

When expected returns became minimum acceptable returns

KEVIN FOLEY
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When was it that we stopped asking what a prudent portfolio looks like and started telling it what return it should produce?

The thought crystalized after a recent meeting with a large Canadian family office.

I was there to discuss fixed-income opportunities with expected returns in the 6-per-cent and 7-per-cent range. Before we even started, the head of the investment committee stated: *“We don’t really look at any investments with expected returns below 8 per cent.”*

The meeting continued because I was there and it was still a worthwhile discussion. But his comment stayed with me. Not because I thought it dismissive, because it felt incomplete – perhaps telling – and made me wonder if it reflected something bigger.

The market doesn’t care what your burn rate is or what your foundation distributes each year. It doesn’t care what inflation is, what fees you pay, or what return your retirement plan, family office, or investment committee has concluded it needs. We all have a number, but the market has never cared what it is.

Have we started behaving as though it cares?

Perhaps the Rolling Stones were half right. It’s true that you can’t always get what you want, but the markets never promised you’d get what you need.

To explore the notion, I asked two of Canada’s larger family and foundation advisers a simple question: If a new client arrived today with a long investment horizon, open to alternatives and private markets, with capacity for some illiquidity and a willingness to build a thoughtful, diversified portfolio from scratch, what long-term return would your process propose?

Their answers were remarkably similar. 6.5 per cent. 6.5 to 7 per cent.

Not because they wouldn’t prefer a bigger, sexier number, because that’s what their capital market forecasts, asset allocation modelling and experience suggests is prudent now.

A 2024 study from U.S. asset manager Commonfund reaches a broadly similar conclusion for portfolio returns over long periods. Interestingly, neither adviser started with expected returns. They

started with the client. How much of a temporary loss could they genuinely tolerate? How much illiquidity would they accept? Would they still sleep at night after a 20-per-cent decline? What would a one-year loss or a difficult decade mean to them?

Only then would they build the portfolio, piece by piece, very diligent about how the pieces work together. That sequence matters. It also explains why the family office comment kept replaying in my mind.

The investments I proposed that day weren't rejected. That one characteristic of them – the expected return – was.

Before we had a conversation about what the investments might contribute to the portfolio, the expected returns had essentially ended it. Few questions followed. That's what stayed with me.

Family and foundation advisers commonly assemble a collection of investments that, together, give the client the best chance of achieving the portfolio's target return, on average and over years, within the client's real risk tolerance and constraints. Somewhere along the way, I wonder if we've started evaluating investments by expected return instead of expected contribution. There's a profound difference.

A thoughtfully constructed portfolio expected to earn 7 per cent isn't built from investments each expected to earn 7 per cent. Same for the 9-per-cent quest. Each piece has a different job. Together, they produce the return, resilience and flexibility the portfolio is trying to achieve. The growth engine, the dependable income, the liquidity for when opportunities appear, and the ones that allow you to own other assets with greater confidence because they behave differently when conditions deteriorate.

When one part of the portfolio drops by 5 per cent owing to an earnings miss or a spike in interest rates, that consistent 6 per cent or 7 per cent investment feels a lot more valuable. It didn't change, but your appreciation for its contribution to the portfolio probably did.

A 6 per-cent or 7-per-cent expected return isn't competing with a portfolio hoping to earn 9 per cent. It's one of its building blocks. The total portfolio is the investment. Everything else is a component. Viewed that way, an investment with an expected return below your target that adds value to the total portfolio becomes something very different. The 9-per-cent expected return portfolio that excludes it is highly likely a much riskier bet.

The first question isn't, "Is that return high enough?" It's "What does this investment do for the portfolio?" That's portfolio construction 101. The other question ranks investments blindly.

This certainly isn't an argument against pursuing higher returns, and it isn't a prediction that markets can't continue rewarding investors handsomely. It's simply refreshing prudence, because history reminds us that markets have a habit of introducing events nobody modelled for, and we're living in a bunch of them.

The people designing strong portfolios understand this better than most. They'd love to sell promises of the highest returns, but they stress-test assumptions before selecting investments, and they know that even their best forecasts will be wrong. They just don't know in which direction, and perhaps that's the point. Even RBC Global Asset Management's latest capital market assumptions expect fewer than a handful of asset classes to average more than 8 per cent annually over the next 10 years.

Which brings me back to that family office meeting. I get how someone decides, "We don't look below 8 per cent", after this prolonged bull market, plus spending needs, inflation, fees and return objectives

that all add up. It's an understandable instinct. But a portfolio isn't built for the world we hope arrives. It's built to survive the one that does.

And perhaps that helps us reframe our initial question.

It's not whether an investment is expected to earn enough, rather, does it make the portfolio better? They're very different questions.

Kevin Foley is managing director of institutional accounts at YTM Capital, a Canadian asset manager specializing in credit and mortgage funds. He spent two decades trading and managing fixed income at a major Canadian bank and serves on several Canadian foundation boards and investment committees.