Couts, Gonçalves, and Loudis (2023) - "The subjective risk and return expectations of institutional investors"

Discussion by Ahmed Guecioueur

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Expectations in asset pricing & household finance

Rational/objective vs. subjective expectations

- ▶ Historically, asset pricing papers to date have proxied "expected returns" by realized ex-post returns

- ▶ Expectations are a key feature of asset pricing models ⇒ a lot of recent interest in the properties (and formation) of the beliefs actually held by investors (Brunnermeier et al. 2021; Adam and Nagel 2023)

- ▶ Early work found subjective expected returns diverge in important ways from realized returns. Examples:
    - ▶ Amromin and Sharpe (2014): negative risk-return relationship
    - ▶ Greenwood and Shleifer (2014): extrapolative expected returns
    - ▶ Giglio, Maggiori, Stroebel, and Utkus (2021): large & persistent heterogeneity

This paper

▶ Adds to recent efforts to understand determinants of the subjective expectations of institutional investors

▶ Like Dahlquist and Ibert (2021), this paper studies institutions' long-term Capital Market Assumptions (CMAs)

▶ Key addition: across multiple (≤ 19) asset classes

▶ $\Rightarrow$ Can study the factor structure of subjective expected returns across asset classes, using empirical asset pricing techniques

The factor structure of subjective expectations

Across-investor factor structure

▶ Brav, Lehavy, and Michaely (2005): market & size factors (but not the value factor) explain analyst return expectations

▶ Wu (2018) and Bastianello (2022): also compare the fits of various factor models to analyst return expectations

▶ Beckmeyer and Guecioueur (2023): common factor in households' subjective Sharpe Ratios seems to capture experience effects

Within-investor factor structure

▶ Kamdar and Ray (2022): common sentiment factor across households' expectations for multiple macroeconomic state variables

▶ This paper: common risk factor across institutional investors' long-term return expectations for multiple asset classes

Great idea and execution! Delivers very interesting findings

1. There is a within-institutional investor factor structure, across their (long-term) expected returns for different asset classes
   - ▶ 1-2 principal components cover 65%-80% of variation on avg.

2. These institutions perceive a positive risk-return tradeoff
   - ▶ Act more rationally than households do

3. 1st principal component appears to be a risk factor
   - ▶ Highly-correlated across institutional investors
   - ▶ i.e. agreement on what constitutes systematic long-term risk
   - ▶ Very interesting that institutions perceive a cross-asset class systematic risk factor

4. Most variation is in subjective risk premia (qty. of risk $\beta \times$ price of risk λ) rather than mispricings (α)

5. Mostly disagreement across asset classes rather than across institutions

Interpreting the institutional setting

Are CMAs "expected" or "required" returns?
- ▶ Could funding shortfalls in pension funds influence reported CMAs?
- ▶ Even non-pension fund institutions might have pension fund clients

How are fees & transaction costs accounted for?
- ▶ Likely to be considerable for private equity & debt, for example

Selection/truncation of asset classes over time?
- ▶ Since all data are self-reported, (strategic) selection might occur
- ▶ Do asset managers add CMAs for asset classes specifically when expected returns are highest and diversification benefits are best?
- ▶ Or maybe just *after* missing out on a good run?

PANEL A - Number of Managers, Consultants, and Asset Classes in our Sample (by Year)

	1987	1996	1997	1998	2000	2002	2004	2006	2008	2010	2012	2014	2016	2018	2020	2022
# of Institutions	1	1	3	4	5	8	7	9	8	12	14	11	12	19	16	16
# of Institutions (direct data)	0	1	3	4	5	5	5	6	5	7	9	9	9	14	14	15
# of Managers	0	0	1	1	1	1	1	1	2	3	4	3	3	8	8	10
# of Consultants	1	1	2	3	4	7	6	8	6	9	10	8	9	11	8	6
# of Asset Classes	4	7	13	13	13	16	16	18	18	19	20	20	20	20	20	20
Av # of Asset Classes per Institution	4	7	9	9	9	9	10	12	12	11	13	13	14	12	13	15

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Why are *long-term* expectations of interest?[1]

Time variation in expected returns ⇒ "strategic" asset allocation

▶ Stock market returns are predictable, by cyclical variables

▶ Given this time variation, Campbell and Viceira (1999, 2002) &
  Campbell, Cocco, Gomes, Maenhout, and Viceira (2001) show that:

  1. a long-term investor's optimal strategy is to "time the market"
  2. failing to do so produces large welfare losses

What to make of expectations over a long horizon?

▶ CMAs have a horizon of 10+ years

▶ By studying CMAs, are we making an implicit assumption that
  institutional investors act sub-optimally?

▶ Or do institutions ignore their CMAs in favor of timing the market?

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1. NB. this is also a comment on Dahlquist and Ibert (2021)

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# Which asset pricing model do institutional investors use?

▶ Debate on which asset pricing model is used by investors, by studying flows into & out of mutual & hedge funds

    ▶ Barber, Huang, and Odean (2016), Berk and Van Binsbergen (2016), Blocher and Molyboga (2017), Agarwal, Green, and Ren (2018), and Jegadeesh and Mangipudi (2021)

▶ Couts, Gonçalves, and Loudis (2023) have direct evidence on expectations of institutional investors

▶ ⇒ Could interpret factor model fits as evidence for/against particular asset pricing models used by institutional investors

▶ Both CAPM & APT have pricing errors (e.g. Figure 8):

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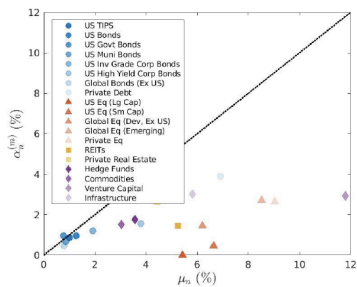
(a) Average CAPM αs   (b) Average APT αs
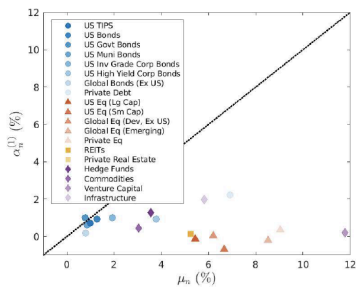
Who perceives a risk-return tradeoff?

State of the literature

- ► Couts, Gonçalves, and Loudis (2023, pp. 5-6) comprehensively review the literature on subjective perceptions of risk vs. return

- ► Including papers that find a perceived *negative* tradeoff: Amromin and Sharpe (2014), Giglio, Maggiori, Stroebel, and Utkus (2021), Jo, Lin, and You (2022), and Gnan and Schleritzko (2022)

- ► My understanding of the literature is that professionals' (e.g. analysts') subjective beliefs are closer to rationality than those of households (e.g. direction of risk-return tradeoff, cyclicality)

To whom do the paper's conclusions apply?

- ► *"Our findings imply that models with subjective beliefs should reflect a risk-return tradeoff."*

Disagreement of forecasts

> "Subjective risk and return expectations *vary much more across asset classes than across institutions. (...)* These results are striking and *explain why expected return variation is largely driven by risk premia* and not mispricing."

- ▶ How surprising? Any models/findings that suggest differently?
- ▶ Could delve deeper from the angle of return predictability

  - ▶ Heterogeneous sources of disagreement
    - ▶ Which macroeconomic state variables best predict different expectations? How do the coefficient loadings differ?
    - ▶ i.e. conduct similar analyses to Nagel and Xu (2022)

  - ▶ Term structure of disagreement
    - ▶ Maybe it's harder to predict far out into the future. Seems true for cashflows (Dessaint, Foucault, and Frésard 2023)
    - ▶ But for equity market returns, the literature includes evidence of long-term return predictability
    - ▶ Caveat: statistical issues due to long-run persistence
    - ▶ Documenting how return forecast disagreement varies with CMA horizon could be interesting to a wide audience

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Document the subjective price(s) of risk over time

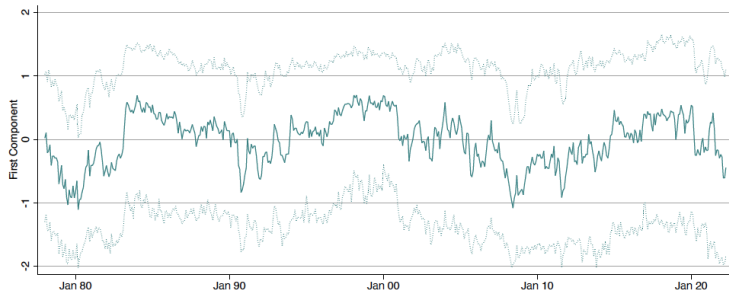## The Kamdar and Ray (2022) sentiment factor (1st PC)

Figure 1: Sentiment Distribution Across Time

Notes: time series of the first component $f_{i,t}$ from an MCA analysis. The solid line is the median value of sentiment, while the dotted lines are the 90-10 percent distribution.
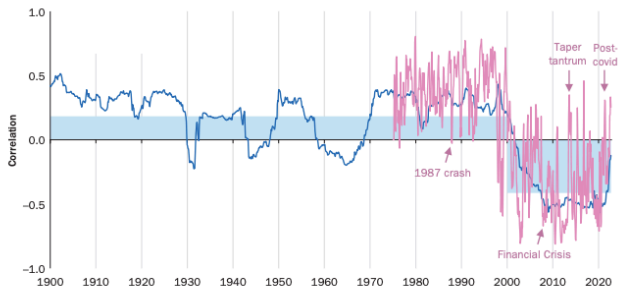
Principal components as prices of risk

▶ Does the 1st PC behave like the market risk premium?

▶ Any descriptive insights on the 2nd+ PCs?

Explore time-variation in stock-bond correlations

- ▶ Something practitioners think about – what do they think?
  - ▶ So far, paper focusses on pooled mean correlations
- ▶ Over the long-term, realized correlations are time-varying:

Chart source: Brixton et al. (2023)

- ▶ Literature to connect to: Ilmanen (2003), Baele, Bekaert, and Inghelbrecht (2010), Song (2017), Kozak (2022), ...

Summing up

Objections a reader might have

1. Interpreting the institutional setting
2. Why are *long-term* expectations of interest?

Conclusions to draw

3. Which asset pricing model do institutional investors use?
4. Who perceives a risk return tradeoff?
5. Document the subjective price(s) of risk over time

Directions to go deeper

6. Disagreement of forecasts
7. Explore time-variation in stock-bond correlations

Good luck!

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