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## Theory to Practice -- An Example

In today's performance-driven market, it is hard to remember the critical difference between investment performance and investor behavior. The primary determinant of an investor's ultimate returns is how they behave, not their choice among similar investments. Successful investors have a reasonable investment philosophy, consistently applied. This is the value Sigma adds for its clients. The following is a somewhat simplified summary of how we might apply our approach to a hypothetical 55 year old new client. The purpose of her investing is to save for retirement in 10 years.

***The primary determinant of your ultimate investment returns will not be your choice of funds, but how you behave.***

Our first step with any new client is to learn about their lives so we can tailor an investment program to their unique needs. Age and time to retirement are important factors, but we live in a world in which 50 year olds are adopting babies, 60 year olds are starting new businesses, and 30 year olds decide they want to retire at 45. Through a questionnaire and face to face meetings, we learn about our client's goals, aspirations and fears.

We then discuss with the client what we believe are reasonable expectations regarding the returns of different types of assets. Our basic information package summarizes average, best and worst returns for 1, 5, 10 and 20 year periods since 1926 for different types of assets. What are reasonable return expectations over the next 10 years? One of many factors we will consider is the level of stock market valuation. As detailed in our newsletter *Does Value Matter?* last July, total returns from stocks in the 10 years following an "expensive" market tend to be below average. As this is written, market valuations relative to earnings, dividends and book value are in the "expensive" category. Averaging the three valuation measures, 10 year average annual stock returns following expensive markets averaged 5.5 percent, approximately half the 70 year average. In no 10 year period after an "expensive" market using any of the three valuation measures has the annual total return been as high as the long term average. Bond and cash returns are best predicted using current yield to maturity -- as this is written, the current yields were about 6.4 percent for 10 year Treasury notes and about 5.1 percent for 90 day Treasury bills. All of these are index returns -- in the real world, realized returns will be lower due to taxes, commissions and other expenses.

Given this somewhat sobering analysis of likely stock market returns, why not just put everything into bonds? Because any prediction of the future, even ours, is likely inaccurate. In addition, while investors notice and fear spectacular but irregular losses of principal, they tend to ignore the more consistent corrosive effect of inflation. On average, declines of around 40 percent come along a little

more often than once a decade, but usually that ground is made up again in a few years. In contrast, inflation has eaten away at your future virtually *every* year since World War II. Bond interest does not keep up with inflation. Since 1926, adjusted for inflation, stocks have produced a total return almost three times greater than bonds. In a long term retirement plan, stocks have to be a cornerstone of investing, even if the market seems richly valued.

***Given the lack of recent experience with bear markets, how much risk a client can “stomach” is difficult to measure***

We then prepare a sample asset allocation to discuss with the client. This will incorporate the information she gave us. An average 55 year old might have a target equity allocation of 50 percent stocks and 50 percent bonds and cash, with a “normal” range for stocks of 40 to 60 percent. What we learn from our client, however, would almost certainly change the actual target. Given the long term superiority of stock market returns, we urge our clients to target as high an equity exposure as they can stomach from a risk standpoint. On the other hand, the lack of recent experience with bear markets makes it more difficult to measure how much risk a new client can “stomach.” When we add the difficulty of this assessment to relatively expensive market valuations, we see no reason to rush towards the high end of our equity target range. For the purposes of this example, we will assume her initial target will be near the lower end of the so-called “normal” range for her age.

We then test the allocation with our likely asset class returns to see if the portfolio will achieve her goals. Sometimes this can be done within the risk tolerances expressed by the client, sometimes it cannot. If not, the only two choices are increasing the expected returns from the portfolio by increasing risk or lowering the amount the client expects to have in the future. This may not be pleasant for the client, but we strongly believe we would be doing a disservice to our clients to tell them what they want to hear instead of what they need to hear. What’s correct from an ethical point of view may be a poor marketing strategy. We may lose potential clients to competitors using what we believe are unrealistic expectations. For example, many financial planners discuss only the index returns from stocks, without factoring in the real world management costs, inflation, commissions, etc. Often the period for which the index returns are shown reflect only a relatively benign bull market. Many planners also seem to assume that people will die exactly on the schedule of mortality tables.

If market returns are below average over the next 10 or 20 years, it will be little consolation to our client that her low returns will be balanced by high returns earned by some future generation. What is important to her is what her actual experience will be, and how that will impact her life. Consequently, we recommend that investors factor in a margin of safety into their assumed returns. Half the time, actual returns will be below “average.” The problem of retiring with “too much” money pales in comparison to retiring with too little money. The fundamental decision in an investment plan is a variation of what the Red Queen told Alice -- jam today or jam tomorrow. When faced with information about risks, a client may decide to not factor in a margin of safety, to ignore real

world costs, to assume average stock market returns and to assume that she will die on “schedule.” We believe this should be an informed decision for the client to make, not us.

***Investing comes down to a variation of what the Red Queen told Alice -- jam today or jam tomorrow***

We do not want to give the impression that we produce detailed, bound coffee-table-edition financial plans. Here again, we admit a bias. A financial plan that shows exactly how much you will be worth on January 30, 2034 may be interesting, but verging on worthless. In the real world, markets fluctuate. We can use historical returns (adjusted to reflect market valuations and many other factors) as a guide to give a range of probabilities, but people are deluding themselves if they do not believe there is a wide range of possible eventual outcomes. A nice specific number for your future wealth runs the risk of producing complacency in a rapidly changing world. Given the uncertainties, we believe we attain most of the benefits of the financial planning process through the steps we have described in setting up an account.

Once we have agreed upon our client’s asset allocation, we set up an investing schedule. If her account starts off primarily in cash, we will most likely move towards her target equity allocation over 12 to 18 months. When the schedule is determined, Sigma selects mutual funds to purchase. Everything we have described to this point (other than setting the asset class return expectations) essentially has been a shared responsibility of Sigma and our client, tailoring her program based upon what she tells us about herself. We helped her in this process by providing her a wealth of information and trying to ask the right questions. At this point, however, the responsibility shifts to Sigma.

We go through a set of quantitative and qualitative screens to come up with a “short list” of funds in each narrow category into which we divide our client portfolios. Among the many factors we consider are consistency of management style and approach, operating expense ratios, portfolio turnover and an unwillingness to take unusual risks to try to be at the top of short term performance charts. Most of the funds we purchase are held in more than one client portfolio, but each of our client portfolios is different, tailored to individual circumstances. Sigma receives no compensation from any fund company, so we are free to choose from among the thousands of funds available to us.

The final stage is monitoring both the funds we purchase for clients and our clients themselves. Our portfolio turnover is usually sparked only by: (1) a change in the lives of our clients (e.g., retirement, sickness, receiving an inheritance); or (2) a change in the funds we own (e.g., a manager change, a change in investment style). Our clients have the responsibility to tell us what is going on in their lives so we can ensure that their investment allocation is appropriate.

Please note the list of factors that lead to our portfolio turnover did *not* include reacting to short term market movements and trying to time the market.

A recently updated study by DALBAR, Inc. analyzes the actual returns earned by no-load mutual fund investors, as opposed to the returns of the funds themselves. Between January 1984 and September 1996, the average growth and income equity mutual fund averaged a 13.2 percent annual return, but *investors* in no-load equity mutual funds experienced an average annual return of only 5.6 percent. The average general corporate bond fund had a 9.6 percent average annual return, but the average bond fund investor experienced only a 6.1 percent average annual return. How can no-load fund investors earn less than the return on six month CD's during one of the biggest bull markets in history for both stocks and bonds? The answer is a lack of discipline, getting too greedy near market tops and too fearful near market bottoms. Perhaps our most valuable service to our clients is helping them stick with a well thought out, rational, long term investment plan.

***Despite the most conservative estimate for equity returns you'll hear from somebody not baying at the moon, we still wind up with a substantial equity allocation***

Even factoring in the most conservative estimate for equity returns you will hear this year from somebody not actively baying at the moon, our client still winds up with a substantial equity allocation.

We did not use calculus, a magic formula, a black box system that predicts the future or traditional market timing of any kind. We try to move in the direction of undervaluation and away from overvaluation in investment alternatives, as opposed to trying to guess next quarter's hot sector regardless of valuation characteristics. Our approach is long term in nature, and major changes in client portfolios will tend to be driven by changes in our client's lives or significant changes in the relative valuation among investment alternatives, not short term market movements or chasing the latest "hot" fund manager or sector. All we can promise to do is to try and reasonably adapt our client portfolios in a changing world and to assure our clients that our own portfolios are invested using the same process. We believe we have a reasonable investment process that we consistently apply. There are a lot of smart people out there, but we prefer to be known as a firm that adds the rarer commodities of consistency, experience and common sense.

If our approach makes sense to you, please contact us.