

# PORTFOLIO PERSPECTIVES

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## Avoiding Permanent Losses



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Imagine waking up to the news that the apartment building you invested all of your retirement savings into was just swallowed by a sinkhole. If you were fortunate enough to have the building insured against sinkholes you may be OK, but if not, your retirement savings are decimated. This is just one example of the five types of permanent loss that can devastate a portfolio and derail your retirement plans.

### The Black Swans of Permanent Loss

The term black swan is a metaphor used to describe events that are highly unlikely but highly impactful. I consider devastation, confiscation, and deflation to be black swans because they are rare but highly impactful to your portfolio.

Devastation is loss due to disaster — like losing your investment nest egg to a sinkhole. Although rare, the impact to your portfolio can be significant. One way to protect against this is to diversify. Don't put all of your eggs in one basket and then make sure your baskets are geographically diversified. You don't want all of your money invested in companies located in Tornado Alley.

Confiscation is loss due to seizure — for example, Argentina's \$30 billion seizure of private pensions in 2008. Confiscation also takes the form of taxes, like the 15% tax surcharge on retirement plan distributions over \$150,000 imposed during

the 1980s. You can protect your portfolio through diversification and tax management.

Deflation is loss due to declining prices, like during the Great Depression when prices fell by 26%. We've only seen a few deflationary periods since 1926. To protect your portfolio you need cash and bonds, as well as ample diversification.

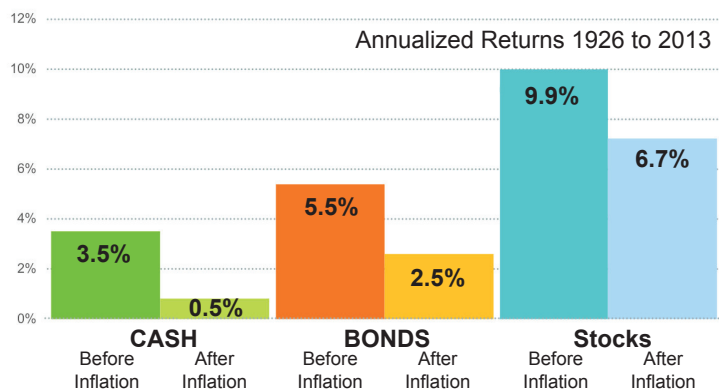
### The Gray Swans of Permanent Loss

Gray swan is a term I'll use to describe events that are highly likely and highly devastating, like inflation and capitulation.

Inflation is loss due to an erosion of purchasing power, which means your dollar buys less and less each year. Historically, over the average 30-year period, inflation has eroded 59 cents of every dollar. That means \$1 at the beginning of a 30-year retirement will be worth only 41 cents at the end of it. You need to more than double your money during a 30-year retirement to maintain your standard of living.

The chart on the next page shows the returns after inflation for various investments since 1926. As you can see, many of the so-called "safe" investments struggle to keep up with inflation. In addition, investments like cash, bonds, and gold have experienced long periods of negative returns after inflation. Stocks on the other hand have done a great job outpacing inflation and have few sustained periods of negative returns after accounting for inflation. However, they are typically riskier investments because of their higher volatility (up and down movement in the value of your assets). Investors with time horizons of less than five years should consider minimizing or avoiding investing in common stocks.

**Inflation Risk: Will Returns Keep Pace with Inflation?**



*Source: Morningstar Direct. Annualized returns before and after inflation. Past performance is no guarantee of future results. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. Stocks are represented by the CRSP 1-10 Index; Bonds are represented by the Ibbotson/SBBI Long-Term Government Bonds Index; Inflation is represented by CPI. Gold represented by London Fix Gold PM PR index. Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Stock investing involves risks, including volatility (up and down movement in the value of your assets) and loss of principal. Investors with time horizons of less than five years should consider minimizing or avoiding investing in common stocks. Bonds are subject to market and interest rate risk. Bond values will decline as interest rates rise, issuer’s creditworthiness declines, and are subject to availability and changes in price. The price of gold may be affected by global gold supply and demand, currency exchange rates and interest rates. Investors should be aware that there is no assurance that gold will maintain its long-term value in terms of purchasing power in the future.*

The other gray swan — capitulation — is loss due to investor behavior, like chasing returns and moving into and out of investments at the wrong time. I calculate that over the last 10 years capitulation cost investors 16.28% on average.<sup>1</sup> That means that, on average, if you invested \$1,000,000 10 years ago you have \$162,829 less today than you could have had.

If you understand the difference between a temporary decline and a permanent loss, then you have a leg up on many investors. Temporary declines are a result of daily, weekly, monthly market movement. The long-term growth of the stock market has been 6.7% adjusted for inflation for the last 88 years. That doesn’t mean the market has earned a positive rate of return every year. There have been 22 down years out of the 88 total years since 1926. The stock market is likely to go down from time to time and declines can be prolonged; however, they have historically been only temporary.

Permanent losses, however, have a real impact on your portfolio and cannot be recovered. Focus on what matters and don’t pay attention to declines that in the long term are most likely temporary.

<sup>1</sup> Source: Morningstar Direct May 2014.

Diversification neither assures a profit nor guarantees against loss in a declining market.

There is no guarantee that the strategies set forth in this article will achieve their intended objectives.

All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

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