THE FRIDAY BRIEF
A weekly discussion of events and their impact on your investments
BEACON INVESTMENT MANAGEMENT

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Replace Worry with Confidence

The recent 8.2% dip in stock indices from their January 15th peak provides an opportunity for reflection. While market declines in general are not pleasant, one can understand investors are understandably squeamish after the 37% drop in 2008 and the peak-to-trough drop of 57% from October '07 to March '09. But ever since stock markets began, values have dropped then recovered only to go on to new heights. Our purpose today is not to predict the market's next move, but to objectively examine its nature and demonstrate why worrying about the dips is needless and avoidable.

In my experience, investors become anxious when markets decline for several days in a row and for more than 3-4%. About the same time CNBC, Bloomberg, and CNN Money bring out the doomsayers to pump the airways full of scary, even apocalyptic prognostications. Unfortunately, those who rely solely on these channels and their own gut for counsel blow with the breeze, fair or foul. Dalbar is famous for studying investor behavior and the huge role emotions play in investor decisions. DALBAR's most recent study found that while the S&P 500 has returned 8.35% over a 20 year period ending in 2008, the average equity investor earned just 1.87%, less than the average inflation rate of 2.89%. Bond investors fared no better. They earning returns of just 0.77% compared to 7.43% for the index.

Behavioral mistakes aren't the only culprits causing damage. Active management and bad advice are also clearly to blame. John Bogle in his new book The Little Book of Commonsense Investing calls it the grand illusion. He estimates that over a 25-year period ending in 2005, the average mutual fund investor earned 7.3% compared to the 12.3% for the benchmark. He and we claim that the returns reported by mutual funds aren't actually earned by fund investors. Active managers in their quest to beat the market add variability beyond that of the market. They may outperform for a time, but they certainly underperform too. When an investor's cash flows adversely coincide with the manager's underperformance he ends up with less wealth than he would have had if he simply invested in the indexes.

In my recent article entitled *Alpha or Wealth* I showed how active management can erode lifestyle because of extra market variability and added uncertainty. I referred to work from Dave Loeper of Wealthcare Capital Management who took a case of an investor saving for 30 years lucky enough to have half of his funds outperform the market by an average of 2% over his accumulation period. The odds of doing that by the way are less than winning the lottery.

Using his model, Dave took a sample client who wanted $60,000 in annual income during his retirement years. Dave went to his capital asset model and calculated that given the investor's current assets and savings, he could have an 86% level of confidence of achieving his goal simply by using index funds with an optimal mix of stocks and bonds.
Dave then ran the same model against a database of active managers forcing half of our client's managers to beat the market by an average of 2%. As with the real world, the returns were not

forced to beat each and every year, but rather to *average* a return of 2% higher than the market. Managers outperform some years and they underperform some years. Because real life investors save and spend their money, their results can be dramatically different from the returns reported by the funds when their cash flows line up adversely with their managers' market underperformance.

Not surprisingly, Dave found that the extra market variability inherent in active management materially reduced confidence for his sample client. He found that to gain the same level of confidence of 86%, his client would have to accept only $30,000 in retirement income – ***HALF*** his spending goal. That's lifestyle destruction!

But the stock market is volatile too, and indexes based on it would be just as volatile. True. Let's examine just how volatile the market is most of the time and what real impact that volatility has on you as an investor. Since 1981, the standard deviation of the global stock market[1] was 15%. This means that 68% of annual stock market returns during the last 29 years were within 15% of the market's average return of 9.7%. Stated differently, two thirds of all market losses (or gains) are 15% or less. A 15% loss in value is painful. Enduring it is made worse as television and newspaper doomsayers pile on. Your assets wither and you wonder how much further they will go and whether you will have enough to meet your needs.

Is it possible to answer these questions objectively and with confidence? We do it every day for our clients. We develop comprehensive plans for each client which include their goals, dreams and priorities. We continually stress-test their plans against market uncertainty to ensure that they are properly funded to meet their goals. But in the process we do not ignore our clients' important lifestyle considerations. Understanding their priorities, we achieve the right balance of risk, savings and goal timing to maximize their current and future lifestyle.

Our clients learn that market volatility is an unavoidable part of investing and we help them plan for it. We calmly discuss goals that range from acceptable to ideal. In the process we learn which goals are most important to them as well as their priorities for working, giving, saving, risk taking, education, estate, and others. They become well prepared for inevitable market slides and we are better prepared to offer advice that honors their priorities should their plans become under or over-funded.

Let's take a look at John and Mary Brown. They have $450,000 invested in our Growth Model (90% stocks 10% bonds). Their accounts just dropped 13.5% during a 15% stock market decline. Are they worried? They are not immune to the constant stream of dire news and conversations with friends, but they don't hit the panic button.

They have embraced our Wealthcare process and have planned for times like this (and much worse). They know that despite the drop in their assets they still have an 86% confidence of exceeding their goals. In fact they know that their $450,000 portfolio could fall another 38% to $275,000 this year before their plan would become underfunded (too much uncertainty). And our process even shows them that there is only a .1% chance of that kind of portfolio decline happening within the year. We replace emotion with confidence that the capital markets will provide sufficient returns to meet all of their needs.

John's and Mary's plan is specific to them, but it is not unusual. They are saving $19,500 a year, want to send their son John Jr. to college, and would like to spend $100,000 a year in retirement (age 63 for John) with a travel budget of $10,000 on top of that. While the idea of leaving an estate of $500,000 to their son is nice, travel is their passion now. They are willing to reduce their estate goal should it become necessary in order to travel now and avoid saving any more than they currently do. They are also willing to take more market risk (hence the 90% exposure to stocks) to accomplish their lifestyle choices and still meet long term goals. We help them reach these goals by continually monitoring their plan for proper funding.

What happens to the Brown's plan if we use active managers? To answer that question I used the Wealthcare database containing monthly data for a broad array of asset classes going back 75 years. To simulate active management, I constructed a portfolio comprised of the following:

40% Concentrated Large Cap Stock
30% Concentrated Small Cap Stock
10% Foreign Stock
10% Emerging Markets Stock
10% Taxable Bonds

I forced the model to outperform each asset class by a full 2% (alpha) over the plan's life charging a 1% fee for management as with the index scenario. Running the model which virtually lives 1,000 times the Brown's lifetimes, I found that confidence of 86% with our index-based Growth model fell to 30% under the hypothetical active manager model. Why the drop? Extra-market variability or ADDED UNCERTAINTY.

To get our young family back to their 86% confidence we had to ask them to stop traveling now and use the money to double their savings, to hope and pray that John Jr. will get a full scholarship to college, to eliminate their estate, to work another 7 years and to halve their retirement spending. Is this measurable destruction of lifestyle?

We and others believe there is a better way. Indexes help you avoid costs, taxes, and the risk of material market underperformance, but Wealthcare helps you maximize opportunities presented along the way to enhance your goals and lifestyle and avoid needless risk and worry.

[1] Actual monthly Equity database consisting of 85% Wilshire 5000 Index and 15% MSCI EAFE Index (Europe, Australia, Far East) as of December 31, 2009.