



The Rationale for an Absolute Return Goal

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**DIAMOND
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The Rationale for an Absolute Return Goal

Executive Summary

At Diamond Hill, all of our portfolio managers have a five-year absolute return objective for their strategies. Those absolute return goals are one of three quantitative inputs in our portfolio manager incentive compensation calculations, along with five-year return relative to benchmark and five-year peer group ranking. The absolute return goal for each strategy represents our view of the return consistent with the risk of the asset class. Our absolute return objectives address the question of what returns should be in a normal environment, which may be different from a forecast of what we (or others) think returns will be.

Previously, our absolute return goals were set using a static return objective based on an assumed risk free rate of 3% plus a risk premium. After careful consideration, we concluded that an absolute return objective based on inflation plus a normal real equity return is a better approach

than a static return objective. This method of setting absolute return goals more closely aligns our interests with investors, ensuring they receive an adequate real return before our portfolio managers can earn maximum compensation.

Effective December 31, 2012, we have replaced our previous absolute return objectives with new targets based on a more theoretically sound framework focused on real returns. Our new five-year absolute return objectives for each strategy are:

Strategic Income:	5-year compounded inflation + 3.0%
Large Cap & Long-Short:	5-year compounded inflation + 5.0%
Select, Financial Long-Short & Research Opportunities:	5-year compounded inflation + 5.5%
Small-Mid Cap:	5 year compounded inflation + 6.0%
Small Cap:	5-year compounded inflation + 6.5%

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Some argue that absolute return objectives are irrelevant or misleading. In *Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor*, renowned value investor Seth Klarman wrote,

“Many investors mistakenly establish an investment goal of achieving a specific rate of return. Setting a goal, unfortunately, does not make that return achievable.”

We recognize that there will be environments where achieving a given absolute return requires extraordinary performance and other periods when such a return represents a low hurdle. Nonetheless, we believe an absolute return goal is an important component in our performance measurement process, aligning our interests with those of our clients and serving as a tangible reminder of the importance of absolute value to our investment philosophy.

Diamond Hill’s absolute return objectives have been heavily influenced by empirical evidence, most notably the nominal returns on large and small company stocks over long periods of time. We continue to look to history to support our views; however, the exceptionally low interest rate environment and

significant economic uncertainties that exist today prompted us to thoroughly examine the sustainability of historical returns as well as our focus on nominal results. Over the past twenty-five years, a stable inflationary environment has ensured that static absolute return goals based on historical nominal returns provided adequate compensation to investors. With most developed nations significantly over-indebted and central banks pursuing historic growth in their balance sheets, that dynamic seems increasingly uncertain. As part of our research, we specifically addressed the following questions:

- Is it better to have a static return target or an objective that varies with risk-free rates or inflation?
- How much weight should be given to the exceptional historical experience of U.S. equity investors in the 20th century?

Based on our critical examination of these questions, we concluded that an absolute return objective based on inflation plus a normal real equity return is a better approach than a static return objective. This method of setting absolute return goals more closely aligns our interests with investors, ensuring they receive an adequate real return before our portfolio managers can earn maximum compensation. A process based on real, as opposed to nominal, goals is also more theoretically sound, matching the objective with the nature of the asset being managed. We looked closely at historical returns around the globe and determined that a normal real equity return is approximately 5.0% for large capitalization stocks (up to 6.5% for small company stocks), modestly below the levels achieved by U.S. investors over the past 100 years. The brief sections below summarize the factors that influenced our revised absolute return targets.

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Building Blocks: The Theoretical Foundation of Equity Returns

When people earn income they have two alternatives, they can consume goods and services today or invest their earnings to be spent in the future (ignoring borrowing and lending). Investing involves risk, and the most fundamental investment risk is the erosion of purchasing power due to inflation. Nominal returns have little meaning without reference to the rate of inflation. Thinking properly about the returns that investors should expect from various assets begins with the principle that all investing should, at a minimum, compensate for the erosion of purchasing power due to inflation. In exchange for deferring spending to later periods, most people require a return that will allow them to spend more in real terms (adjusted for inflation) in the future. The short-term real return on risk-free (no default risk) government securities therefore provides the first “building block” required to construct expectations about real returns on equities.

As savers venture from risk-free to risk assets, they should demand additional compensation in the form of a return premium. Premiums should be demanded for each incremental risk that cannot be diversified away. Collectively the extra return demanded for duration, credit, liquidity, and other risks associated with owning equity securities may be thought of as the “Equity Risk Premium” (ERP), and it provides the second “building block” needed to form expectations about real equity returns.

There is significant academic literature focused on the ERP that considers both the theoretically appropriate level as well as historical returns. Definitions differ slightly across studies with some believing ERP is the return in excess of short-term risk-free rates and others who refer to ERP as the return in excess of long-term risk-free rates. The framework we have put forth treats the term premium between long-term and short-term risk-free securities as part of the aggregate ERP. Given our objective of identifying the real return on equities in a normal environment, we do not believe the distinction affects conclusions about the historical data, but it should be noted by those reviewing research on the topic. In the next section, we summarize some of the historical data on real interest rates and ERP.

Global Evidence

A wealth of data is available on the long-term returns to various assets in global markets. While a great deal of focus has been placed on the U.S. investor experience in the 20th century, it is also useful to consider a more expansive view that includes international markets. Below we highlight some of the most notable historical results, organizing data into the two components of our building blocks framework.

- **Short-term real interest rate:** In the U.S., compensation for deferring consumption has been 0.6% per year between 1926 and 2010 according to Ibbotson Associates data. In “Equity Premiums around the World,” Dimson, Marsh, and Staunton (DMS) consider a slightly longer time period, examining U.S. and international markets between 1900 and 2010. They find a real interest rate of approximately 1% in the U.S. Across eighteen developed countries, DMS find an average short-term real rate of 0.1% and a median of 0.8%. *Currently short-term risk-free rates in the U.S. are less than 0.25% compared to expected inflation of 2% plus. The negative expected real rate provides no incentive for earners to save without incurring risk.*
- **Risk premium in the U.S.:** Ibbotson Associates data shows a realized equity risk premium for large capitalization stocks of 6.3% between 1926 and 2010, while DMS find a 5.3% premium for a capitalization weighted index of stocks between 1900 and 2010. In the 1926 to 2010 time period, approximately 1.1% of the realized premium is attributable to appreciation in the valuation multiple, while in the longer 1900 to 2010 time frame, valuation change is responsible for 0.6% of the realized premium. Excluding increases in the valuation multiple, the realized risk premium was 4.7 - 5.2%. Robert Arnott takes an even longer view in “Equity Risk Premium Myths,” considering data from 1802 to 2010, and finds a realized risk premium of approximately 4%, about 1% lower than Ibbotson and DMS.

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- **Risk premium outside the U.S.:** DMS examine realized equity risk premiums in eighteen developed countries between 1900 and 2010 and find an average risk premium approximately 0.5% lower than in the U.S. The international markets experienced a similar benefit from expansion in the valuation multiple. Excluding the impact of changes in valuation multiple, the average risk premium for the eighteen countries was slightly below 4%. Nine of the eighteen countries had realized risk premiums below 4% and the average across the European nations was approximately 3.5% excluding changes in valuation multiple.

Based on our review of the evidence, we believe appropriate estimates of normal real risk-free rates and equity risk premiums are 0.5% and 4.5%, respectively, for large capitalization stocks with an additional 1.5% risk premium for investing in small capitalization stocks. This view balances a healthy respect for the actual historical results with a recognition that returns derived from expansion of valuation multiples cannot be counted on in the future. Furthermore, we believe the favorable experience of U.S. investors relative to investors in other developed countries may be unrepeatable given new economic challenges as well as the increase in global investment alternatives.

Conclusions

In recent decades, stable inflation and growth in the U.S. made static absolute return objectives a realistic estimate of normal equity returns. However, as we contemplate the potential for a more uncertain economic future, it is helpful to keep in mind Albert Einstein's dictum that "everything should be made as simple as possible, but no simpler." Our previous approach, while satisfactory for many environments, was too simple and prone to error in a more uncertain investment landscape. As a result, we have replaced our previous absolute return objectives with new targets based on a more theoretically sound framework focused on real returns. Our new five-year absolute return objectives are listed below. Inflation is measured using CPI (All Urban Consumers from the Bureau of Labor Statistics).

Strategic Income:	5-year compounded inflation + 3.0%
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The views expressed are those of the research analyst as of January 23, 2013, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.

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– **Austin Hawley, CFA**

Research Analyst, Assistant Sector Leader, & Co-Director of Research

ABOUT THE AUTHOR

Austin serves as Co-Director of Research, Co-Portfolio Manager, Research Analyst, and Assistant Sector Leader for Diamond Hill Capital Management, Inc. He joined Diamond Hill in 2008. From 2004 to 2008, Austin was an Equity Analyst at Putnam Investments. From 1999 to 2002, Austin was an Investment Associate at Putnam Investments. Austin has a Bachelor of Arts in History from Dartmouth College

(cum laude), a Master of Business Administration from Dartmouth College (with distinction) and holds the CFA designation.

A handwritten signature in black ink that reads "Austin".

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