

Investment Management: Eating Pie Will Keep You on the Treadmill



By Mike Shell

One of the great freedoms we have as Americans is the freedom to lose our money or to make some. Indeed, thanks to the efficiencies of the Internet, transaction costs have all but gone away. But I don't believe there is another industry where the majority of participants are as unprepared and misinformed as in the capital markets.

I recently met with a successful surgeon who is nearing that age when surgeons start to take on less risky operations and start to prepare for the next phase of life: retirement. By 1999 the surgeon had accumulated a significant amount of capital and invested it with a trust company. He and his wife sat down with a couple of "financial planners" at the trust company as they put together a pie chart of mutual funds and the expected rate of return for the portfolio. The planners believed his returns would average near 11 percent, since that was what the S&P 500 had averaged since 1926.

Eight years later, he's beginning to think seriously about winding down his practice so he and his wife can travel and do other things they enjoy. When he sat down and put a pen to it, he was shocked to find he hadn't earned any profits on the investments over the past eight years. The only growth he saw was his own large annual contributions. His actual average rate of return was about zero.

But what was his real rate of return? Was it zero? No. What will \$3 million in 1999 buy today? Even assuming a small three percent inflation rate and simple math, the money is worth 24 percent less today. Second, he has yet to achieve the 11 percent expected return the financial planners were hoping for. In simple terms, he has 88 percent less than

expected. And finally, he lost something more precious than money: eight years of time he can't get back.

He said every time it seemed he was getting ahead, a "market correction" would come along and take it back. In the annual review, the surgeon was always told to be a "long-term" investor. The problem with pinning yourself to a "long-term" time frame is by the time you figure out you're wrong, it may just be too late for you to get it right!

Planners commonly point to a long-term stock, bond, and T-bill chart showing the average returns of those securities since 1926. The surgeon recalled being told something like "Stocks have averaged 11 percent over the last 80 years so wouldn't you expect them to continue about the same?" That may seem logical; after all, 80 years is a long time. However, the starting point matters! In 1926 the dividend yield for stocks was 4.5 percent, stocks were trading at only 10 times earnings, and earnings growth then was about one percent more than it is today. The planners used flawed assumptions in their expected return; they hadn't studied the market's history.

Today, many brokers and financial planners use the pie chart method for asset allocation. They create investment portfolios based on the Nobel Prize-winning "Modern Portfolio Theory." The main issue with this approach is the users don't really understand what they are doing. This pie chart approach leads to a "broadly diversified" group of securities. In other words, they really don't know what areas of the market to focus their capital on, so they cast the net wide and hope for the best. Diversification to some degree is necessary, but it is often used as a crutch for ignorance.

Once the planners had put together a pie

chart, their idea of "active management" was to "rebalance" the holdings annually. Each year they would sell some of the winners and add to the losers. Someone once called this "watering your weeds and cutting your flowers." During the eight years, there had been strong trends in some parts of the market and continuing negative trends in others. They continued to add money to weak areas of the market with the assumption that the law of gravity applies to the market.

Finally, they accepted the risk of the market rather than manage it. In early 2003 the portfolio was down "only" 35 percent, relative to the S&P 500 being down 50 percent. The planners thought their "relative" out-performance was great. Fortunately, he's now found an investment manager who doesn't agree.

No one trades the market; we only trade our beliefs about the market. For those who believe these are prudent methods for managing money, then I guess it is true for them. ■

Mr. Shell is a portfolio manager at Shell Capital Management, LLC, a Knoxville-based SEC registered investment management firm specializing in tactical, trend-following, absolute return investment programs. For more information about investment programs designed to achieve your objectives, contact him at 865-539-9070 or www.Shell-Capital.com.

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