

theadvisor

Chasing Performance—At What Cost?

There was an interesting article in the March 9, 2008 *New York Times* by Mark Hulbert titled "Can you Beat the Market? It's a \$100 Billion Question". The article features Professor Ken French – academic resource for Dimensional Fund Advisors and a Finance professor at Dartmouth. Dr. French computed the aggregate amount investors spend annually chasing the largely illusive goal of out performing the market. He estimates that in 2006 the cost of this activity neared \$100 billion! Professor French says that the amount, as a percentage of the total market capitalization of the stock market, has remained fairly constant over time at about 0.67% per year of the total market capitalization.

The article explains that instead of being a "zero sum game" (where the winners and losers even out), chasing performance is a hugely "negative sum game" (where the losers outweigh the winners).

All That Noise

One of the big stumbling blocks modern day investors encounter in crafting a successful long term investment plan is the ever present "noise" coming from various elements of Wall Street. Risk and return are related – not perfectly – but over the long term they are closely linked. A look at the returns for stocks (using the S&P 500 as a guide) and Treasury Bills over the past 5 years might be instructive.

| Year | S&P 500 | Treasury Bills (6 month) |
|------|---------|--------------------------|
| 2003 | 28.7% | 1.80% |
| 2004 | 10.9% | 2.18% |
| 2005 | 4.9% | 4.31% |
| 2006 | 15.8% | 4.88% |
| 2007 | 5.5% | 4.88% |

The depiction above is a fair example of being compensated for taking market risk. Yes, there are years where Treasury Bills outperform stocks. Over the entire 35 year timeframe, however, stocks (again using the S&P 500) outperformed Treasury Bills by more than 4% per year. Over the past 20 years the margin of out performance is closer to 6% per year.

If you pay too close attention to the media pundits you may be scared out of staying the course and instead focus on the short term variations in the markets...hardly a formula for financial independence. Our approach is to build a long term strategy based on your particular goals and firmly rooted in solid academic research.

Plus and Minus

As we continue to point out, the *long-term* financial underpinning upon which we base *long-term* strategies is largely positive. The American economy and much of the developed global economy are growing based mainly on ingenuity. Perhaps in all of human history the least likely time to become a long term pessimist is now.

Yet there are many structural issues within our own maturing economy for instance that must be changed. The run up in oil prices the past year or so has been fueled by the evil twins of speculation and a falling dollar. The dollar has stabilized a bit lately and oil prices, predictably, have also eased. The budget and trade deficits are of course primary reasons behind the weak dollar. Perhaps the most problematic of all – only 38% of our current Federal budget is for “discretionary” spending. Fast forward another decade and projections put the discretionary spending percentage under 25% of the whole budget. With only 52% of Americans paying *any* Federal income tax a great deal of pressure between spending and taxation appears on the horizon.

Purchasing Power Protection

We believe that the primary focus of most retirees should be purchasing power protection instead of principal protection. The headwinds of *inflation* do indeed tend to become stronger in retirement. The Bureau of Labor Statistics has been calculating an “experimental” consumer price index for those in retirement. Over the past 20 years this inflation rate has been about 10% higher than the more widely reported CPI.



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The second less understood facet of purchasing power protection is *innovation*. Would you settle for the best pharmaceuticals on the market 10 years ago or the best television or mid size car from a decade ago? Probably not, but the advent of more advanced medications and flat screen TV’s is not considered inflation because it is advancing quality. To roughly gauge this we need to look at the average annual increase in disposable income. Over the past 20 years this has figure has grown by about 4.3% per year. This likely gives us a better measure of maintaining standard of living over a reasonably long timeframe. This is the cornerstone of our focus on higher long-term return investments like equities even for our retired clients. It is nearly impossible to keep pace otherwise.

Risk Tolerance Revisited

One of the reasons that we like to review risk tolerance levels (as expressed in the Investment Policy Statement) is that this level should try to balance our understanding of what is needed against what you can tolerate. We have always thought that the word “risk” was improperly applied in this context as “risk” as it is used here means “volatility” rather than the possibility of permanent loss. Historically and mathematically there is very little risk of the loss of invested principal over a long-term investing timeframe. There is, however, sometimes substantial risk that you will experience volatility and variability in values over shorter-term timeframes. Thus the balancing act that we seek to portray in the IPS.

What we want to avoid is letting risk tolerance levels become reactive and emotional as markets wax and wane. Often we see clients wanting to change risk tolerance levels in response to present market conditions when our primary goal is to seek a long term return that will enable the client to maintain purchasing power over the next 20 or 30 years. This simply cannot be done in a reactive fashion. Remember, you accomplish long term financial goals by action rather than reaction.