360 insights

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How Good Is Your Investment Intuition?

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IN THIS ISSUE

P2 The Upside to Being "Average"

P4 Behind the Scenes of Your Portfolio — Dr. Meir Statman

P4 Loring Ward Welcomes Payel Farasat

Let's test your investment intuition. Imagine you are about to retire and you have the option to choose between two investment portfolios, both of which will earn an average return of 7.5% over the next 30 years. We'll call them Portfolio A and Portfolio B.

Portfolio A will lose 15% the first year then gain 30% the second year, repeated for the next 30 years.

Portfolio B will lose 1% the first year then gain 16% the second year, repeated for the next 30 years.

Even though both portfolios have the same average return, Portfolio A will move up and down each year more than Portfolio B. In finance speak, Portfolio A is said to have a higher volatility than Portfolio B.

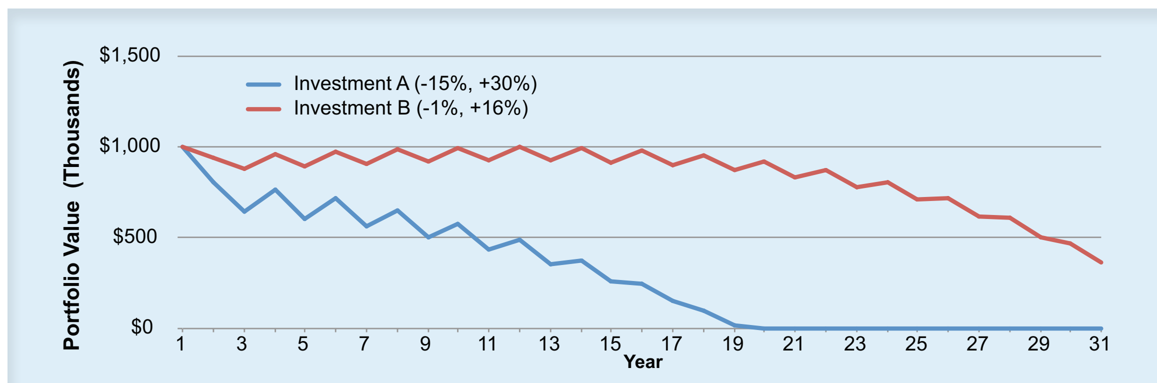
Which portfolio do you think would be more likely to last throughout a 30-year retirement?

Check out the chart for the answer. (*Warning, the results of this illustration may be shocking!*)

As you can see, Portfolio A, the option with the higher volatility, runs out of money in year 19. Portfolio B, the lower volatility option, not only lasts through year 30, but still has $364,644 left in the account… and that's on top of the two million dollars you've withdrawn from the account over 30 years.

How can there be such a difference when both portfolios earned the same average return over 30 years? The answer is volatility!

Volatility is one of the biggest threats to your retirement, yet most people are unaware of its impact. The greater volatility of Portfolio A reduces its compound growth rate. It also increases the effect those annual withdrawals have on the portfolio value. Since the annual withdrawal is increasing each year, its proportion in relation to the total portfolio value becomes greater, especially when the big down years hit. The technical term for this effect is variance drain and it is often misunderstood by investors.



The chart illustrates what would happen if you started out with $1,000,000 and withdrew $50,000 each year, growing the withdrawal by 2.5% to keep up with inflation to maintain your standard of living ($50,000 at the start of year one, $51,250 at the start of year two… all the way to $104,878 at the start of year 30).

Extreme portfolio fluctuations can cause your periodic withdrawals to become an excessive drag on your portfolio's growth. Growth is what you need to stay abreast of inflation so that you can maintain your desired standard of living.

See "How Good is Your Investment Intuition?" *continued on page 4.*

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The Upside to Being "Average"

by **Matthew Carvalho, CFA, CFP®**
Director of Investment Research
Loring Ward

The Need for Diversification

Index Performance 2000-2014

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2000 - 2014 Annualized Returns	2000 - 2014 Standard Deviation
US REIT 31.04%	US REIT 12.35%	US Short Term Bond 6.09%	Emerging Markets Value 62.26%	US REIT 33.16%	Emerging Markets Value 32.95%	US REIT 35.97%	Emerging Markets Value 42.20%	Global Short Term Bond 6.59%	Emerging Markets Value 79.11%	US REIT 28.07%	US REIT 9.37%	US Large Value 17.51%	US Small Cap 38.82%	US REIT 32.00%	US REIT 12.74%	US REIT 23.10%
Global Short Term Bond 8.28%	US Short Term Bond 8.71%	Global Short Term Bond 5.10%	Intl Small Cap 61.81%	Emerging Markets Value 30.66%	Intl Small Cap 25.04%	Emerging Markets Value 31.96%	Intl Large Value 6.95%	US Short Term Bond 4.69%	Intl Small Cap 50.82%	US Small Cap 26.86%	Global Short Term Bond 2.31%	Intl Small Cap 17.48%	US Large Value 32.53%	US Large 13.69%	Emerging Markets Value 8.08%	Emerging Markets Value 22.80%
US Short Term Bond 8.08%	Global Short Term Bond 6.44%	US REIT 3.58%	US Small Cap 47.25%	Intl Small Cap 29.40%	Intl Large Value 14.54%	Intl Large Value 29.33%	US Short Term Bond 6.87%	Cash 1.60%	Intl Large Value 36.75%	Intl Small Cap 24.51%	US Large 2.11%	Intl Large Value 17.29%	US Large 32.39%	US Large Value 13.45%	US Small Cap 7.38%	US Small Cap 20.42%
US Large Value 7.02%	Cash 3.83%	Cash 1.65%	Intl Large Value 45.96%	Intl Large Value 24.47%	US REIT 13.82%	US Large Value 22.25%	Global Short Term Bond 6.30%	65/35 Mix -24.41%	US REIT 28.46%	Emerging Markets Value 18.41%	US Short Term Bond 1.56%	US REIT 17.12%	Intl Small Cap 25.55%	US Small Cap 4.89%	Intl Small Cap 7.22%	Intl Small Cap 18.99%
Cash 5.89%	US Small Cap 2.49%	Emerging Markets Value -4.54%	US REIT 36.18%	US Small Cap 18.32%	65/35 Mix 8.80%	Intl Small Cap 19.46%	65/35 Mix 5.55%	US Small Cap -33.79%	US Small Cap 27.17%	US Large Value 15.51%	US Large Value 0.39%	US Small Cap 16.35%	Intl Large Value 21.47%	65/35 Mix 4.45%	US Large Value 6.62%	US Large Value 15.39%
65/35 Mix 0.94%	Emerging Markets Value 1.48%	Intl Small Cap -7.42%	US Large Value 30.03%	US Large Value 16.49%	US Large Value 7.03%	US Small Cap 18.37%	US Large 5.49%	US Large Value -36.85%	US Large 26.46%	US Large 15.06%	Cash 0.04%	US Large 16.00%	65/35 Mix 16.67%	Global Short Term Bond 1.90%	65/35 Mix 6.13%	65/35 Mix 10.20%
US Small Cap -3.03%	65/35 Mix -2.35%	65/35 Mix -7.77%	US Large 28.69%	65/35 Mix 14.09%	US Large 4.91%	65/35 Mix 16.48%	Cash 4.66%	US Large -37.00%	65/35 Mix 23.31%	65/35 Mix 11.49%	65/35 Mix -2.59%	Emerging Markets Value 15.87%	US REIT 1.22%	US Short Term Bond 0.78%	US Large 4.24%	US Large 15.26%
Intl Large Value -1.92%	US Large Value -5.59%	US Large Value -15.53%	65/35 Mix 27.80%	US Large 10.88%	US Small Cap 4.55%	US Large 15.80%	Intl Small Cap 3.28%	US REIT -39.20%	US Large Value 19.69%	Intl Large Value 4.82%	US Small Cap -4.18%	65/35 Mix 11.53%	US Short Term Bond 0.71%	Cash 0.02%	Intl Large Value 4.21%	Intl Large Value 18.12%
Intl Small Cap -7.24%	Intl Small Cap -10.63%	Intl Large Value -15.90%	US Short Term Bond 2.76%	Global Short Term Bond 2.66%	Global Short Term Bond 3.08%	Cash 4.80%	US Large Value -0.17%	Intl Large Value -44.29%	US Short Term Bond 3.83%	US Short Term Bond 2.82%	Intl Large Value -11.69%	Global Short Term Bond 2.10%	Global Short Term Bond 0.62%	Emerging Markets Value -4.08%	Global Short Term Bond 3.69%	Global Short Term Bond 1.38%
US Large -9.10%	US Large -11.89%	US Small Cap -20.48%	Global Short Term Bond 1.94%	Cash 1.20%	Cash 2.98%	US Short Term Bond 4.25%	US Small Cap -1.56%	Intl Small Cap -48.03%	Global Short Term Bond 2.29%	Global Short Term Bond 1.99%	Intl Small Cap -15.81%	US Short Term Bond 1.48%	Cash 0.02%	Intl Small Cap -5.35%	US Short Term Bond 3.67%	US Short Term Bond 1.48%
Emerging Markets Value -31.47%	Intl Large Value -17.78%	US Large -22.10%	Cash 1.02%	US Short Term Bond 1.20%	US Short Term Bond 1.75%	Global Short Term Bond 4.09%	US REIT -17.56%	Emerging Markets Value -50.27%	Cash 0.10%	Cash 0.12%	Emerging Markets Value -17.86%	Cash 0.06%	Emerging Markets Value -5.11%	Intl Large Value -5.41%	Cash 1.85%	Cash 0.58%

Source: Morningstar Direct 2015. Index representation as follows: U.S. Large Cap (S&P 500 Index), U.S. Value Stocks (Russell 1000 Value Index), U.S. Small Company Stocks (Russell 2000 Index), U.S. Real Estate Market (Dow Jones U.S. Select REIT Index), International Developed Value (MSCI World Ex USA Value Index (net div.)), International Small (MSCI World Ex USA Small (net div.)), Emerging Markets (MSCI Emerging Markets Index (net div)), Global Bonds (Citi WGBI 1-5Yr Hdg USD), US Bonds (BofA ML Corp & Govt 1-3 Yr TR)., 65/35 Index Mix: 2% Cash, 16% ST US Fixed Income, 17% Global Bonds, 15% US Large, 12% US Value, 8% US Small, 14% Intl Large Value, 7% Intl Small, 5% Emerging Markets Value, 4% US REITs; rebalanced annually. Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Treasury notes are guaranteed as to repayment of principal and interest by the U.S. government. Past performance is not a guarantee of future results. All investments involve risk, including loss of principal. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Fixed income investments are subject to interest rate and credit risk. Emerging markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. Real estate securities funds are subject to changes in economic conditions, credit risk and interest rate fluctuations. All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

When you look at the returns of a variety of asset classes over the past 15 years, it's hard to find any meaningful patterns. The chart here shows the returns on 10 different asset classes since 2000 and it's quickly evident that the star of one year rarely shines the brightest the following year.

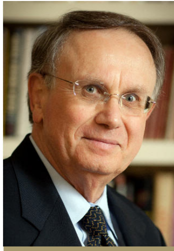
In fact, starting in 2000 if you invested in the top performing asset class of the previous year (Emerging Markets Value in 1999), over this 15-year period you would have earned an annualized return of just 2.4%, basically the equivalent of cash and far below any mix of asset classes. Imagine all the investors who piled into US REITs following a stellar 2006 only to see losses on that asset class of 17.6% the following year, or being scared into bonds in 2009 just as stocks started their unexpected recovery. Not only was the overall return poor, but the amount of volatility experienced over the period was extremely high.

How can you prevent your portfolio from experiencing large swings year to year? It's simple — diversification. Over the last 15 years a blend of 65% stocks and 35% bonds was never the top performer but it was also never the bottom performer. At the end of the period it posted an annualized return of 6.1%. That compares quite favorably to the S&P 500 which averaged a gain of 4.2%.

Standard deviation measures volatility, or the ups and downs of an investment. Lower numbers mean less volatility. Over this 15-year period, the blend of stocks and bonds had a 10.2% standard deviation while the S&P 500 had a much higher 15.3%.

A diversified portfolio won't outperform in every period. But the benefit to an investor is the dampening of the range of returns, which may help us sleep better at night. If you're in — or nearing — retirement and are currently taking money out of a portfolio, a lower range of possible annual returns can help increase your odds of successfully meeting your goals over the long term.

The appeal of trying to outguess the market is significant, but time and time again the investment world shows us we can't predict what will occur next. Instead we should diversify and recognize that while we won't be the best performer each year, we have ensured no single asset class will ever spell doom for our financial goals.



Behind the Scenes of Your Portfolio
Dr. Meir Statman

This is the first in a series featuring members of Loring Ward's Investment Committee, who provide the research, analysis and decisions behind the investment choices in your portfolio.

In addition to his many years on Loring Ward's Investment Committee, Dr. Meir Statman, the Glenn Klimek Professor of Finance at Santa Clara University, is a pioneer in the important field of behavioral finance. His invaluable contributions have helped illuminate the cognitive and perceptual biases that can shape financial decision making.

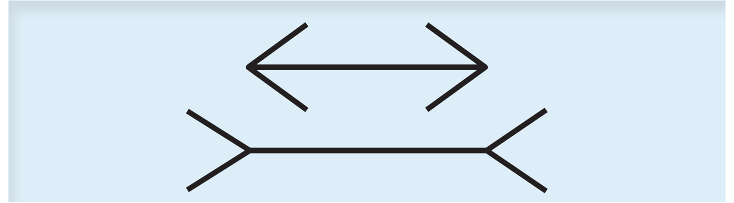
Here is how Dr. Statman defines behavioral finance:

"[It] is the study of the behavior of normal investors. We are not rational but neither are we irrational. We are normal smart most of the times but sometimes we are normal stupid."

For example, if we always behaved rationally we would never keep money in the bank instead of using it to pay off credit card debt. We wouldn't sell investments at the first sign of trouble or buy investments based on hunches, hot tips or media hype.

Since research shows that about 95% of our decisions are made with our emotions and only 5% using logic, learning how to understand and control our emotions can help us make better financial decisions.

Consider these two lines. One looks bigger than the other, but if we measure them, they are equally long.



This simple optical illusion is just one example of how our minds can deceive us. And when it comes to finance, these mental "deceptions" or "biases" can have a serious impact on our financial futures. Behavioral finance research by Dr. Statman and others has identified several key ways in which our brains trick us into seeing the investment world one way, when in reality it's something quite different. For example, too many investors (and even many professional money managers) suffer from overconfidence bias. They think they are better investors than they really are.

Recently, Dr. Statman was awarded IMCA's 2015 Matthew R. McArthur Industry Pioneer Award for excellence in the field of investment consulting. The Award honors professionals who exhibit commitment and unsurpassed leadership in developing industry-specific technologies or innovations. Dr. Harry Markowitz, a fellow member of Loring Ward's Investment Committee, is also a past recipient of this Award.

In a recent 3-minute video on "Masters of Modern Finance" at **tinyurl.com/drstatman**, Dr. Statman discusses his career and some of the highlights of his research.

Loring Ward Welcomes Payel Farasat

We're pleased to introduce Payel Farasat as our new Chief Investment Officer. She will direct investment policy, research and portfolio management strategies and work closely with the investment team, including Dr. Harry Markowitz and Dr. Meir Statman. Payel spent the past seven years at Charles Schwab & Co., most recently as the Western Regional Vice President and earlier as Senior Manager of Strategic Trading. She also served for seven years as an advisor with Ameriprise.

"There's a lot of humanity to being an advisor," says Payel. "You become very humble when you have to sit across from clients and manage their life savings. This is big stuff. It is my privilege to lead the talented investment team at Loring Ward."

How Good is Your Investment Intuition?

continued from page 1

So how can you control volatility within your portfolio? Diversification doesn't guarantee gains or protect from losses but it is a great way to manage portfolio volatility.

Strategies that invest in one segment of the market, like U.S. Large companies, don't provide the breadth of diversification needed for a successful retirement in my opinion. Diversification is more than just investing in several hundred U.S. companies. It starts with the correct mix of bonds for volatility reduction and stocks for growth.

Once you and your advisor have determined that mix, then begins the process of owning several thousand great companies domiciled across the globe. Diversification needs to be expansive to be effective.

Diversification neither assures a profit nor guarantees against loss in a declining market.

International markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. As a result, they may not be suitable investment options for everyone.