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Review Category Capital Market Expectations

Done Reviewing

Incorrect

Brian O'Reilly Case Scenario

Brian O'Reilly is a capital markets consultant for the Tennessee Teachers' Retirement System (TTRS). O'Reilly is meeting with the TTRS board to present his capital market expectations for the next year. Board member Kay Durden asks O'Reilly about the possibility that data measurement biases exist in historical data. O'Reilly responds:

“One bias results from the use of appraisal data in the absence of market transaction data. Appraisal values tend to be less volatile than market determined values for identical assets. As a result, measured volatilities are biased downward and correlations with other assets tend to be exaggerated.”

Board member Arnold Brown asks O'Reilly about the use of high-frequency (daily) data in developing capital market expectations. O'Reilly answers, “Sometimes it is necessary to use daily data to obtain a data series of the desired length. Ironically, high-frequency data improves the precision of sample variances, covariances, and correlations but not the precision of the sample mean. High-frequency data are more sensitive to asynchronism across variables.”

Durden states that he recently read an article on psychological biases related to making accurate and unbiased forecasts. She asks O'Reilly to inform the board about the anchoring and prudence biases. O'Reilly offers the following explanation:

“The anchoring bias is the tendency for forecasts to be overly influenced by the memory of catastrophic or dramatic past events that are anchored in a person's memory. The confirming evidence trap is the bias that leads individuals to give greater weight to information that supports a preferred viewpoint than to evidence that contradicts it.”

The board asks about forecasting expected returns for major markets, given that price earnings ratios are not constant over time and that many companies are repurchasing shares instead of increasing cash dividends. O'Reilly responds that the Grinold–Kroner model accounts for those factors and then makes the following forecasts for the European equity market:

- The dividend yield will be 1.95%.

Correct Answer Your Answer

A	X
B	
C	

Confidence Level:

Low

Time Spent:

2 mins 6 secs

Difficulty Level:

Difficult

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- The long-term corporate earnings growth premium will be 1% above expected real GDP growth.
- Expected real GDP growth will be 2.5% per year.
- The risk-free rate will be 2.0%.

Q. Given O'Reilly's forecasts for the European market, the expected long-term equity return using the Grinold–Kroner model is *closest* to:

- A. 7.35%.
- B. 6.35%.
- C. 8.35%.

Incorrect

Correct Answer Your Answer

A	X
B	
C	

Confidence Level:

Low

Time Spent:

2 mins 6 secs

Difficulty Level:

Difficult

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Solution

C is correct. The Grinold–Kroner model estimates the expected return on equity as follows:

$$\begin{aligned}
 E[R_e] &\approx \frac{D}{P} + (\% \Delta E - \% \Delta S) + \% \Delta P/E \\
 &= 1.95 + (5.25 - (-1)) + 0.15 \\
 &= 8.35\%
 \end{aligned}$$

where

$E(R_e)$ = expected rate of return on equity

D/P = expected dividend yield

$\% \Delta E$ = expected percent change in total earnings

$\% \Delta S$ = expected percent change in number of shares outstanding

$\% \Delta P/E$ = expected percent change in the price-to-earnings ratio

$(\% \Delta E - \% \Delta S)$ = the growth rate of earnings per share

$\% \Delta E$ = nominal earnings growth = real earnings growth + long-term inflation + corporate premium

= 2.50% + 1.75% + 1.00%

= 5.25%

Alternatively, the expected return from the Grinold–Kroner model can be expressed as the sum of:

Expected cash flow (Income) return: $D/P - \% \Delta S = 1.95 - (1.00) = 2.95$

Expected nominal earnings growth return = $\% \Delta E = 5.25$ (as shown above)

Expected Pricing return: $\% \Delta P/E = 0.15$

Expected Return = **8.35%**

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instead of subtracting it.

Capital Market Expectations, Part 2: Forecasting Asset Class Returns Learning Outcome

c. Discuss approaches to setting expectations for equity investment market returns

Incorrect

Correct Answer Your Answer

A	X
B	
C	

Confidence Level:

Discuss ⓘ

Discussion

GJ Why do you include P/E multiple growth in long-term return calculation? It is not sustainable. [topic](#)

Created 18 days ago by Guanyu Jin 0 replies | Last Activity: 18 days ago
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KR They got me...

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CZ sometimes you just wonder if the question writers actually understand english

Tags: [error](#), [plzfix](#), [wtf](#) 0 replies | Last Activity: 25 days ago
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DM I think this question could be improved if they specified exactly what they meant by "Long-term". The narative would suggest that it is a short term forecast whereas the question indicates long term.

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TB In fact - this is not correct - they replied for the short term E(R).

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MG gottem

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Camacho

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FY So what's the correct answer?

Created 4 months ago by Fangyuan Yin

2 replies | Last Activity: 2 months ago

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Answer

X

Confidence Level:

Low

Time Spent:

2 mins 6 secs

Difficulty Level:

Difficult

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