Investment Objective: From Here to There

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The Fiction of Precision

Defining your investment objective is often perceived only as a numbers driven exercise. A template questionnaire, a Monte Carlo simulation, and Voila! You are to believe in the statistical precision that comes out on the other side like: a 95% chance you will not run out of money! The flawed oversimplification that typically accompanies this approach fails to account for client objectives that are as varied as the lives they lead, the values they hold dear, and the priorities that they establish. Investment decisions should be consistent with your resources (time and money), your tolerance and ability to incur risk, and your goals. Creating awareness of how these forces interact and how they may change with time and life circumstances is important in helping you maintain an investment profile true to your priorities.

Context shapes perception and it is from this point we try to shape perspective and a strategy that is suitable for your goals. Mismatches between choices and objectives occur when proper thought is not given to long-term outcomes. The outcome may vary from gifting, inheritance, charitable endowments, to being able to live a comfortable life. Regardless, each requires a balance with more qualitative issues which is seldom a black and white exercise. Risk tolerance, personal values, lifestyle, life stage, and needs vs. wants all will be key determining factors.

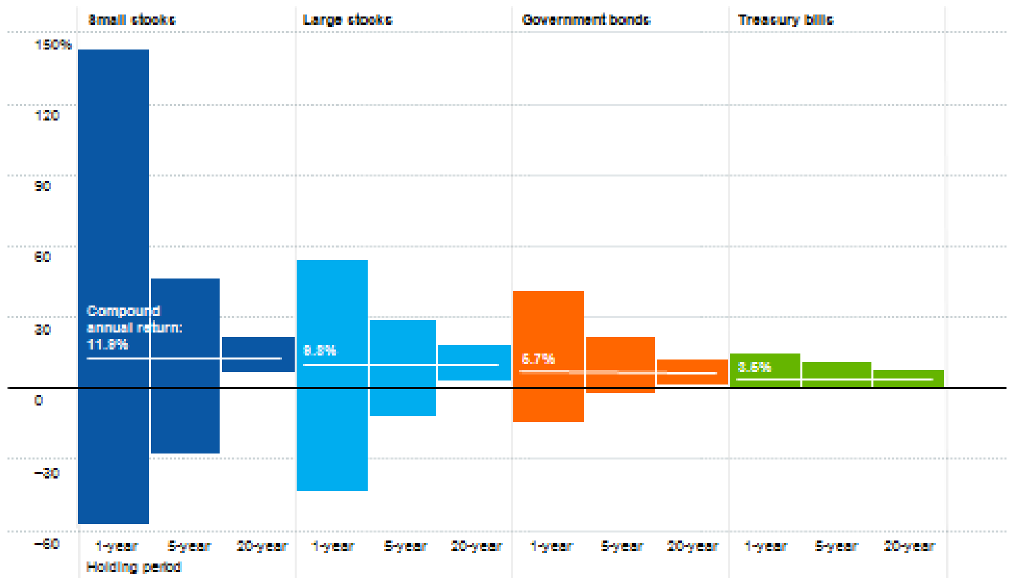
Risk and Return – Time is Money

We necessarily begin with an assessment of your current resources available for investment and ask: what do you need or want this investment pool to do for you? We take a realistic look at your goals and then look to construct a bridge from here to there. What is the most efficient path for your investment success? How much room for error is in the plan? What is the likelihood of error? How do you feel about the potential downside? Simply stated, what is the chance of things going wrong and how bad could it get? *Many crystal balls, and portfolios, have been shattered in the midst of market declines.* The fact is, no one can predict with certainty or consistency what markets will do over short periods of time; and we can only look to history to help us gauge how markets will perform in the future over longer time periods.

The charts below are instructive because they illustrate that time tends to reduce risk of investment loss. It is not a guarantee against loss, but the odds of loss historically lessen with time. In any 1 year period, markets can decline substantially across all asset classes, with stocks showing the largest declines; over 5 year periods the magnitude of loss reduces significantly; over 20 year periods risk of loss dissipates. The past is not a neat and tidy look into the future, but the period from 1926-2012 includes world wars, depressions, recessions, inflation, terrorist attacks, banking crises, etc., and helps us understand how assets have performed against these forces.

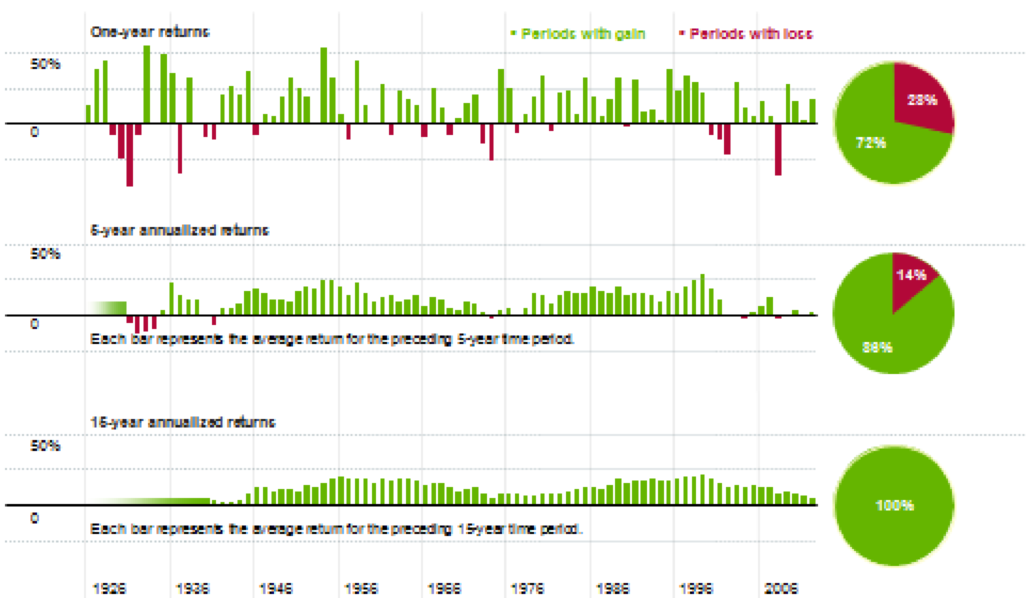
The charts also clearly express that higher stock returns are accompanied by higher risk. Chart 1 illustrates how bad it can get by different asset classes over 1, 5, and 20 year periods. Chart 2 quantifies the chance of things going wrong with 100% exposure to stocks over 1, 5, and 15 year periods at 28%, 14%, and 0%, respectively. If you are near retirement do you want to risk a 28% chance in any given year that your portfolio will fall in value by 50-60%. That would likely alter your retirement plans in a material way. How about a 14% chance that your portfolio will decline 15-30%? This simple framework helps to clarify and define your risk parameters.

Chart 1: Reduction of Risk Over Time
1926–2012



Past performance is no guarantee of future results. Each bar shows the range of compound annual returns for each asset class over the period 1926–2012. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. © 2013 Morningstar. All Rights Reserved. 3/1/2013

Chart 2: Risk of Stock Market Loss Over Time
1926–2012



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Emotions, Control, and Non-Control

The aftermath of the Crisis focused people's minds on risk and what it really means to them. Unfortunately, many people learned some very hard lessons about being overextended and overexposed to various risks. More unfortunate were those who learned the wrong lessons from the crisis. Many people sold at the wrong time and their paper losses in 2009 became permanent losses, because their fear of losing more caused them to sell at precisely the wrong time. It is often said that fear and greed are the only emotions that exist in the market. Each can create bad outcomes if they are not managed well. Managing risk begins by clarifying the factors that where we have some control versus those we cannot control.

Control Factors	Non-Control Factors
Type of risk exposure	Market movements
Fees	Time
Discretionary expenses	Needs

We start with the logical assumption that most people do not have unlimited resources, simply because most people do not! This means that time becomes an important consideration. How much can you afford to lose in the short-term is a very real risk, and becomes more of a risk as you move toward your retirement years. This is why fixed income assets tend to become a higher percent of the asset mix. As people move toward retirement stability becomes more important.

Type of Risk Exposure vs. Market Movements

Some asset classes and markets are risker than others. As we have seen in the charts above, risk relates to return. How much risk do you need to take to achieve the return you need to meet your goals? How much variation in your account levels can you withstand? The suitable asset mix will expose you only to the amount of risk you need reach your objectives. Getting this mix right is one part art and one part science. Managing the tension between risk and return is a core element in portfolio discipline. Your risk exposure will depend on various factors that are specific to you and your circumstances.

Fees vs. Time

Fees are often overlooked (because they are often buried in fine print), or otherwise not properly disclosed. As an investor you should be aware of, and have the right to know, the total cost of your investment program:

Total Cost = Cost of Investments (Mutual Funds/ETFs) + Commissions + Sales Loads + 12b-1 fees + Adviser Fees

Under standard industry fee structures these fees compound and grow over time, and they generally can range from 15-20% of account value in a moderate risk portfolio in just an 8 year time period! For retirees on fixed incomes, fees are generally more onerous because they are typically in low-risk, low-return portfolios – which means that fees eat up a larger percent of the invested funds. You can now see how fees can greatly deter you from reaching your financial objectives. At CVA we will do a no cost assessment to show you how we can save you money, that can then work for you and increase the odds of your investment success.

Discretionary Expenses versus Needs

What can you spend money on is not the same as what you need to spend money on. If you are in a position where your choices are between exotic travel, vacation homes, or a new BMW every 2 years, you likely have enough financial cushion and flexibility in how you structure your portfolio. Options are good if they are wisely employed. On the other hand, if you are of more modest means, or have financial obligations that need to be met, you may need to, or already have adjusted your spending patterns. The risk and reward profile in your portfolio will leave you less cushion for error, especially if you are near retirement. Still, being too conservative can make it difficult to keep pace with rising prices with core necessities like health care, food, and energy. Rising life expectancy rates adds another risk.

Summary

Suitable investment objectives are not about gunning for high octane performance or keeping up with the Joneses.' The same set of risk factors does not have the same consequences for every investor. Thoughtful consideration of your income, assets, and liabilities, as well as a range of issues that define your values and goals should dictate your investment choices to ensure consistency with the priorities you establish.