

The Sustainable Portfolio

“Sustainability” is a popular word these days, and the beginning of the year is a good time to contemplate the application of the concept to your portfolio. Investors and their advisers often forget that the true objective of investing is to provide a hedge against future purchases. In the day-to-day rough and tumble of the markets, investing seems so much like a game that it is easy to try to achieve small “wins” that may be at the expense of long-term goals.

Most of our individual clients are trying to build a portfolio that will meet their necessary withdrawals for spending in retirement. Most of our non-profit clients are trying to build an endowment portfolio that will fund their operations for decades to come. For these clients, what happens day to day, week to week or quarter to quarter is of little consequence ~ their goals lie far in the future. Nothing really changes for a new retiree on the day she stops working, after all. The danger is not that she will have no money the next day, but that she will have no money when she is 94 years old, the result of her necessary withdrawals and poor performance due to an ill-designed portfolio. The key is to develop a long-term plan to maximize the chances of sustainability, of being able to cover your spending needs 10, 20 or 30 years into the future and beyond.

A decade ago, the dichotomy between the short-term game and the long-term sustainability goal was at an extreme as the Internet bubble and day trading reached their peaks. Frustrated with the inability of the media and investors to focus on anything but the here and now, we undertook a long-term research project oriented towards portfolio sustainability. Our objectives were to provide a way for our clients to see clearly their progress in achieving their investment goals and to insulate clients from the noise of short-term market movements and the groupthink of the herd of investors. Due to what we felt were the shortcomings in the process many other advisers used to consult with their clients on the sustainability issue, we felt a particular urgency in undertaking our own research.

Many financial planning programs require you to predict future returns from stocks and bonds, with an assumed return that occurs each year with no variation. For example, you tell the program the stock market will generate 10 percent a year, and the program assumes the market returns *exactly* 10 percent *every* year. Even leaving aside the issue of how you are supposed to forecast returns, this is akin to a magician putting a rabbit in his top hat in front of the audience. The single greatest risk to the sustainability of withdrawals from a portfolio over time is the sequence of portfolio returns. Life does not happen in a smooth, never-changing pattern. A dollar invested in the Standard & Poor's 500 index of large U.S. stocks for the ten years ended December 31, 1999 was worth \$5.32, assuming no taxes and reinvesting dividends. A dollar invested for the next ten years, however, was worth only 91 cents. It is only common sense to realize that the experience of a retiree during the first period was very different from that of a retiree during the second period. That difference is not something you should assume away.

Many financial planning programs increase the risk of a portfolio not meeting a retiree's needs, because they pretend that the greatest risk to portfolio sustainability (the sequence of varying real-world security returns) does not exist.

Other methods of predicting portfolio sustainability rely on complex, black-box statistical techniques with sophisticated names like "Monte Carlo analysis." While these represent an improvement on the programs that assume the same returns each year, they also have their flaws. For example, they typically assume complete independence of returns from one year to the next - as if the devastating losses of 2008 had no influence on the behavior of investors at the beginning of 2009. Stock and bond prices, and

therefore financial market returns, are not a natural phenomenon like glaciers, but the result of human psychology. Investing is, at best, a social science. Unrealistically treating it as if it were a natural science increases your chances of failure. Investor *behavior* determines prices.

While human behavior is hard to predict, we believe history is a better guide than the musings of a silicon chip chewing on a statistical software program. Accordingly, the portfolio sustainability analysis that resulted from our research focuses on historical securities returns going back to 1870. It is not perfect, but it has one huge advantage over other methods - anything it contemplates is possible, because it is something that has already happened. We analyze the chances of your portfolio meeting your spending needs for the long run at different withdrawal rates and portfolio allocations. Of course, past performance is no guarantee of future returns.

To give you a flavor of the inputs into our sustainability analysis, the enclosed sheet lists the returns from four major asset classes: large stocks, small stocks, foreign stocks and bonds for the past 44 years, with a box around the best performer each year. This is index data, with no effect from timing, security selection, costs or taxes. On the right are aggressive and balanced diversified portfolios mixing the assets. Investing in either of the diversified portfolios has had a better long-run return than the S&P 500 index with less risk. Bonds, the best performing asset class by a margin of greater than 40 percent in 2008, were the worst performing asset class in 2009 by a margin of 26 percent. Chaos is out there (remember 2008?), whether we like to remember that unpleasant fact or not - and the ability of anyone to predict 2010 returns is likely to be purely a matter of luck. Fortunately, that does not matter, even though most people pretend it does. The lessons of history, with all their flaws, are the key to sustainability, to maximizing the chances that your portfolio will meet your ultimate investment goals.