

Average Annual Returns Can Lead Investors Astray

<http://blogs.forbes.com/advisor/2011/04/19/average-annual-returns-spy-dow/>

John E. Girouard, 04.19.11 (Forbes Magazine dated April 19, 2011)

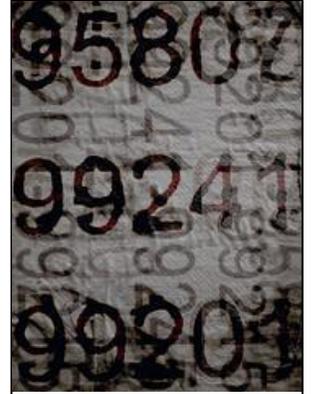
There is a glaring error in the math commonly used in the investment industry to illustrate comparative performance of stocks, bonds and other vehicles. It's so overlooked that even some of the representatives that companies send out to explain and promote their products are unaware of it. The culprit is average annual returns, and the flawed way they are used in marketing materials for financial products.

The financial industry has a duty to investors to explain that, in addition to past performance being no guarantee of future returns, average annual returns tell you little of practical use about real returns, which are in part a function of volatility and timing.

Average annual return is as irrelevant to investing as average annual temperature is to weather. Minneapolis's average is 45 degrees, but that won't help you pick the right clothes to wear in January. By the same token, knowing the average annual return of stocks in the past won't help an investor with financial planning.

I saw this compromised math in use recently when I attended a presentation by a representative of one of the major Wall Street firms. He used a chart to show how a theoretical portfolio might perform depending on asset mix, and during various blocks

of time between 1950 and 2009. The result was that stocks had an average annual return among some 21,000 possible blocks of time of 10.8%, bonds were 6.2% and a blended portfolio was 9%.



But then the investment company's chart took the average annual return and applied it to a theoretical \$100,000 portfolio with the result that, after compounding for 20 years, a theoretical all-stock portfolio growing at 10.8% a year would become \$777,670 and a bonds-only portfolio would have grown to \$333,038.

The glaring error is that stock market returns vary every year. To project a theoretical return based on the assumption that stocks rise by the same percentage every year is careless and misleading and the practice should be discredited and discontinued. The stock market has never risen by the same amount for decades at a time, so the calculation is just a distraction for anyone trying to put together a retirement plan.

In a recent report, noted expert Ed Easterling of Crestmont Research calculated that the average annual return for the Dow Industrials from 1900 to

2010 excluding dividends, taxes and transaction costs was 7.1%. But when he applied the math of compounding to the Dow Industrials—which rose from 66.08 in 1900 to finish last year at 11,577.51—the real return was only 4.8%.

The difference between a theoretical 7.1% and a real 4.8% over time is huge. Applying the same math as the investment company charts to the Dow at 7.1% a year since 1900, the index should be trading at 125,000. Another graphic way to illustrate it is in dollars: At the perceived return of 7.1%, \$1,000 invested in 1900 would have grown to \$1.9 million. But in reality, based on the actual compound return of the Dow, \$1,000 would have grown to just \$156,363, a \$1.7 million dollar discrepancy.

The more realistic figures for actual products are included in prospectuses but investors who read them and then look at the marketing materials could be forgiven for feeling confused.

After the presentation of the chart with the flawed calculation, I spoke to the representative. “You know that your chart has it all wrong, don’t you?” He shook his head. I showed him the math on the back of one of his hand-outs and when I got done, he nodded slowly and said, “Well, I’ll be darned!”

When an advisor sits down to help a client create a portfolio, the mix of assets is guided by comparing competing returns in the context of relative risk. If an investor focuses on the 10.8% assumption above and tries to compare that with a low-volatility, fixed-income investment like a real estate investment trust, bonds, or the savings component of mutual whole life insurance, they are comparing apples and oranges. Any decision they make is tainted.

Yes, by choosing slow-and-steady an investor may miss some big rallies in stocks when they could have taken outsized profits in good years. For some investors, for some portion of their assets, the potential reward of stocks is worth the risk. But if you’re designing a portfolio that has the goal of providing a stable retirement, which many people are aiming for today, slow-and-steady is the investment that doesn’t keep you awake at night wondering whether your stock portfolio can keep up with your needs.

It’s time the financial services industry step up to the plate and starts talking to clients and advisors in plain English using simple, accurate math.