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BAD MATH, INVESTMENT ADVICE CAN BE COSTLY

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People who should know better make some amazingly foolish assumptions when it comes to investing. The problem is that they spread those assumptions as fact without looking at reality.

For example, if you invest for a long enough time, the good and bad returns tend to "even out" or "cancel each other out," and hence time diversifies a portfolio reducing risk.

This argument sounds reasonable. After all, from 1990 to 2004 -- a period of 15 years in which total returns for the SP500 ranged from +37.4 percent to -22.1 percent -- the average annual return was 12.4 percent. An investment of \$1,000 at that rate of return, compounded over 15 years would leave you with \$5,790 at the end of 2004. As the chart below shows, however, reality is significantly less. What happened?

Year SP500 Total return growth of \$1,000

1990	-3.17%	\$ 968
1991	30.55	\$1,264
1992	7.67	\$1,361
1993	9.99	\$1,497
1994	1.31	\$1,517
1995	37.43	\$2,084
1996	23.07	\$2,565
1997	33.38	\$3,421
1998	28.58	\$4,399
1999	21.04	\$5,325
2000	-9.11	\$4,840
2001	-11.88	\$4,265

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2002 -22.10 \$3,322

2003 28.70 \$4,276

2004 10.88 \$4,741

The returns shown above are historical data and should not be used to predict future market performance. Past performance is not indicative of future returns. The SP500 is an index and does not reflect an actual investment account's performance. All investments face the potential for loss, as well as the prospect for gain.

The problem with using averages to estimate returns, is you overlook the mathematics of gains and losses. It doesn't take a 22 percent gain to recover from a 22 percent loss, it takes 28 percent, because you are starting with a smaller after-loss base. It also matters when losses occur. A 22 percent loss early in the 15-year period has far less impact on your portfolio than a 22 percent loss in year 12, when your balance is higher and you have less time to recover.

To recover from a loss of, you will need a gain of:

10 percent 11 percent

25 percent 33 percent

50 percent 100 percent

75 percent 300 percent

90 percent 1,000 percent

Suppose you looked at a different 15-year period, such as 1965-80. The average return for the period was 8.2 percent. Compounded annually that would have resulted in the growth of \$1,000 to \$3,275. But, \$1,000 investment in the stocks of the SP500 would actually have grown to just \$2,637 because of the timing of losses and gains. You also have to remember that the SP500 is an index, and does not include the impact of commissions or trading costs, which would have reduced your return even more.

Looking at the Dow Jones Industrial Average for the same period of 1965-80, shows an average annual return of 1.4 percent for 15 years. Compounded annually over the period, the average return shows \$1,000 growing to \$1,238. Based on the actual numbers, an investor would have had just \$994 left at the end of 15 years. Here again, all the cautions of using index values apply, as do the mathematics of losses and gains.

This is the great fallacy of thinking that the longer your time period, the less risk you assume. Losses always matter. You can't control the timing of a market downturn, nor can you predict how long it will take to return to break even.

What you can do is use an investment strategy that strives to minimize losses. This means using stop losses in your personal portfolio or working with an investment advisor who appreciates the fact that averages are not reality when it comes to investing. Minimizing losses are essential to successful investing. You can't count on time to bail you out.

Warren W. Wall CFP, CSA is a local financial author and advisor with W. Wall & Company, Inc. a Registered Investment Advisor. Are you asking tough questions about retirement? For more info and a free

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