The Wall Street Charade- Turning the risk/ reward concept on its head

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Wall Street knows something the average investor does not. You might call it the industry's dirty little secret, if it didn't involve billions of dollars and millions of investors. The deception is preserved by a confluence of people and pretense. One element is perfunctory research, ostensibly done to help investors make informed decisions. In reality, the research is slanted to keep investors in the market, making trades, generating transaction fees and brokerage commissions for Wall Street firms. Another supporting pillar of the deception is the pay plan at many major brokerage firms. Salespeople receive lopsided commissions for peddling profitable proprietary products, typically investments the firm would never buy for its own portfolio. Broker training at these firms emphasizes sales techniques over investment knowledge. The facade taps into investor fear and greed, relying on uninformed decision-making to sell high-profit product, particularly when markets roil. Wall Street happily iterates the unchallenged gospel of risk/reward: investors must take higher risks in order to attain higher returns. The strategy promotes lucrative products and asset classes that expose investors to uncompensated risk. P/E ratios and similar simplistic data are proffered as foundation for sophisticated investment strategy when, in fact, knowledgeable analysts know such primitive data is extraneous.

Writing in Financial Analysts Journal, investment industry commentator clifford Asness notes: "From the perspective of post-bubble 2005 after the many scandals, the observation that Wall Street is not looking out for you should be less than earth shattering. Wall Street exists largely to sell stocks and bonds and to broker stock and bond transactions in both directions, not to make intellectually honest arguments. similarly, the media exists to sell media. Speaking the truth may or may not be in both of their long-term interests, but investors must recognize that it is not always done. The very idea of Wall Street making impartial recommendations about its own products is a strange one."

Wall street is smart, telling investors what they want to hear; good news about hot stocks. But if brokers really think these stocks are so promising, why aren't they buying them for their own portfolios?

Investors fall prey to lofty return expectations. Brokers know investors tend to overestimate returns on retirement portfolios, and so may take advantage of the pipe dream by playing along,implying that 15 percent annual returns are realistic. They know that historically, 9 percent is probably a best-case scenario and 7 percent closer to reality, but allowing investors to fantasize about 15 percent means investors can put less into retirement savings today, keep more money for things they want now, and still have a comfortable retirement; it's music to their ears.

They not only speculate on 15 percent a year,they refuse to believe they will have any losing years. The time needed. to make up for a losing year is far longer than investors realize, and the portfolio must perform even better than originally assumed during the make-up period just to get back to even. This assumes the portfolio suffers no additional losing years while recuperating. That's a lot of assumptions. All this makes it doubly difficult for advisors trying to give their clients solid advice about retirement investing. How do you convince someone to accept a conservative investment strategy that strives for a consistent 6 or 7 percent average annual return while avoiding losing years? Investors listen to the talking heads spewing nonsense supported by the media, which is in turn supported by the advertising megabucks of the brokerage firms. Investors listen and believe. From brokers and late night TV Investors hear about those who "made millions" flipping real estate or futures trading. As long as investors live in this fantasyland, they don't have to face the harsh reality of saving more and spending less now in order to ensure the retirement they want. It's a tough sell for advisors trying to do the right thing for their clients.

What's the Reality?

One reality of retirement investing is that investors should take less risk, which over time, almost always results in greater returns. I'm not suggesting the equity in retirement portfolios should be converted into government bonds, but rather that by improving the certainty of returns, portfolios will earn more over time. By improving the certainty of returns, retirement planning becomes much easierbecause of the consistency of income stream assumptions. clients will more likely adhere to financial plans because with no draw-downs or loss periods, the plan is easier to live with.

Of course, the certainty of returns assumes the avoidance of large losses, which cripple long-term performance. Even occasional losses can be devastating to a portfolio. The example on page 20 represents a client who has been listening to Wall Street advice. She decides to pursue higher returns through an aggressive strategy with the trade-off of slightly higher risk. Over the ensuing 12-year period, the portfolio has six positive and six negative years, but the up years (+15 percent) are consistently much better than the down years. (-5 percent). It never suffers a down year that exceeds the previous up year. It doesn't sound bad, does it?

Although seemingly small and far outpaced by the wins, the losses leave the porfolio with an unimpressive 4.2 percent overall return. Meanwhile, a less aggressive investor plods along at a steady, if unexciting, 6 percent annual return that avoids losing years. While 6 percent may not seem all that impressive either, by simply avoiding losing years, the conservative strategy outperforms by more than 30 percent. over a decade or two, even an occasional losing year may mean choosing between working several more years and accepting a substantially lowered lifestyle in retirement. Make no mistake; if it's possible to lose money, it will eventually happen. It's bad enough to lose previously won gains, but when a portion of a portfolio's investment capital is also lost, those assets are unavailable to participate in subsequent market recoveries. That's one reason why recovering from down years invariably takes much longer than investors anticipate.

The example illustrates several points often difficult to communicate to clients planning their retirement:
. A consistent rate of return, even though conservative, will produce higher and more predictable returns, so retirement plans can be constructed with greater certainty.

. Even over extended periods, a single large loss can be too much to overcome in terms of total return.

. Smaller losses, though apparently offset by gains the following year, have a cumulative effect that can eviscerate total return.

. Lost principal cannot participate in gains when the market rebounds.

. The power of compounding is one of the most potent forces available, but it only works with consistently positive gains.

. The mantra that higher returns can only be realized by taking higher risk is a fairy tale. Higher returns are achieved by taking less risk, providing the strategy is able to avoid the loss of critical core assets.

Value: Good in Up or Down Markets

Retirement portfolios should have a portion of their assets in a strategy that does well in down markets. The price of this safety net is to give up some of the upside in order to avoid sustained losses. The first question to ask about any investment strategy is not “How much can I make?” but “How much can I lose?”

The strategy should contain thoroughly tested risk parameters that clients can live with through both up and down cycles. Even the savviest investors fail to make money every year just ask Warren Buffet. In some years, the best overall strategy doesn’t work, or doesn’t work as well as other strategies. Clients need reminding that retirement investing is a marathon, not a sprint. It’s not about chest-thumping winners; it’s about always safeguarding core assets. Aggressive investing - such as speculative growth stocks - is fine for those content with a strategy that works about 30 percent of the time. But few investors want a strategy that doesn’t work 70 percent of the time. It’s impossible to beat a market you are consistently in agreement with, yet investors succumb to the herd mentality and take their cues from Wall Street and the media. The legendary investor Ben Graham said, “You are never right or wrong because the crowd disagrees with you; you are right or wrong because your data and reasoning are correct.”

The market is wonderfully effecient; everything that is known about a stock is already included in its price. To make money consistently and avoid losses, you must have a variant opinion and you must be right. While nothing works all the time, value investors experience shorter and shallower downturns, and when a down market rebounds, value investors are in a position to make greater returns. One of the metrics used is the price to book (P/B) ratio,calculated by dividing the current price per share by the book value per share. Companies out of favor have low P/B ratios but tend to produce higher returns with lower standard deviation over the long haul. The principal reason a value strategy more often outperforms while avoiding big losses is that a company is at its lowest value when expectations for it are at their lowest level. When you buy a company at its tangible value - its real book value - there is little real risk. This is how Warren Buffet, Kirk Kerkorian and other value investors operate. They certainly don’t follow the advice of the big brokerage houses.

Advice forYour Clients

Misinformation abounds, much of it germinated by Wall Street firms. It directs investors into strategies and products that generate huge profits for Wall Street but do little to increase investor wealth. Here are a few ideas to pass on to your clients:

. Be wary of investing with anyone less wealthy than you. Don’t invest unless the person recommending the product has more money invested in it than you do.

. Advisors should be compensated for creating value. Investors can lose their own money for free.

. Evaluate a strategy for potential loss first, for gain second.

. Contrary to what Wall Street tells you, higher returns are the result of taking less risk, not more.

. Abandon those 15-percent annual return assumptions. Save more and spend less now; retire comfortably and on schedule.

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