ARTICLE:

Solving the Investor's Plight

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INTRODUCTION

Based on our experience and years of study, without question, the single most important determinant of real-life, long-term investment success is not how well investments perform, but how well the investor manages his or her own behavior. Few people truly understand investor behavior and its typically devastating impact. Given the challenging investing environment we have endured over the last ten years, this topic has never been more important or relevant.

This article looks at the rewards of being a long-term investor, behaviors which are detrimental to reaching nearly every family's goal of achieving Financial Independence, and some very sad real-world statistics surrounding this topic. We will then explore an approach to remedy these destructive habits by helping investors stay focused on what is truly important to them and their families' financial future.

WHY BE AN INVESTOR?

Let's first take a glimpse at just how rewarding it can be to remain an investor over long periods of time. In the past thirty years, we have experienced six bear markets, including the worst one-day fall in history (October 19,1987) and the single two worst downturns since the 1930s (2000-2002 and 2007-2009). So where are we now? As of July 30, 2010, the Dow Jones Industrial Average closed at 10,465. On the 30th of June 1980, the index closed at just 867.* This calculates to a total return of 1,107%, over a 12-fold increase without considering dividends. Including dividends, the total return was approximately 1,615%, meaning $1 million invested on June 30th, 1980 would be worth over $16 million today in a non-taxable account!

While this is no prediction of the future, it does suggest that chances are every person who panicked out of equities during even one of the many crises we endured is very sad about doing so, or would be if they only knew the facts. Interestingly, we do not typically learn about these facts in the popular media, which is focused on what is happening minute-to-minute in the financial markets. The bottom line is that allocating capital to foreign and domestic businesses remains the single best long-term solution to combat inflation.

THE INVESTOR'S PLIGHT

It is human nature to panic in bad times and become overly euphoric in good. The core emotion of fear, an often paralyzing and overwhelming obstacle to acting in one's own best interest, has the firmest grasp on most people's actions. Also, people tend to believe that what is up is going up forever, and what is down is going down forever. Thus, their emotions tell them to allocate heavier into what is up and disinvest from what is down. One need only study investor behavior over long periods of time to see just how it works.

The average equity investor lagged the average annual return of the S&P 500 by a full 5% per year for the 20 years ending December 2009 according to Dalbar's most recent quantitative analysis of investor behavior. Equity investors outpaced inflation by just 37 basis points during this time period (less than 4/10%). Sadly, the gap during the 20 years through 2008 was even greater, as the average investor made only 1.87% per year, a full 6.5% behind the S&P 500, and over one percent below the annual inflation rate of 2.89%! For most investors, real returns after taxes and inflation were negative, meaning they lost value.

You might expect fixed income investors or those in packaged asset allocation programs to fare better. Actually, their results are even worse. The average fixed income investor had an annualized return of only 1.02% and the average asset allocation investor in packaged asset allocation vehicles gained just 2.34% during the 20-year period ending in 2009. Both of these were well below average inflation of 2.80%. Clearly, investors are having a hard time accumulating wealth to reach their financial goals.

Why is this you might ask? Part of the answer is in the average number of years people held their investments. Equity investors and fixed income investors had an average holding period of about 3.2 years. Investors are allowing their investment horizons to be compressed to 3-4 years when their long-term goals typically need to be accomplished over 30 or 50 years. A couple aged 65 and 62 have a 30-year time horizon for preserving their real wealth and generating income, without even considering their children and grandchildren.

One issue investors' face is that they are emotionally involved with their own wealth accumulation and are continuously influenced by other's opinions, the media, and worst of all their own fears. Much of what they feel comes from misinformation and even worse, disinformation. Left to fend for themselves, without benefiting from strong leadership, investors can have trouble maintaining a strategic, long-term focus and will be susceptible to making decisions based on short-term market fluctuations and their emotional signals.

THE DECADE'S BEST PERFORMING MUTUAL FUND, OR WAS IT?

To drive home the point that most investors behave irrationally, let's look at one final recent example. A December 31, 2009 Wall Street Journal article recounted the saga of the best performing mutual fund of the decade, ending December 29, 2009. With an annualized 10-year return of 18.2%, the winning fund was the $3.7 billion CGM Focus Fund. Simply remarkable given the challenging time period and how it bested the second place fund by 3.4% per year.

Before you jump to buy this fund, or beat yourself up for missing out on its tremendous run, let's take a look at how the average shareholder fared. When we calculate the dollar-weighted return, we find the average investor racked up a loss of 11% per year, a divergence of over 29% annually! How is this possible? Investors poured in their capital after the fund gained 80% in 2007, only to pull out during the ensuing year as the fund plummeted 63% from its high point to low point, losing 48% for the calendar year. This is a poignant example of emotionally based performance chasing and its dramatic negative impact on people's lives.

IS THERE A SOLUTION?

In my experience helping successful families, the primary goal for most is to become and remain financially independent; the point at which they can receive desired cash flow for as long as they live without the overarching concern of outliving their money. Once that is accomplished, the focus shifts to preserving wealth for their heirs, while keeping the IRS from being their primary beneficiary. This feat requires strategic thinking developed and implemented through trusted advisors providing strong leadership.

Interestingly, it is very rare to find somebody with these goals clearly defined and on a path to achieve them. Those without a clear picture of what they are trying to accomplish over the long run are the easiest prey for the devastating impacts of investor behavior. By setting goals, developing strategies to achieve them, and tracking progress at stated intervals, the likelihood of damaging oneself through poor investor behavior is dramatically reduced.

Most investors crave leadership, a source of confidence and comfort, but seldom ever receive it. The lucky few who find a trusted professional adviser with knowledge, wisdom and experience in a goals-based approach, who keeps discussions centered on progress relative to goals rather than market indices or the hottest stock, are rewarded with a greater chance of reaching Financial Independence. We find these investors are better able to remain focused on their family's 'end-in-mind', despite constant short-term distractions.

In addition, an investor who finds a professional who adheres to a strict discipline of allocating among historically non-correlated asset types and styles based on a clearly stated personal investment policy with rebalances at stipulated intervals (based on a defined discipline and not on emotion and/or short-term predictions) is one who can feel confident that his or her resources dedicated to achieving and maintaining financial independence are being handled appropriately.

CONCLUSION

As we have discussed, investors face a difficult challenge and many fail to enjoy the positive long-term returns provided by investing in successful businesses. By taking a long-term, goals based approach, and benefiting from sound leadership, it is possible for investors to gain a higher level of clarity and confidence, allowing them to restrain their behavioral instincts and avoid becoming part of the sad side of the statistic that shows how poorly many investors have fared.

If you have questions about this or other planning issues, please give us a call at 216-765-0121.

*Based on the Dow Jones Industrial Average Index, including dividends from June 30, 1980 to July 30, 2010. Source www.djindexes.com.