

# RESETTING

## Unreasonable Expectations

If Clients are Realistic About Returns They Will be Happier and More Secure

For investment advisors, managing the performance expectations of clients can be more challenging than actually managing their investment portfolios. There are at least two important elements at work here: clients having reasonable expectations and portfolio performance that tends to be reasonably close to that expectation.

Oddly enough, bull market periods are one of the greatest challenges when it comes to developing “reasonable” expectations. Unusually high rates of return (for example, the U.S. equity market during the 1990s) can set expectations that are both unrealistic and unachievable over long time frames.

During the exuberant 10-year period from 1989-1998, the S&P 500 Index had an average annualized return of 19.2 percent. Unfortunately, the average 10-year rolling return of the S&P 500 Index over the 42-year period from Jan. 1, 1970, to Dec. 31, 2011 (during which there were 33 rolling 10-year returns) was 11.56 percent. The performance of U.S. stocks during the 10-year period from 1989-’98 was quite a departure from the longer-term reality. Sadly, investor expectations of performance are quickly upwardly mobile—even when such expectations are clearly unrealistic.

Here’s the problem: high expectations lead to performance-chasing—and investors late to the game often get burned. Late comers to the tech sector boom of the 1990s got creamed in 2000, 2001 and 2002. During periods of high returns, expectations of the future can become unrealistically high. Likewise, during periods of poor stock performance

(2000-’02 or 2008) investors can become unduly pessimistic and may abandon their portfolio game plan—often at exactly the wrong time. In short, periods of boom or bust have the potential to create unrealistic expectations on both ends of the performance spectrum.

Unrealistic “up-side” expectations are hard to manage going forward, which means that clients face a high probability of being disappointed even if their portfolio delivers what would otherwise be deemed an acceptable level of performance. In other words, their portfolio is doing fine, but their expectations are messed up. On the other hand, after a messy bear market, it can be difficult for investors to remember that investments actually do produce positive returns. Unrealistically high performance expectations on the one hand, and unrealistically low performance expectations on the other hand, both create problems. The goal is obviously to have realistic performance expectations and build a portfolio that consistently delivers performance that is reasonably close to the expectation level.

So, what’s a reasonable expectation for an investment portfolio? As previously noted, the average 10-year rolling return of the large US stock (i.e., the S&P 500 Index) since 1970 has been 11.6 percent. Let’s use that as a reasonable return expectation. (Even if you don’t feel that figure represents a reasonable performance expectation, bear with me here). I understand that an investment portfolio that consists solely of large cap US equity is not a diversified portfolio—more on that later.

BY CRAIG L. ISRAELSEN



### EXPECTATION CONTROL

Let’s now examine how often a 100 percent equity-based investment portfolio (the S&P 500 Index) delivers performance close to that “reasonable” rolling 10-year return of 11.6 percent. To measure this we can impose upside and downside performance bands of 500 basis points above and below the mean 10-year return of 11.6 percent (the upside and downside performance bands are shown by the red lines in Figure 1). This created an upside performance limit of 16.6 percent (11.6 percent plus 5.0 percent) and a downside performance limit of 6.6 percent (11.6 percent minus 5.0 percent).

As shown in *Figure 1*, an all-equity investment portfolio was outside of the 500 bps limits 39 percent of the time (13 of the 33 rolling 10-year periods). The 500 bps performance bands are shown as red lines. In other words, nearly 40 percent of the time, the all-equity investment portfolio produced returns that were significantly different from the mean 10-year rolling return. In recent years, the rolling 10-year returns have been dramatically lower than the average 10-year return of 11.6 percent. This is the type of downside performance volatility that can rattle even the most resolute investor.

Now, let’s consider the rolling 10-year performance of a multi-asset portfolio that includes seven equally-weighted portions of large cap U.S. equity, small cap U.S. equity, non-U.S. equity, real estate, commodities, U.S. bonds and U.S. cash (see *Figure 2*). Clearly, this represents a more diversified investment portfolio

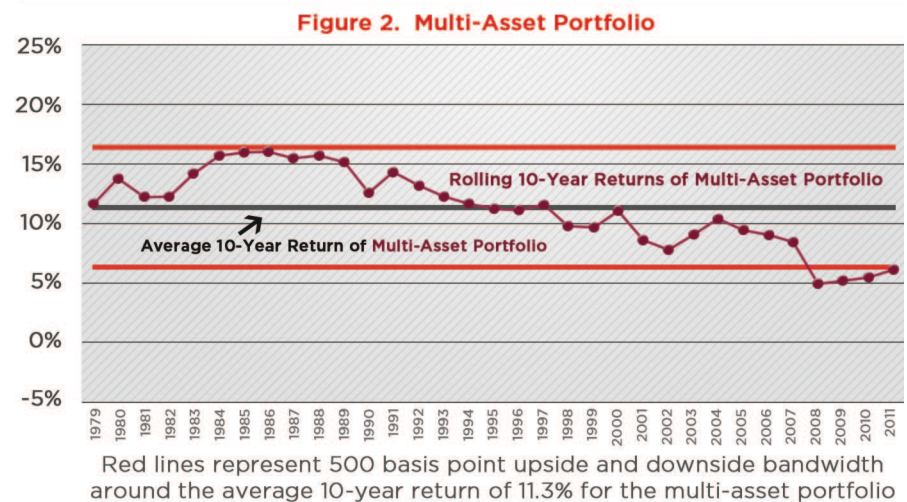
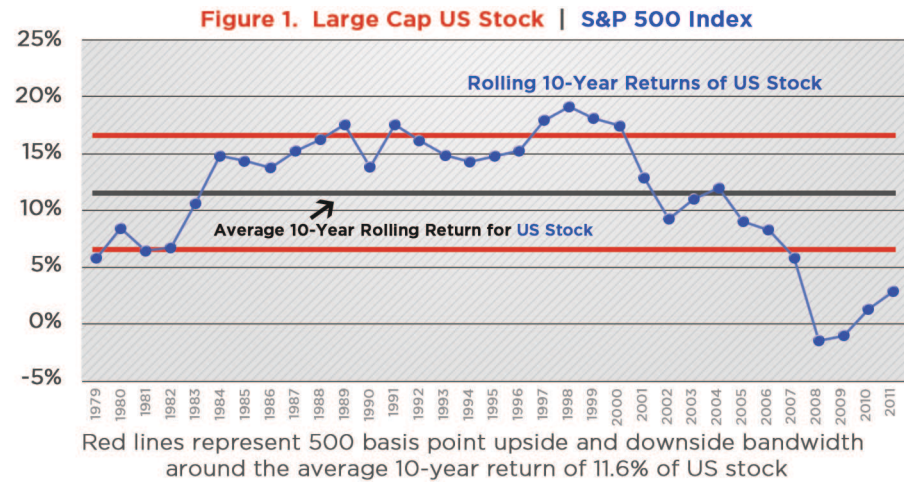
than simply investing in large U.S. stock.

A diversified investment portfolio that was rebalanced annually generated a mean 10-year rolling return of 11.3 percent, very close to the 11.6 percent mean 10-year rolling return of a 100 percent large cap U.S. equity portfolio. But, unlike the 100 percent stock portfolio, the multi-asset portfolio had dramatically more consistent 10-year rolling returns. In only 12 percent of the periods (four of the 33 rolling 10-year periods) was the 10-year rolling return of the portfolio outside of the 500 bps bandwidth limit. Interestingly, it never exceeded the upside limit and only in recent years did it exceed the downside limit.

A well-diversified portfolio that includes both equity and fixed income assets produced returns comparable to a 100 percent equity portfolio, but with a level of consistency that was significantly better than an all-equity portfolio.

Of course, there is a trade off when building a diversified portfolio. You'll notice that the multi-asset portfolio never had the 10-year annualized returns up near 20 percent that the 100 percent of large U.S. stock portfolio generated in the late 1990s. For some investors, "missing the upside" can be as painful as experiencing the downside. This is where investor/client education can hopefully create the right type of expectations. When building a diversified, multi-asset portfolio for a client it is vital that the advisor inform the client that the performance benchmark for their "multi-asset" portfolio is NOT the S&P 500 Index—in spite of the fact that the S&P 500 Index is widely reported and often cited as the "stock market" return.

The S&P 500 Index is a perfectly acceptable index for a client that has a 100 percent large U.S. stock portfolio. But, if the client's portfolio includes U.S. stock, non-U.S. stock, bonds, real estate, cash, and other diversifying assets it is crucial that an appropriate performance benchmark be identified and communicated to the client. Failure to do so creates a situation where performance expectations become misaligned because the performance index being used by the client is not comparable to the asset allocation of



their actual portfolio.

An example of a performance benchmark for a diversified investment portfolio is the 7Twelve portfolio ([www.7TwelvePortfolio.com](http://www.7TwelvePortfolio.com)). Advisors must identify performance benchmarks that are congruent with the portfolios they are building for clients.

To summarize, having a multi-asset investment strategy and the courage to stick with it during up and down markets is a characteristic of successful investors. Long-term investors learn that portfolios ultimately regress to their mean, particularly as the investment holding period lengthens. For equity portfolios that mean return is somewhere around 10 percent (that is, for periods of 20+ years). But, as we have seen, a 100 percent equity portfolio can experience significant performance variation above and below its mean return over shorter time frames such as 10-year rolling periods. It

is precisely that variation that can lead otherwise logical investors to behave badly, such as selling at lows and buying at highs. Conversely, investment portfolios that utilize broad diversification generate returns that are far more stable, and thus consistently closer to the expected mean return.

When investor expectations are reasonable, when appropriate benchmark indexes have been selected, and when portfolio performance is less volatile because of broad diversification, the advisor-client relationship can be much more enjoyable and fruitful. [in](#)

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