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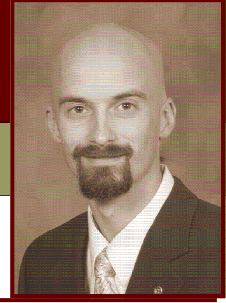
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TPWC Market & Economic Update

Building the Optimal Portfolio

By Jeff McClure

Recovery at the Mid-Point

About 75% of the companies in the Standard and Poor's 500 Stock Index (S&P 500) have reported their earnings for the fourth quarter of 2010 at this point. On average, they are up about 30% over what they reported for the same period in 2009. That is absolutely good news. For the twelve months ending in January, the Index had a total return, including dividends, of over 22%.

As I write this, the Index stands at 1334 or about double its low back on March 9th of 2009. Despite a doubling in value, the S&P 500 as well as the Dow Jones Industrial Average are still well below their high points back in 2007.

A literal 100% gain in the major market indexes in under two years is quite an astonishing rise in value to most people. Of course, if you have been reading this letter for the past several years, then you may not have been so surprised.

My best estimate is that we are about half way through the value recovery of the equity markets in the United States. Since recoveries, like most other things, do not fol-

low a straight line, it is very likely that the second half will take longer and be far less dramatic than was the first.

The Danger in Projections

We here at The Personal Wealth Coach try our best to never do projections. We use *expected* rates of return with the clearly stated understanding that the rates are long term *averages*, and not some fixed rate into the future. We also use historical charts to demonstrate how markets historically have behaved. It is critical to understand that the future will not look like the past.

We can look at worst case scenarios in history and plan for similar events. We can also look at long term real returns over the last three and a half decades to set our expectations. Those two approaches are reasonable and backed up by many carefully structured studies as the best way to plan for the future.

We humans, though, have a wonderful ability to project. When things have been going one way for a while, we unconsciously assume that whatever trend we have seen recently will be repeated into the

indefinite future.

When the short term trend is down we all have a powerful tendency to be pessimistic and fearful, no matter how much we believe that the market slide is temporary. That is an obvious danger to the portfolio. Market downturns tend to decline fastest as they approach the bottom because of that tendency to project.

The critical thing to remember in market downturns is that the only reason the market value declines is because people are selling more than they are buying. The more *fear* there is among investors, the more they will tend to sell. That emotion is as contagious as the flu, but commonly does not reflect economic reality.

The danger when the market is rising is more subtle but just as critical to avoid. Back in the late 1990s there was a general assumption that the equity markets would continue to rise at a nice double-digit rate into the indefinite future. I saw many assumptions even in print that suggested that we were somehow entitled to a minimum of

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12% annual gains in the stock market. The reality was quite a different thing.

Perfect vs. Reality

The Perfect portfolio would look something like the one in the top chart. Let's say you started with \$250,000 in 1977 and were able to perfectly match the return of the S&P 500 Stock Index. You would have had a total *real* (inflation adjusted) return averaging about 8.2% per year. So if you were to find the Perfect Investment your portfolio would look like the top chart. Unfortunately, along the way you might have had a hard time believing that you had made a good decision.

Starting in 1977, even without withdrawals, your portfolio would have had a *real* total return of less than 0% for the first five years. Beginning in 1982, you would have then seen a whopping 20% per year return right up until mid-1987.

In 1987 you would have seen the Index fall over 30% in two months! Looking back we can see that the "crash of '87" was just a blip, but if you had been expecting 20% annual returns you would have been very disappointed. Actually, the Index had a positive return in 1987, but after five years averaging 20% per year, few people noticed. The "fear" flu was in season.

The Index got back to "normal" albeit with some bumps and grinds until 1994 when it again went on a tear. From mid-1994 until mid-2000 the average annual rate of return jumped to 24% per year! Of

40% per year.

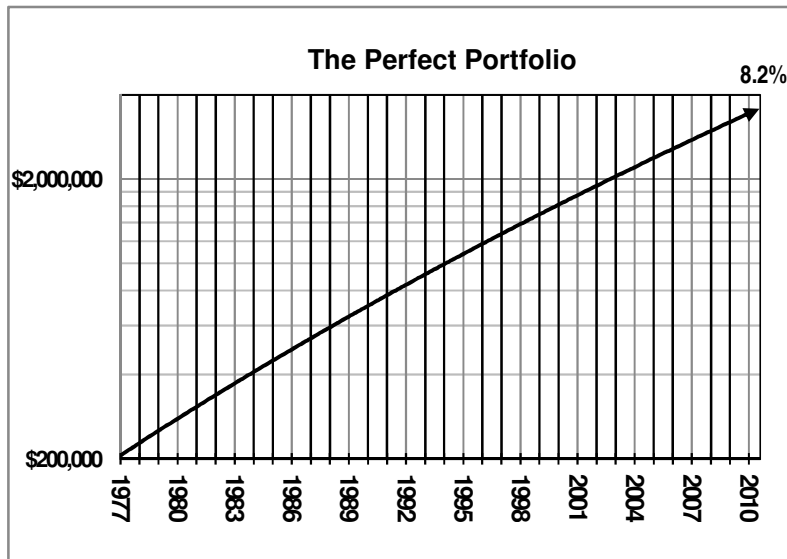
Inflation

Before we go any further, I do want to point out that there really was inflation over that almost 36 years. Inflation averaged just under 4% per year, so the *nominal* return of your hypothetical portfolio would have been just under 13% per year. Ironically, that assumption back in the 90s was not that far off base.

It would not be too unreasonable then to think that all would have been well had you dropped a retirement portfolio into an inexpensive index mutual fund and started withdrawing \$1,500 per month (7.2% per year). A portfolio that was going to make about 13% per year over the next 35 years certainly looks like a safe place to be.

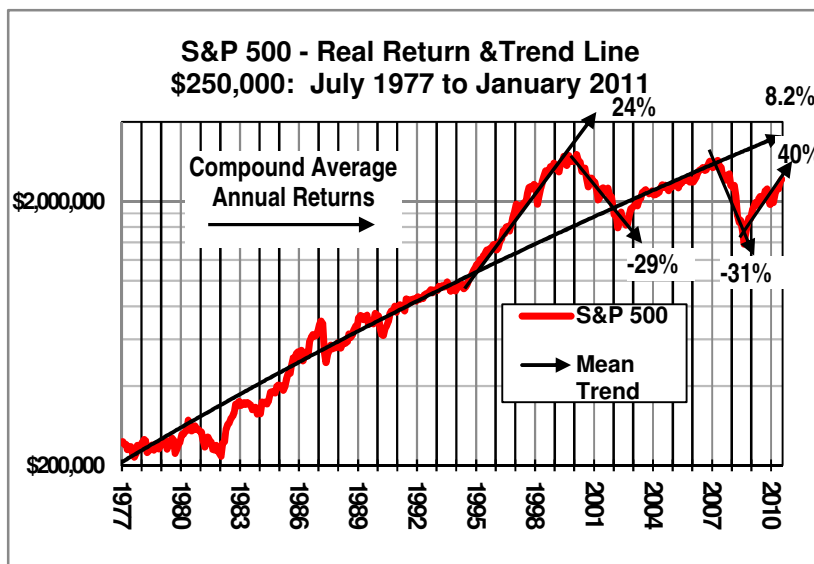
In this case, you even know that the *mean* or average real total return (after inflation) would be 8.2% per year, so common sense says that you are safe.

Unfortunately for many investors, the reality is that the investment markets are *counterintuitive*. In other words, what common sense tells you about finance is nearly always *wrong!*



course that was followed by two years when the average loss was 29% per year.

Once again the Index got back on its "normal" track until late



2007 when it turned downward with a vengeance, losing about 31% per year until March 2009. That brings us up to date, with the average return since then at about

A Dying Portfolio

Lets assume that you were 60 years old back in 1977 when you started taking that \$1,500 per month, and that you adjusted your

¹ One cannot invest in either an index or in a pure asset class. In this case the asset classes from which the allocated portfolio is created are actually Morningstar Categories, which, in turn, represent the average performance of the mutual funds tracked by Morningstar which are categorized as being in a specific asset class. The Morningstar categories used are 22% Diversified Emerging Markets, 4% Real Estate Stocks, 34% Mid-Cap Value, 38% GNMA Bond Funds, and 2% Cash.

withdrawals each year for inflation, but never took any extra. What would have resulted using *real*, inflation adjusted values, would be what you see on this page.

By mid 1982 your portfolio would have dropped to \$140,000 after adjusting for inflation! In nominal dollars though it stood at \$237,000 so you might not have panicked. Your first real test probably would have come in the bull market of the late '90s.

Even after inflation, in 2000 your portfolio would have had a value of well over \$400,000. It would have taken a great deal of discipline for you not to have increased your withdrawals or taken some extra money to fund something special.

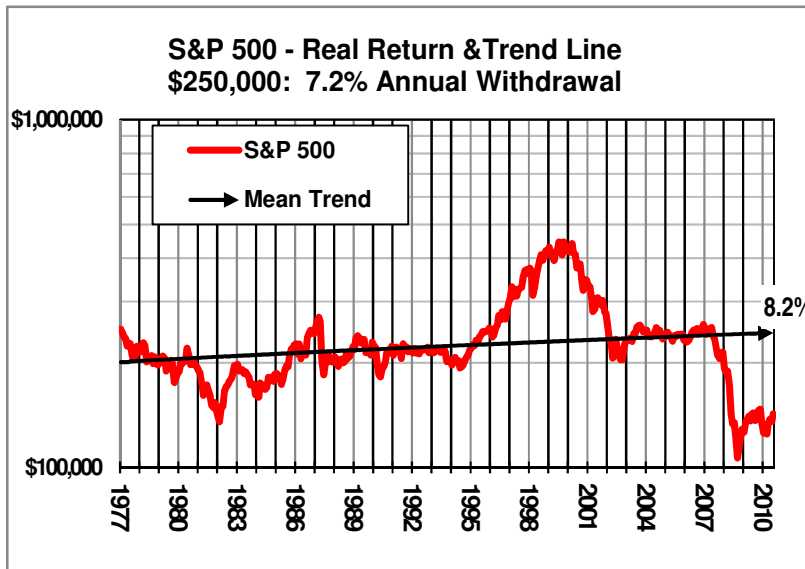
Even if you had held tightly to the discipline of a constant, inflation-adjusted withdrawal, you would have seen your real value fall to just over \$100,000 in 2009. Even after the 100% gain between the bottom of the market and now, you would still be just back to \$146,000.

****For the sake of full disclosure here I want to point out that inflation would have had a huge effect on the numbers we are using. In fact, you would have today several times what I just quoted in nominal dollars. That huge dollar amount though would purchase just what \$146,000 would have bought back in 1977. I could approach this by starting with \$25,000 and made the monthly withdrawal \$150, but in this illustration I am using numbers that make sense to us today rather than the numbers that made sense thirty-five years ago.****

Note that the mean (average)

trend line, which is still at 8.2%, remains slightly positive. That tells us that the *average* monthly return was quite sufficient to fund your retirement income. So, if the average annual rate of return was sufficient, why is this doomed?

Remember that the S&P 500



has had an average annual return over the last two years of about 40% per year. However, the hypothetical retirement portfolio

**When you need
income from your
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the enemy!**

achieved a real return of only 17% per year because of withdrawals. The withdrawal rate in mid-2009 was running at a whopping 18% per year. In fact the current real withdrawal rate is substantially higher than the portfolio is likely to gain in the future. If you were 60 when you retired in 1977, and you are 85 today, you had better hope that you don't live a lot longer.

Averages

The problem with averages is that they don't tell the whole story.

If you are standing with one foot in dry ice and the other in boiling water, your average temperature would be just about body temperature at 100° F. Of course that average temperature would not keep you from losing both feet, one to the minus 109° F dry ice and the

other to the 212° F boiling water.

The same thing happened in the portfolio. A fact of finance is that the greater the *variance* from a straight line return experienced in a portfolio, the lower the *actual* return will be. Note that the problem is not *losses* but *variance*.

In the nitty-gritty real world of investing, it would have been *extremely* unlikely that real people would not have

dipped into the portfolio either for an increased income or lump-sum withdrawals during the bubble-years leading up to 2000. Had they done so, then at the market bottom in 2009 there is a very high probability they would have run out of money.

Note too that despite the high returns and corresponding low percentage of withdrawal during the up-side variance, when the portfolio stabilized it was no higher than it was before the boom!

When you need income from your portfolio, *variance* is the *enemy*!

Addressing the Problem

If the problem is variance (and it is) then the solution is to minimize the variance. Note that I did not suggest focusing on minimizing the *losses*. The real world of market investing reveals that one cannot choose one's variance. If we

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have up-side variance we will have down-side variance.

It has taken me nearly thirty years in the investment business to understand that it is critical to have a portfolio which has elements that have the potential to cushion against down-side shocks, *and to maintain those elements even when the up-side is all anyone can see.*

That means that as the market rises, there will be times that a well positioned portfolio will not rise with it.

Market Timing

Ideally we could figure out how to time the market and get out before it went down. Unfortunately, that practice has proven only to be an excellent way to lose money!

The DALBAR corporation has been running a study on market timers as a group since 1994. The only thing remarkable about their record is the amazing losses they have chalked up! A solution that virtually guarantees a long-term loss is not one I will even attempt.

Optimized Allocation

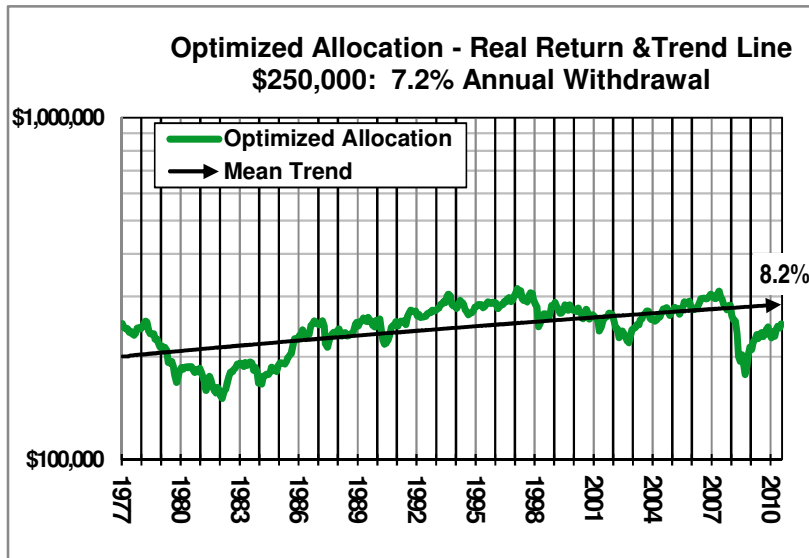
The solution is something called an optimized asset class allocation. The chart on this page has almost exactly the same average annual returns as the S&P 500 for the 35 years. The difference is that the portfolio runs much closer to the mean trend line. In short, it has far less *variance*.

The market “crash” in 1987 has shrunk to a small fraction of what we saw on the other charts. If you look carefully though, you will notice that the values *after* the crash

are very much the same. The Optimized portfolio simply didn’t rise as much so it didn’t fall as much.

Note too that for the market boom period from 1994 through 2000, while the S&P 500, Dow, and NASDAQ were roaring into unbelievable highs, the Optimized allocation actually *lost* real value.

Greed & Fear vs. Belief



It has often been reported that the stock market is driven by two prime emotions, *greed* and *fear*. It has also been said that the definition of a successful investor is one that can overcome both of those emotions and substitute rational *belief* for them.

Warren Buffet comes to mind as an example of just such a rational investor. His investment portfolio has very notably avoided participation in the various manias that have propagated through the ranks of public investors over the years. In doing so he has been supported by his shareholders who have continued to believe in his philosophy of an evidence and value based approach to investing.

The Value of Optimization

The total real income drawn from the hypothetical portfolio shown on this page was \$604,500 over the 35.8 years in the chart. The initial investment was \$250,000 and the inflation adjusted net value at the end of January 2011 was \$247,996. Here in mid-February, the value of the underlying portfolio would have already crossed back above the \$250,000 starting value.

The end result of utilizing a Markowitz optimized allocation would have been rather un spectacular, unless you count having drawn out the equivalent of \$604,500 from an investment of \$250,000, and still having the \$250,000 as a spectacular result!

Greed is Coming

There will be times when the enemy is *fear* and others when it appears more subtly as *greed*, but the real enemy hidden behind those emotions is *variance*. In investing as in so much else, moderation is the virtue of virtues.

For the first six weeks of 2011, the S&P 500 Index outperformed the Optimized Allocation. We will see more of that in the near future. Once again we are avoiding excessive variance. Believe it or not that is a *good thing*. Beware the greed monster! It will come.

Until next time, invest well, be careful, strive to be happy!

Once again, these are all inflation adjusted numbers. In nominal dollars the end value would have been \$1,120,920 and the total sum of withdrawals would have been \$1,452,453. \$\$\$

Past performance is no guarantee of future returns. For tax or legal issues consult with a qualified tax advisor or attorney. Information in this letter should not to be used as investment advice. Individual portfolio design must be tailored to individual needs, values, risk tolerance, and objectives.