Money

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WHEN AVERAGE IS YOUR ENEMY

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If you've ever told yourself that your investments will be okay as long as you average a certain percent return, you could be in for a rude awakening. Have you ever wondered why your brokerage or 401(k) account balance doesn't necessarily reflect the average gains reported in the media? It's possibly due to an enemy called average.

Most people have been taught to think in terms of average rates of return. However, the concept of average is often misunderstood when it comes to financial losses. For illustrative purposes, let's look at the following hypothetical chart, which shows how a 20% average rate of return over two years creates completely different results when a negative number is involved. Please note that a 20% return rate is not an actual rate of return, but used for the purpose of simple calculation.

$1,000 with a 20% Average Rate of Return For 2 Years
How Much Do You Have?

Starting	1st Year	2nd Year	Average	Ending Value
$1,000	20%	20%	20%	$1,440
$1,000	60%	-20%	20%	$1,280
$1,000	100%	-60%	20%	$800
$1,000	140%	-100%	20%	$0

Are you surprised to see that even though each scenario had a 20% average return over two years, the ending values are vastly different when a negative return is incurred? Averages can be deceptive. Actual returns and average returns are not the same when you factor in a negative number.

A negative return wreaks more havoc than you might recognize. When recovering from a down year, you must not only make up the amount you lost, but during the time it takes to get back to where you were before, you've lost the ability to earn interest on that money. It's a lost opportunity. And lost opportunities can be expensive.

Consider this: When does -30 + 43 = 0? Chances are, you've never seen this equation in math class. If you have $100,000, and you lose 30% in a down market, your new value is $70,000. Some would guess that if you lose 30% but gain 30% back, you would be back where you started. Not true. With a new value of $70,000, you need a 43% return ($30,100) in order to get back to $100,000. Mathematically, when you incur a loss, you need to have a gain that is larger than the loss — just to break even. It's critical to understand how this math affects income planning, because what you don't know could cost you your retirement.

If you're in retirement taking income from assets that are exposed to market volatility, and you sustain losses, there's the possibility you may run out of money. You simply may not have enough time on your horizon to recover from the loss. One down year can do more damage than many good years can repair. If, on the other hand, you're taking an income from a portfolio that has never incurred loses, your chances of making that money last and having some left as a legacy can be much better. Having a plan in place to help mitigate market volatility is imperative in retirement.

Hoping that the market won't experience a downturn is never a good strategy when it comes to managing your portfolio. A better way to manage risk, regardless of market conditions, is through the application of scientific and mathematical formulas. The idea that an average return is all that's needed to see you through retirement resembles an ostrich with its head in the sand. It's a passive approach that usually ends in less-than-stellar results. It's the full exposure 100:100 plan: 100% of the market's upside and 100% of its downside. Are you willing to subject your retirement income to such a precarious scenario?

Instead of full exposure and the inherent negative returns, consider a tactical retirement strategy where you are no longer exposed to 100% of the market's ups and downs. A tactical plan is one that strive to grow your money while aiming to help prevent extreme losses and minimizing volatility. It may have a ratio to aim for 80:40, 60:0, or any other combination other than 100:100 and help ensure you don't run out of money during the distribution phase of retirement.

When creating your strategic plan, be sure to work with a knowledgeable advisor who specializes in retirement strategies — someone who will ask the right questions and fully understand your situation. Because the lack of a plan is simply a plan to fail, there's no better time than now to put your plan together.

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