



Managing Your Investment Expectations

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Investing during turbulent market conditions can be a scary proposition. Watching your wealth increase dramatically one day, and then cut in half the next, is not for the faint of heart.

The real problem occurs when investors don't have realistic expectations: they're not sure of what kind of return they will get on an investment or how much of a roller coaster ride they will need to endure before they get there. So the question becomes do you ask the ride operator to stop the ride and let you off or do you follow through to the end and possibly have the time of your life?

Before you even get in line for that ride, you need to ask yourself some questions. What return can I expect from this asset? How much volatility do I have to withstand to achieve that return? And how long will the money be invested before I need it?

Whenever I sit down with a prospective client, I always hand them a risk-tolerance questionnaire to complete. This helps me understand what the client is expecting from me, as well as the various investments they make.

One of the questions asks, "What return do you expect from a diversified portfolio of stocks and bonds?" One prospective client of mine answered 15 percent to 20 percent annually. He also indicated that he wouldn't be able to tolerate a downward move in the market of more than 5 percent. It's not much of a surprise that this person had been through four investment advisers in the last 10 years. I knew that if I were to help this client grow his wealth, I'd have to manage his expectations.

Numerous studies have shown what we already intuitively know: If you want great rewards, you must take risk. Risk and reward go hand in hand. Anyone who promises that he can provide you a great return with minimal risk is either lying or just doesn't understand the nature of risk.

Let's ponder this from a logical perspective. What if treasury bonds (bonds issued by the U.S. government and generally considered a relatively risk-free investment) paid an annual interest rate of 15 percent and the stock market returned 11 percent with some obvious risk, where would you invest your money? Where would your neighbor invest his money? Your co-worker? The answer is clear, everyone would invest his money in the risk-free 15 percent treasuries. You would have to be crazy not to.

Once everyone started flooding the Fed with cash to buy these bonds, the Fed would realize that they had too many investors for the amount of bonds to issue. So, what would the Fed do? They would lower the rate until they had just enough investors to pay for all of the bonds being issued. But what rate is that? 12 percent? 6 percent? 3? If the market can be expected to return 11 percent with a fair amount of risk, what return would you be willing to accept with very little risk? The answer is different for everyone depending on various economic conditions. Historically, the 10-year treasury's average yield is around 5 percent. This low rate shows that many people are looking to the safety of risk-free investments. But, before we go any further, we should define "risk" in the context we use it here.

Risk can be many things, including:

- Default risk: The risk of not getting your money back.
- Inflation risk: The risk that prices will go up at a quicker rate than your return.
- Market risk: The risk that the entire market goes down.

For the sake of our discussion, let's focus mostly on market risk, or volatility, because default risk is of little concern once we diversify--this is when you buy many broadly based index funds covering many asset classes. So if GE goes out of business, it is less than 1 percent of your portfolio and will have little impact on your return. And unless the entire U.S. economy goes bankrupt, you are protected from default risk. Inflation risk is also not a concern given

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that we are investing in the total stock market. So our only risk is if the entire market goes down because of unforeseen economic, political or social situations that affect the financial markets.

For example, if you invested in the S&P 500, which is an index made up of the 500 largest companies in America, you had an average annual return of 11.7 percent for the last 80 years. But during that 80-year period, the index only had a return between 11 percent and 12 percent three times. It is important to remember that the average is just that, an average. The market has had annual returns as high as 64 percent and as low as -43 percent. These numbers illustrate the flaw of looking strictly at the “average” return. Someone once said if my feet are in the freezer and my head in the oven, on average, I’m comfortable.

So our risk in diversified investing is not default risk, but volatility—the possibility that we could have a year down 20% or more. Sure, in the long run, market gains will offset that down year and bring it back to the average, but that may be of little consolation when your life savings, which was once \$500,000, is now \$400,000.

Let’s take a look at this chart:

Risk and Return by Asset Class from 1927-2007			
Asset	Annualized Return	Lowest 1-yr Return	Standard Deviation
30-day T-Bill	3.77%	0%	3.49%
10-year Treasuries	5.32%	-6.13%	6.89%
Large Cap Stocks	10.97%	-43.35%	20.26%
Small Cap Stocks	12.18%	-59.12%	38.09%

It shows the returns of various asset classes given their various levels of volatility over the past 80 years. As you can see, risk and reward are highly correlated. If you want the high returns small-cap stocks offer, you need to be willing to sit through some painful stretches of down years.

The next time you think about the return you want from your investments, understand what risk is associated with that return. It is very easy to pick small-cap stocks because of their high return or bonds for their safety, but vital to understand what you are sacrificing in the process. In small caps, it’s piece of mind. In bonds, it’s return on your investment and, ultimately, money in your pocket.

Don’t let your adviser talk to you about returns without also discussing risk. If your adviser tells you about a high return with little or no risk, run away as quickly as possible. Those are usually the investments with the most risk. This important dialog with your adviser will be a tremendous benefit for shaping your financial future.

Risk and reward are strange bedfellows that work in tandem. You already know there are no free rides. But before you buy your ticket, make sure you can stay on the ride till the end, then buckle up and hold on tight.

Ryan Zacharczyk is President of Zynergy Financial Planning, LLC, a financial planning firm specializing in working with mature adults 50 years old and above. Zynergy provides comprehensive financial planning services for individuals 50 and older, helping them achieve their objectives in estate planning, investment management, tax minimization, and insurance planning.