A Marathon, Not a Sprint

CPA Wealth Provider- October 2006

My son, who is a CPA, called me last week to ask for my advice. After picking the phone up off the floor where I had dropped it, I asked him what was up. It seems that one of his New Year's resolutions was to do a better job with his equity portfolio. He turned 40 last year, a milestone that apparently prompted a reassessment of his retirement assumptions. Given the inconsistant performance of his portfolio, his dream of selling his practice and sailing off into the sunset at age 50 is in serious jeopardy.

I realized he must have exhausted all other sources of investment advice before calling his old man, and I did not want to disappoint him. It struck me as odd, however,that someone whose profession included advising others on wealth management would have a difficult time managing his own retirement portfolio. In the interest of occasionally seeing my grandchildren, I decided not to mention that little tidbit to him. I recalled a conversation we had in the late'90s. At the time, he had decided to adopt a more aggressive investment strategy after reading about an asset manager who generated some impressive returns using tech stocks (ah, the beautiful preburst bubble) and emerging market funds.

"I just don't want to look back a few years from now and kick myself for missing out on big returns because I was too conservative,"he said.

His strategy shift surprised me at the time because unlike his younger brother, a real estate developer,he had always been a conservative sort,especially when it came to investments.

Evidently, seeing others cashing in on the tech boom pushed him over the edge; he wanted to be able to brag about some high-flying stocks of his own. I recall suggesting that he might want to reconsider his decision, and instead place greater emphasis on protecting his core assets designated for retirement. I also recall he reacted by saying something like, "Uh, huh...I'll think about it, Dad." Needless to say, he opted for a run at double-digit returns. Here's how he has done in the six years since his famous "conversion":

Despite having three standout years,and not losing more in any year than he had gained in the previous year, his "go-for-it" strategy failed to generate the double-digit annual returns he had hopedfor. What's worse, however, is that despite generating a positive if disappointing 6 percent annual rate of return, he had actually lost money overall. And that was before factoring in fees, transaction costs, and inflation. After six years, he was worse off than when he started and was now six years closer to retirement. How could that be? The same performance pattern applied to a hypothetic $100,000 portfolio (below) reveals why he lost money.

An investor with this portfolio might think, after the second year, "Well, I took a beating (-42 percent) in year 2, but at least I am still a little ahead of the game since I was up 46 percent last year." Not so. That 42 percent loss in the second year produced a 14.5 percent overall loss for the two-year period, dropping him $14,000 below his starting point entering year three. My son was about to learn a lesson that he, and his clients seeking wealth management advice, would find both invaluable and immutable. Whether or not he chose to accept my advice, I was destined to be his messenger of reality.

The fact is, as an investor, you have to avoid big losses- even at the expense of giving up much of your upside gains. Losses, even occasional ones if they are more than a percent or two of your portfolio, can cripple your retirement plans. As I reminded my offspring, "The proof is in the figures staring you in the face."

BORING BUT BEAUTIFUL

Consider a conservative portfolio that plods along at a steady although unremarkable 6 percent annual return. Here's a look at that same invested $100,000 spread over a six-year period.

How boring. No big years to brag about. But because there were no losses, there were no deficits to make up.After six years, this strategy would have beaten my son's portfolio by 44 percent. And if he converts to a conservative strategy at a steady 6 percent now it will take him approximately 6.5 years to reach the $142,000 plateau of our plodder,assuming he suffers no more losing years.

DURING DOWN MARKETS

A portion of every retirement portfolio should be in vehicles that do well in down markets. In recent years, institutional investors have shifted huge amounts from traditional managers to those who can hedge and profit in down markets. According to a recent article in The New York Times,"Pension plans and other large institutional investors are expected to invest as much as $300 billion in hedge funds by 2008, up from just $5 billion a decade ago."

I spoke to Steve Abernathy, CEO of New York-based The Abernathy Group. Nelson's Directory of Investment Managers ranked his firm the number one money manager eight times in 12 years. An advocate of lowering capital at risk by hedging, Abernathy frequently asks investors to review the two Portfolios below and pick one:

Abernathy says most people intuitively choose portfolio B because of the apparent 20 percent higher return. "But that's a miscalculation because the higher Capital at Risk and Standard Deviation (risk measurement) can render the 20 percent higher investment return virtually meaningless. Portfolio A, with just 30 percent of its capital at risk, is far less likely to suffer a crippling loss than portfolio B. Losses can gut the financial assumptions of the most carefully constructed wealth management strategy." He notes that certain hedge fund managers typically have less capital at risk than traditional or long-only managers.

"A simple example of lowering capital at risk would be buying a stock at $100 and a put at 90. If an unforeseen event occurs-a terrorist attack, natural disaster or the CEO goes down in a plane crash-and the stock plummets to 30, hedged investors only participate in the drop down to 90. Their exposure is limited to 10 percent versus 100 percent for a portfolio. If a catastrophic event causes the market to collapse, no matter how smart you are or what you have done to protect it, the long portion of your portfolio is going to take a hit. But the stocks you shorted also go down so your portfolio is stabilized and there is little or no overall loss."

Abernathy did some revealing research on the impact of portfolio losses. He compared hedged and unhedged portfolios based on S&P 500 performance over a 25 year period (1980-2004). Without hedging,a $1,000 investment would have grown to about $10,300-an average compounded gross annual return of 10.21 percent.

Standard deviation was 15.58 percent. A hedged portfolio mimics the S&P index but when the S&P has a down month, the hedged portfolio will not be down by more than 1 percent because of the protection provided by hedging. The trade-off for this protection is that the hedged portfolio gives up 45 percent of the index gains. That may seem like a staggering amount to surrender in exchange for protecting core assets,but the hedged

portfolio actually outperforms the S&P slightly while reducing the standard deviation by some 60 percent. In other words, an investor can bypass almost half of the index upside and still outperform it over the long term while dramatically lowering the risk of losing any investment capital.

DANGER OF SPECULATION

Most retirement plans are based on the assets within the plan generating a rate of return that outpaces inflation and creates real growth. Even where significant wealth already exists, erratic investment performance may mean someday having to choose between a lesser lifestyle in retirement or working additional years. Another demon lurking in the shadows of retirement investing is speculation. Everyone I know who invests in equities-my son included-believes he or she will outperform the market. Of course, over any extended period of time, virtually no one outperforms the market index. In fact, few asset managers manage to even match it. Abernathy agrees. He thinks one reason revolves around fees and transaction costs. Investors typically pay annual management fees of 1.25 percent, plus transaction costs of another 50 basis points. So even if an asset manager can generate returns comparable to the S&P-historically about
1 percent annually-the investor will only realize about 7 to 7.25 percent after fees and expenses. Taxes gobble up as much as 35 percent of that, leaving a net gain of perhaps 5-6 percent annually. I know most investors expect to do much better but that is the reality upon which sensible retirement assumptions should be based. Using an annual return calculation higher than 6 percent is wishful thinking because the odds against exceeding historical averages are enormous. Think about lottery odds. Abernathy suggests that the sooner CPA advisors can get their clients to accept this fact, to adjust their expectations downward, and to adopt a strategy that lowers the potential for capital at risk, the sooner advisors can construct a roadmap that accurately reflects how much will be available for retirement. I know people who still expect to duplicate that one bang-up 18 percent year they had a decade ago. Listen, it's not going to happen. If you have clients like this, you need to gently but firmly bring them back to reality. I have seen what happens when investors chase returns by embracing an overly aggressive investment strategy. It paves the way for big losses, recovery from which always takes longer than expected, if it happens at all. To CPAs advising their clients on wealth management, I humbly offer the same recommendation I gave to my son: seeking superior returns should be a secondary consideration in retirement planning; capital preservation should be your primary priority. Protect your core assets against big losses. The average annual return for the S&P 500 since 1980 is 10.21 percent. You can't beat it. Adopt a conservative, long-term approach that lowers the potential for destructive losses. If you are assuming annual returns above 6 percent, consider the reams of historical data that refute such assumptions. Lower your performance expectations and start putting more money aside for retirement. Remember, it's a marathon, not a sprint.

THE ABERNATHY GROUP II
ASSET PROTECTION • WEALTH MANAGEMENT