

Financially Speaking

With Trisha Arndt, CFP®

Chasing Returns Can Put You Behind the Pack

I had lunch at a restaurant here in town last week and happened to run into someone that I know casually. He dashed over when he saw me to share his latest investment strategy. He had looked over the year-end performance numbers for his 401k investment options and moved all of his money into the one that was “doing the best”. He planned to use this same strategy every year going forward.

Seems like a logical methodology right?

Wrong.

You see, one undeniable fact about investing is that you can't buy past performance. The investment option that he moved all of his money into may have had the best performance last year but there is no guarantee that it will do so this year. In fact, the odds are that it won't.

No one asset class has consistently had the best performance every year. If you look at the Periodic Table of Asset Classes – a summary of how the various asset classes have performed each year historically (as represented by market indexes) – you may be surprised by what you find.

For instance, the best performing asset class in 1999 was Emerging Markets, racking in an astounding 66.42% return (data provided by Zephyr StyleADVISOR). A lot of people rushed into Emerging Markets investments after seeing those numbers, excitedly anticipating great growth on their money.

In 2000 Emerging Markets was literally the worst performing asset class, logging a loss of 30.6% for the year.

Oops.

Similar trends can be found time and time again. The markets tend to be cyclical and unfortunately the “right” place to invest is often the place that is the hardest for we humans to put our money in.

You see, people tend to invest on an emotional level. We are euphoric when something is doing well and we want to be part of it – hence we tend to invest when valuations are very high. Correspondingly, we are disheartened when things aren't going well and our natural reaction is to take our money out or not add to it. This emotional way of handling our investments results in a very interesting phenomenon – investor returns tend to trail the returns of the investments they own, often by a significant margin.

While a limited number of strategies for trying to time the market – i.e. pick the right time to invest – have had some success, a majority of investment professionals, including myself, recommend using an appropriate asset allocation model instead. Asset allocation is the process of dividing your investment dollars among a variety of complementary asset classes so that your portfolio is well diversified. A well-diversified portfolio will rarely outperform the top asset class in any given year, but over time can help manage risk – i.e. minimize the loss years – while providing a solid long term return.

It is important to remember that diversification and asset allocation do not assure a profit or protect against a loss in declining markets. In investing there are no guarantees, only ways to improve your odds.

Diversification is often most appreciated when we enter rough patches in the equity markets, such as the one we have been experiencing so far this year. Why? Because while the equity markets have pretty much all suffered losses, certain sectors of the bond markets have seen nice gains. The gains on the bond portion of someone's portfolio could help, or maybe even completely, offset the losses in the equity portion of their portfolio.

Having an asset allocation strategy can also help you stick to an investment discipline when you are tempted to run. For example, someone with a large number of years to retirement may actually find that market downturns such as this help their long term performance. This is because if they continue to add continuously to equities regardless of market conditions they will be purchasing a larger number of shares per dollar when the values are down.

Each person's asset allocation model will be different as it should take into account their individual risk tolerance and time frames. Most retirement plans today offer some sort of tool to help you determine what yours should be. If you are not familiar with how to locate or use the tools provided contact your human resources department to ask for assistance.

The bottom line is that it generally doesn't pay to chase past performance. Instead, determine an asset allocation that is appropriate for you and have the discipline to stick to it. I think Warren Buffet said it best when he said, "... be fearful when others are greedy and greedy when others are fearful."

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