the correlation between their returns. In reality, asset classes tend to be defined more narrowly. For example, most investors treat domestic and foreign equities as distinct asset classes rather than part of a single asset class for all stocks. However, the objective of capital market analysis is the same regardless of how broadly or narrowly asset classes are defined.

Another important consideration is the time horizon over which asset class returns are expected. An investor may expect the annual return on domestic equities to be only 2% next quarter, but 8% on average over a long term of 20 years.

Capital market expectations are used to determine an investor's optimal asset allocation, which is the most important factor in a portfolio's performance. While it was once common practice to set return expectations based on a simple extrapolation of historical returns, it is unrealistic to expect that future returns will replicate past performance. Rather, investors should use forward-looking methods that are consistent across different asset classes (**cross-sectional consistency**) and time horizons (**intertemporal consistency**).

A Framework for Developing Capital Market Expectations

Conducting thorough and disciplined capital market analysis involves the following steps:

1. **Specify expectations**

The analyst should write the desired outputs, such as expected returns, volatility, and correlations, in advance. It is critical to specify the relevant time horizon. The analysis must be appropriate for the particular situation. For example, if a fund only invests in domestic bonds and equities, the research should be limited to those asset classes. It is also necessary to identify and define the relevant asset classes. Defining asset classes too narrowly significantly increases the scope of the analysis.

2. **Research historical data**

Although simply extrapolating historical returns is inappropriate, the past can reveal the factors that affect asset class returns (return drivers). Using historical data can help an analyst establish a reasonable range of expected future returns.

3. Specify methods and models

The methods and models used should be explicitly stated and justified. An analyst must choose the best forecasting approach for the given time horizon. For example, discounted cash flow models are generally regarded as more appropriate for long-term time horizons.

4. Determine best sources of information

Different data sources are available for research; thus, the analyst must choose the best ones while also considering accuracy and cost. Analysts must also consider which frequency (i.e., daily, quarterly) is appropriate for their purpose.

5. Interpret current investment environment

Analysts should use a common set of assumptions, methodologies, and judgments to ensure cross-sectional and intertemporal consistency.

6. Provide expectations and document conclusions

In this step, the analyst produces the outputs specified in Step 1, accompanied by supporting reasons and assumptions.

7. Compare expected to actual outcomes

Forecasts should be compared to actual results. Over multiple cycles, this analysis can be used to refine and improve the process of setting capital expectations.