Section 5
Investment Risk vs. Investment Return

INTRODUCTION

When I did the research for my book, *Peace of Mind Planning: Losing Money is No Longer an Option*, I thought I’d find a uniform way of applying the terms and formulas used by most financial planners (Series 7 licensed advisors who work through Broker Dealers (B/D), Registered Investment Advisors (RIAs), or Investment Advisor Representatives (IARs), etc.)

Not only was that NOT the case, but I found that the use of investment risk is only ½ of the formula needed to help clients figure out what investments are “best” or most “suitable” to help them with their short-, medium-, and long-term investment goals.

The other half of the investment equation is the expected rate of return and how much risk should or must be taken in order to generate certain levels of returns.

My research indicated that the vast majority of investors are taking far too much risk when trying to reach their investment goals. My hope with this material is that it will help change the way people see risk in the investments they choose on their own or ones recommended to them by their advisors.

QUANTIFYING MEASURES OF RISK (in investments)

The following material is not for the faint of heart. Some of it will be a little overly technical, but I hope it will be fully understandable in the end. I will do the best I can to explain things in plain English vs. industry speak.

To me, investing really boils down to whether you agree with the following statement:

“*Investors should NEVER take more risk than is NECESSARY to reach their investing goals.*”

Put another way:

**Investors should take the least amount of risk to reach their investment goals**

If you do not agree with that statement, then you really don’t need to take the time to read this section of the course (it’s for readers who want less risk when trying to achieve their investment goals).

Put another way in a question form: Why would someone invest in something more risky if the potential return is the same as a lower-risk investment? The logical answer from any sane person would be they wouldn’t.

Working on the assumption that it is always better to invest in something less risky than more risky if the potential return is the same, what needs to be done next is to figure out how to measure the risk of an investment.
It sounds like a simple enough task, right? It should be easy to measure the risk of an investment. Sadly, that is not the case. There are more ways to measure the risk of an investment than you can imagine.

I’m NOT going to cover all of them in this course material. Doing so would be overkill and would give readers a headache.

This material will cover some of the more common metrics, and then I’ll do my best with examples to illustrate the risk of some of the more commonly used investments or investment mixes.

I’d like to also let readers know that I’m not just a pontificator when it comes to investment risk. I’ve spent several years and a small fortune developing a risk assessment software program (OnPointe Risk Analyzer). The software can determine the risk tolerance and risk capacity of consumers. It can also score an investment portfolio and be used to design an investment portfolio that is in alignment with the consumer’s personal risk score.

Throughout several sections of the course’s material, I use charts from the OnPointe program. It’s an industry program used by advisors so they can give better advice and more suitable recommendations to clients.

**TERMS**

Before I get into the metrics/number of ways to quantify risk, I want to start by explaining a few terms. Let’s start with risk tolerance.

**Risk Tolerance**—risk tolerance is someone’s personal attitude about investment risk, e.g., how comfortable is someone with dramatic losses in their investment portfolio when the stock market goes negative.

For example, a person who doesn’t like to lose more than 10% of their money at any given time in the stock market has a fairly low risk tolerance. On the other hand, someone who doesn’t mind losing 35%+ at any given time in the stock market has a fairly high risk tolerance.

Risk tolerance is somewhat of an emotional indicator that is driven by someone’s aversion to losing money in the stock market.

**Risk Capacity**—risk capacity is defined differently than risk tolerance. A classic definition of risk capacity is the amount of risk you need to take in order to reach your investment goals (either asset accumulation, income in retirement, or both). Another definition is: What is your financial ability to take risk? This is determined by your income, expenses, and when you need your money for retirement (sooner or later).

Risk capacity is supposed to be more of a facts-and-circumstance determination that takes emotion out of the equation.

The definitions sound simple enough; but when applying it, the definitions seem incongruent (not compatible) to what happens in the real world.

**Risk tolerance** and **risk capacity** do not always align.
An investor might have a **high risk tolerance** (doesn’t mind big losses in the stock market); but because of a limited amount of funds available to generate needed retirement income, there is a **low risk capacity**. In this circumstance, it would be wise to err on the side of caution and use more **conservative investments**.

Conversely, an investor might have a **low risk tolerance** (wants to avoid big losses in the stock market) but a **high risk capacity** due to an excess of assets needed to generate the needed retirement income. In this circumstance, you could argue that it would make sense to invest a little more **aggressively**.

<table>
<thead>
<tr>
<th>Risk Tolerance</th>
<th>Risk Capacity</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>High</td>
<td>No Action Required*</td>
</tr>
<tr>
<td>High</td>
<td>Low</td>
<td>Consider Reallocating to More Conservative</td>
</tr>
<tr>
<td>Low</td>
<td>Consider Reallocating to More Aggressive</td>
<td>No Action Required*</td>
</tr>
</tbody>
</table>

*The no action required boxes are only accurate if investors have an investment mix that matches their risk tolerance and risk capacity.

The previous box is something that can be used as a guide (preferably along with risk tolerance software) to determine whether investors have their money in the right types of investments to match both their risk tolerance and risk capacity.

Unfortunately, the vast majority of investors do **NOT** have investments that match their risk tolerance/risk capacity which is why investment risk software coupled with input from a **good advisor** is needed.

**Correlation**—correlation is a statistic that measures the degree to which two securities move in relation to each other. Correlation is computed into what is known as the correlation coefficient, which has a value that must fall between minus one (-1.00) and plus one (+1.00).

A **perfect positive correlation** means that the correlation coefficient is exactly +1.00. This implies that, as one security moves, either up or down, the other security moves in **lockstep** in the **same direction**. A perfect **negative correlation** means that the correlation coefficient is exactly -1.00. This means the
Understanding Investment Risk

two assets move in lockstep in the opposite directions. A zero correlation implies no relationship at all.

For example: Large cap mutual funds generally have a high positive correlation to the market as a whole. Therefore, most large cap mutual funds will have a correlation close to 1.00. Small cap stocks have a positive correlation to the S&P 500, but it is not as high as a large cap fund. The correlation is generally around 0.80. Real estate (Real Estate Investment Trusts) typically has a low correlation to the stock market. (0.25-0.50).

**Beta**—many people think Beta is a risk measuring tool. Technically, Beta is a volatility indicator, not a risk indicator.

As it relates to investments and finance, the Beta of an investment is a number describing the correlated volatility of an asset in relation to the volatility of the benchmark that said asset is being compared to.

Just as correlation typically uses the S&P 500 for comparison, most use the S&P as the benchmark to measure the volatility of other investments against. By definition, the benchmark itself has a Beta of 1.0. Investments you compare to the benchmark are ranked according to how much they deviate (vary) from the benchmark.

If an investment has a Beta of 0.5, it’s 50% less volatile than the S&P 500. If an investment has a Beta of say 1.3, it’s 30% more volatile than the S&P.

As stated, while volatility doesn’t exactly equate risk, many in the industry will use Beta as a risk indicator (and it makes some sense as long as you are not using Beta as the sole indicator of risk).

While this may be a little confusing, using an example of both Beta and correlation should help.

The S&P has a Beta of 1.00 and is 100% correlated to the market as a whole.

A typical 60/40 mix of stocks to bonds has a correlation of between .97-.99 going back to January of 2000 but a Beta of only .60.

What does that mean? It means that a 60/40 mix goes up and down (is correlated) with the market as a whole, but it’s less volatile (meaning when it goes up and down, it doesn’t go up and down as severely as the market as a whole).

A good way to understand the difference between correlation and Beta is with a chart. The following chart is the S&P 500 and a typical 60/40 mix of stocks to bonds. During the time frame of the following example, a 60/40 mix is .97% correlated to the market (the S&P 500) but has a Beta of only .61 (meaning it’s not as volatile as the S&P 500).

The following chart is from January 2000-December 2009 (the last two big stock market crashes). The green line is the 60/40 mix and the black line is the S&P 500.
You’ll notice that they go up and down in sync (because they are 97% correlated). But the negative return downturn for the S&P 500 is much greater than the 60/40 mix. That’s because the 60/40 mix has a Beta of .61 (61% of the S&P 500).

So, Beta is a good risk metric to know because it tells you how volatile an investment is as compared to the stock market as a whole.

Correlation is good to know as well because it will help you determine how diversified your investments are as compared to the market as a whole. It’s not a good idea to have a significant portion of your investable assets correlated to the stock market (because in a stock market crash all holdings that are highly correlated will follow the market down).

**Rate of Return** (average ROR) vs. **Compound Annual Growth Rate** (CAGR)

This is very important to understand because many times ROR will be used incorrectly by advisors or even in a misleading manner (intentionally or not).

While this seems elementary, there is a big difference between calculating the average ROR vs. the Compound Annual Growth Rate (CAGR). The ROR is the gain or loss on an investment over a specified time period expressed as a percentage.

The compound annual growth rate (CAGR) is the mean annual growth rate of an investment over a specified period of time longer than one year.

The best way to explain the difference is to use an example.

If you start with $100,000 and in year one you generate a 25% return, you have $125,000. If you lose 25% in year two, what do you have? $100,000? Nope.

<table>
<thead>
<tr>
<th>Year</th>
<th>Start of Year Balance</th>
<th>ROR</th>
<th>Growth Balance</th>
<th>Year-End Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
<td>25%</td>
<td>$25,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>2</td>
<td>$125,000</td>
<td>-25%</td>
<td>($31,250)</td>
<td>$93,750</td>
</tr>
</tbody>
</table>
If you averaged the ROR, you’d get zero (25% - 25% = 0%). However, in real life, you only realize the CAGR, NOT the average annual return many brokers and fund managers claim. The CAGR for each of the two years is minus 3.175% (not zero).

Look at the next set of numbers where the average ROR over 10 years is the same 7% for both investments, but the total value again is different.

<table>
<thead>
<tr>
<th>Year</th>
<th>Static ROR</th>
<th>Year-End Balance</th>
<th>Random ROR</th>
<th>Year-End Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 = Deposit $500,000</td>
<td>7.00%</td>
<td>$535,000</td>
<td>0%</td>
<td>$500,000</td>
</tr>
<tr>
<td>2</td>
<td>7.00%</td>
<td>$572,450</td>
<td>7%</td>
<td>$535,000</td>
</tr>
<tr>
<td>3</td>
<td>7.00%</td>
<td>$612,522</td>
<td>0%</td>
<td>$535,000</td>
</tr>
<tr>
<td>4</td>
<td>7.00%</td>
<td>$655,398</td>
<td>3%</td>
<td>$551,050</td>
</tr>
<tr>
<td>5</td>
<td>7.00%</td>
<td>$701,276</td>
<td>14%</td>
<td>$628,197</td>
</tr>
<tr>
<td>6</td>
<td>7.00%</td>
<td>$750,365</td>
<td>12%</td>
<td>$703,581</td>
</tr>
<tr>
<td>7</td>
<td>7.00%</td>
<td>$802,891</td>
<td>0%</td>
<td>$703,581</td>
</tr>
<tr>
<td>8</td>
<td>7.00%</td>
<td>$859,093</td>
<td>6%</td>
<td>$745,795</td>
</tr>
<tr>
<td>9</td>
<td>7.00%</td>
<td>$919,230</td>
<td>18%</td>
<td>$880,039</td>
</tr>
<tr>
<td>10</td>
<td>7.00%</td>
<td>$983,576</td>
<td>10%</td>
<td>$968,043</td>
</tr>
</tbody>
</table>

Average ROR 7.00% 7.00%

$983,576 = Average ROR total
$968,043 = Random rate of return total using the CAGR to tally the numbers

Difference = $15,533

The point with this section of the material is to make sure readers know the difference so they can make sure they are looking at the CAGR numbers when reviewing different investment options, NOT the average ROR.

**RISK METRICS**

I wrote a 57-page white paper for advisors so they could better understand investment risk. As I was preparing this course material, I thought I would include a substantial part of that paper in this section of the course. After re-reading it, I’ve come to the conclusion that it’s too technical and will be somewhat, if not very, confusing for the average reader. As such, I’m NOT going to cover the following risk metrics that are used in the financial services industry.

- Standard Deviation
- Downside Deviation
- Sortino Ratio
- Sharpe Ratio
- Value at Risk (VaR)
- Calmar Ratio
- R-Square
Don’t feel bad if you have never heard of most or all of the items on this list. Most financial planners are not familiar with most of them (even though they should be).

Also, for the record, I’m not a fan of Standard Deviation (SD) (a favorite risk metric used in the financial services industry). In short, SD punishes investments that have volatility to the upside. Since I’ve never heard a consumer complain when their portfolio spiked up 10, 20+ percent to the upside, I don’t agree with it being used as a primary metric when measuring the risk of an investment.

Do you need to know the list of risk metrics in the previous list in order to make informed decisions about your investments? Not really.

However, I do believe there is one metric you need to become familiar with and that’s maximum drawdown. Why? Because this metric is one that tells you more than the rate-of-return story tells. It’s a metric that really crystallizes the risk of an investment and can and should be used by consumers and their advisors when deciding which investments to choose (like ones that have similar rates of return with the least amount of maximum drawdown).

“Maximum Drawdown”— maximum drawdown of a period of time is defined as the maximum percentage loss from a peak to a trough after the peak.

The following chart of SPY (SPDR S&P 500 ETF) between 2005 to the end of 2012 shows the maximum drawdown of this period (-50.78% (monthly average number)) as well as the secondary large drawdown (-16.22% (monthly average number)) in 2011. The drawdown valuations are monthly valued (which is what most software uses for valuation purposes. If daily valued, the drawdowns would be -55.2% and -18.6% respectively).

In English please…ok, so, from 2005 to 2012, the S&P 500 generated an average rate of return of 4.9%. To generate that ROR, the client had to risk a 50%+ loss over that time frame. If your advisor asked you if you would have been happy with an average rate of return of 4.9%, you might say that’s ok; but if he/she added that to achieve that return you’d have to risk a 50%+ loss of your money to do so, what would you say? NO WAY!
Also, the problem with losses is that it’s not good enough to earn the same rate of return in a positive direction the year following a loss. That will not get the investor back to even. Look at the returns an investor would need to earn after a loss to get back to the same value before the loss (and this does not include fees).

<table>
<thead>
<tr>
<th>Amount of Loss</th>
<th>% Gain Needed to Recover the Following Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>25%</td>
</tr>
<tr>
<td>30%</td>
<td>42.9%</td>
</tr>
<tr>
<td>40%</td>
<td>66.7%</td>
</tr>
<tr>
<td>50%</td>
<td>100%</td>
</tr>
</tbody>
</table>

For example, if an investor started with $100,000 and had losses of 50%, what would the investor need to earn the next year to get back to the starting balance? 100%. Many people think the percentage is 50% (it sort of logically makes sense, but it’s not correct).

$100,000 \times -50\% = 50,000$ (new account value after loss).

$50,000 \times +50\% = 25,000$ (leaving an account balance of $75,000, or $25,000 short of the starting balance). As the chart indicates, the investor would need a return of 100% on their money to get back to the starting balance.

It is this key point that drives me to seek out wealth-building tools designed not to go backwards (but still offering good upside gain when the market is moving in a positive direction).

Here is an interesting chart of a few of the more popular mutual funds. The chart shows their maximum drawdown numbers from the 2007 stock market crash and the required rate of return to break even.

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Maximum Drawdown</th>
<th>Return Required To Break Even</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fidelity Contrafund</td>
<td>-46.34%</td>
<td>86%</td>
</tr>
<tr>
<td>American Funds Growth Fund of America</td>
<td>-48.80%</td>
<td>95%</td>
</tr>
<tr>
<td>Franklin Income Fund</td>
<td>-39.07%</td>
<td>64%</td>
</tr>
</tbody>
</table>

This is what really upsets me about the mutual fund industry. They do not provide these easy-to-calculate statistics that investors and their advisors should have before determining if a mutual fund’s risk is worth its potential/expected rate of return.

In 2011, the S&P 500 was up only 2.11%. However, the maximum drawdown was -16.22%. So, again, I ask you, if you understood the maximum drawdown risk in 2011, would you have risked 16.22% of your money to generate a 2.11% rate of return? NO WAY!

Did you know that 2011 was the most volatile year in decades?
As I just stated, the S&P 500 was up 2.11% for 2011. That doesn’t seem volatile. If an investor only looked at his/her investment statement on January 1, 2011, and then again on January 1, 2012, he/she would see that 2.11% return. As such, the investor might think it could have been a better year but that it was nice to have some amount of positive returns over the year.

But I just asserted that 2011 was a hugely volatile year. Let’s look at a chart that will illustrate the volatility.

Overall, the S&P had approximately 13 countertrend moves of approximately 7% or greater. There were six instances where the S&P 500 index had a drawdown of -7% or more during 2011.

If six 7%+ drops don’t get an investor’s attention, maybe a -16.22% drop will? I think so, and that’s exactly what happened in 2011.

What does a -16.22% drop look like on paper?

If you had $100,000 at the peak in 2011 right before the drop, you’d have $83,780 after the drop—a drop that took place in approximately 30 days.

Even for investors who think they don’t mind risk, a -16.22% drop in asset values in approximately 30 days will test anyone’s resolve. Even a buy-and-hold investor who doesn’t normally watch the markets on a daily, weekly, or even monthly basis is forced to sit up and take notice of a -16.22% drop in such a short period of time.

What percentage of investors sold some or a good portion of the equities near the bottom of the -16.22% drop in 2011? If you’ve read the DALBAR Study, you’d probably say most investors.

When would the investors who sold near the bottom get back in? Again, the DALBAR Study would suggest that they would come back into the market nowhere near the bottom.
Understanding Investment Risk

When coupling selling at or near the bottom with getting back into the market well after the upswing has occurred, investors end up losing much of their asset values.

We have very specific data going back 50+ years. When you analyze that data, what becomes clear is that it can be very risky to invest in the stock market.

To get a better feel for how risky, let’s look at the drawdown percentages of the S&P 500 from 2000 to 2012 (data covering the last two stock market crashes).

The following data about "Maximum Drawdown Risk" (MDR) was obtained from Fasttrack. It’s fascinating.

Most investors and even most advisors don’t have any idea that the maximum drawdown risk of the S&P 500 on average from 2000-2012 (a period of time during which we had our two last major market crashes) was -13.5% (computed over a 12-month window) and -19% (when computed daily).

Do you think this is good information for investors to have so they can make informed decisions about investing in the S&P 500 or other investments (mutual funds, bonds, REITs, etc.)? Of course, which, again, is why I decided to write this course.

I believe IF consumers understood the amount of risk they were actually taking to achieve the investment results they are receiving in most, if not all, of their investments, they would seek other alternatives.

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500 12-Month Moving Windows Computed Yearly</th>
<th>S&amp;P 500 Computed Daily</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>-13.12%</td>
<td>-17.20%</td>
</tr>
<tr>
<td>2001</td>
<td>-23.12%</td>
<td>-29.70%</td>
</tr>
<tr>
<td>2002</td>
<td>-28.36%</td>
<td>-33.75%</td>
</tr>
<tr>
<td>2003</td>
<td>-4.08%</td>
<td>-14.05%</td>
</tr>
<tr>
<td>2004</td>
<td>-3.31%</td>
<td>-8.16%</td>
</tr>
<tr>
<td>2005</td>
<td>-4.00%</td>
<td>-7.17%</td>
</tr>
<tr>
<td>2006</td>
<td>-2.88%</td>
<td>-7.70%</td>
</tr>
<tr>
<td>2007</td>
<td>-4.85%</td>
<td>-10.09%</td>
</tr>
<tr>
<td>2008</td>
<td>-37.66%</td>
<td>-48.76%</td>
</tr>
<tr>
<td>2009</td>
<td>-18.18%</td>
<td>-27.62%</td>
</tr>
<tr>
<td>2010</td>
<td>-12.80%</td>
<td>-15.99%</td>
</tr>
<tr>
<td>2011</td>
<td>-16.26%</td>
<td>-18.60%</td>
</tr>
<tr>
<td>2012</td>
<td>-6.60%</td>
<td>-9.94%</td>
</tr>
<tr>
<td>Average</td>
<td>-13.48%</td>
<td>-19.13%</td>
</tr>
</tbody>
</table>
If the previous chart doesn’t get your attention about how much risk the average investor is taking when in equities, nothing will. The chart covers the time frames for our stock market’s two big crashes in recent memory, and it should be quite the eye-opener.

What do you think about the average drawdown risk on a daily computed basis in the S&P 500 being -19.13% and -13.48% on an annual basis?

When it comes to risk, what do you think? Do you want to invest in the “least risky way to achieve your goals”? As every S&P 500 investor found out during the last two stock market crashes, there is nothing low risk about being invested in the index.

I don’t want to sound too redundant, but this is a major problem with the financial services industry. Many financial planners are brainwashed by their Broker Dealer or RIA firm to think that, to achieve market rates of return, you have to be in the stock market. This leads to a reliance on what many call the outdated Modern Portfolio Theory (asset allocation investing) which had led just far too many investors to take on more risk than is necessary to achieve their wealth-building/retirement goals.

**Summary on Risk Formulas/Indicators**

It is my hope with this section of the course material you were able to get to learn about some of the risk indicators that “professional” money managers/financial planners are supposed to use when helping clients pick investments.

You may choose to do more research on one or more of these indicators and choose to use the indicator you like best over another when determining the most suitable investments for your clients.

Ideally, the advisors you use would use multiple indicators to help you choose suitable investments for individual situations.

**Determining the “Best” Money Management Platform**

This is the Holy Grail of questions. What is the “best” money management platform? Depending on the type of advisor you work with, you will get a different answer.

I will list in the coming pages only a few of the typical money management platforms used by Broker Dealers, RIAs, and “fee-only” planners. The list is certainly nowhere near exhaustive considering there are dozens of platforms and variations of certain platforms that are used.

Different platforms can be designed for different types of investors. Short- or long-term investment horizons can use dramatically different platforms. Investors can be very conservative or want maximum growth regardless of risk; and depending on either, as well as the time frames involved, they may use one platform over another.

Again, my goal is not to cover every platform for every type of investor. My goal is to discuss some of the more widely used platforms and to point out the
pros and cons of each platform from a risk perspective. Doing so will lay the foundation for a discussion about the best overall platform for the majority of most investors based on a risk vs. reward point of view.

**Absolute Return vs. Relative Return**

Before I list and discuss the most common investment platforms, it’s important to make a distinction between absolute return and relative return.

**Absolute return** measures the return that an asset achieves over a certain period of time (negative or positive). The focus is on achieving a certain rate of return over time and can consider risk into the equation (limiting risk to a certain level).

**Relative return** isn’t trying to generate a specific rate of return over time; but, instead, the concern revolves around comparing its returns to other similar investments or a benchmark.

In general, a **mutual fund** seeks to produce returns that are **better than its mutual fund peers** in its category and/or the market as a whole. This type of fund management is referred to as a **relative return** approach to fund investing.

As an investment vehicle, an **absolute return fund** seeks to make positive returns by employing investment management techniques that differ from traditional mutual funds.

Put another way, it’s not that a mutual fund doesn’t care if it has a positive or negative return; but the main concern is **beating other similar mutual funds** in its category or sector or beating the seemingly elusive benchmark such as the S&P 500. This is a relative return.

A **relative return** investment is always reaching for positive growth or, in the alternative, avoiding negative years as its mandate and doesn’t concern itself with peers or benchmarks.

Most investors don’t know that most mutual funds by their own prospectus are **forced to be invested** in the stock market with 80% of their money. As such, the investments it picks are important when comparing it to other similar mutual funds which also have to be invested with 80% of their money.

Unfortunately, even when the **stock market is crashing**, these funds must stay invested with 80% of their money (which is why mutual funds crash right along with the stock market in general and their corresponding index).

As a **relative return** investment, a mutual fund that **lost 50%** from the highs of 2007 to the lows of 2009 still could be a **highly rated fund** with a good reputation because the S&P 500 index was down **59%** over the same time frame.

Using that same example with an **absolute return fund**, if it went negative in **any significant manner**, the chances are that the fund manager would **not be happy** because the design which many times would allow the flexibility to go to all cash or safer alternative investments may have failed.
It’s sort of ironic that a mutual fund seen as a relative return vehicle could be seen as a success with a 50% loss, and an absolute return fund with a loss of say 10% over the same time horizon could be seen as a failure.

**Active vs. Passive Investing**

Another important concept to briefly discuss is that of active vs. passive investing.

A simple explanation of active investing is that an investor or fund manager believes they can pick the best stocks in the market that will have the best returns. This also means that the investor or manager believes they know when to get rid of (go to cash) or buy an investment at the right time so as to minimize loss and maximize gain.

Passive investing, on the other hand, is a strategy where the investor or fund manager invests in accordance with a pre-determined strategy that doesn’t entail any forecasting or decision making when it comes to the right time to buy or sell.

A good example of passive investing is when someone invests in the S&P 500 stock index. A passive investor thinks that the market as a whole over time will outperform an actively traded platform that tries to “beat the market.” This has proven to be the case between 80-85% of the time if you believe the Motley Fool statistics.

**Hybrid Investing**—you can be a passive investor and buy actively traded funds. For example, you have a buy-and-hold mentality (one of the platforms discussed in upcoming pages). However, instead of buying and holding the S&P 500 index, you choose to buy and hold a tactically managed (actively traded) fund. The manager of that fund is going to actively trade the fund, but the passive investor simply holds the fund (vs. trying to time when it’s best to buy and sell the fund over a short-term basis to minimize losses and maximize gains).

**DALBAR Active vs. Passive Study**

Recently there has been a huge shift in the industry from active management to passive money management. The following are all getting a lot of play these days, and they are all passive investment strategies:

1) **John Bogle from Vanguard** talking about how great index funds have done over time.

2) **Robo platforms** that are mostly passive investment models.

3) **Target retirement funds** (like a 2030, 2040, etc., fund firms offer).

4) **Asset allocation strategies** (a passive buy/hold/reallocation strategy that has been around forever and is still used by most of the industry).

In 2017, DALBAR put out a one-time study on active vs. passive investing. It indicates that historically active investments generally generate lower returns than passive investments. However, passive investments are more vulnerable to behavioral influences that are costly to investor returns.
The question addressed by the DALBAR study is the extent to which the historical performance advantage of passive investments is eroded by behavioral influences.

The study does NOT deal with what some unrealistic investor who has NO emotions over time but what the real world "average investor" does when the market crashes (and how does that affect what they do with their active vs. passive investments).

In other words, do investors with passive investments have more of a tendency to sell at the wrong times vs. those who use active investments (because the active manager is supposed to be doing the buying and selling, not the investors)?

While the DALBAR study is seven pages filled with information comparing and contrasting the pros and cons of both passive and active investing, the following chart has its summary numbers:

<table>
<thead>
<tr>
<th>Period Ending 12/31/2016</th>
<th>Annualized Investor Returns</th>
<th>Active Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actively Managed</td>
<td>Passive Funds</td>
</tr>
<tr>
<td>15 Year</td>
<td>4.04%</td>
<td>2.85%</td>
</tr>
<tr>
<td>10 Year</td>
<td>4.37%</td>
<td>4.37%</td>
</tr>
<tr>
<td>5 Year</td>
<td>8.51%</td>
<td>8.12%</td>
</tr>
<tr>
<td>3 Year</td>
<td>3.66%</td>
<td>5.40%</td>
</tr>
<tr>
<td>1 Year</td>
<td>6.73%</td>
<td>9.38%</td>
</tr>
</tbody>
</table>

I found the study fascinating. Over longer time frames, active investing (buying and holding funds where money managers actively trade) did better than passive buy/hold investing. Why? Because the full DALBAR investor behavior study indicated that most passive investors buy and sell at the wrong times (they panic sell). The result is lower returns than the investor who just buys and holds actively traded funds.

**Monte Carlo Simulations (MC)**

Because I couldn’t find any other logical place to explain MC simulations and the pros and cons, I’m putting it here, just prior to going over the types of money management platforms.

MC simulations are used to model the probability of different outcomes in a process that cannot easily be predicted due to the intervention of random variables.

MC simulations are named after the gambling hot spot in Monaco, since chance and random outcomes are central to the modeling technique, much as they are to games like roulette, dice, and slot machines.

In the financial services industry, there is a standard way to run MC simulations. Computer programs (like our OnPointe Risk Software) run the
numbers, and most advisors don’t fully understand how they are calculated. I will attempt to explain in plain English how the numbers are generated as best I can.

What is MC simulating? MC simulates the future investment return of the asset that is being tested (stock, mutual fund, EFT, etc.). The user chooses the number of times the simulation will run. Most programs run at least 5,000 simulations. If you plotted them on a chart, it might look something like the following.

After the simulations are completed and after the numbers are created, a software program would create one smooth looking line to illustrate what the most likely outcome would be for an investor based on the data from the 5,000 simulations (or whatever number of simulations is picked).

In my 5,000 MC simulation example, there are truly 5,000 unique outcomes. Investors could receive returns from any one of the 5,000; but, again, the MC simulation plots the most likely outcome.

Why I don’t like MC simulations

Advisors love to use MC simulations when selling the asset mix they propose clients use to grow their wealth. Advisors love to show the smooth upward trending line and saying that the line is the 95% probability line.

What the smooth line ignores is that many of the 5,000 simulations had bad outcomes. The smooth line doesn’t illustrate that there will be another market crash and how that would affect the investor’s money.

When we put together the OnPointe Risk Software, we used MC simulations in their traditional manner; but we also selectively picked out a positive and negative (above and below the smooth line) simulation out of the 5,000 run to show how investors could, in the real world, get a much better or a much worse outcome than what the smooth line indicates.
Let’s look at an example from the OnPointe Risk Software.

Assume the following:

- **Age:** 40
- **Initial amount to invest:** $10,000
- **Annual contributions to investment account:** $10,000
- **Age to begin withdrawals:** 65
- **Amount to withdraw annually:** $75,000

I am not going to take into account taxes (income or capital gain), money management fees, or just about any other variable you can think of. This is just a simple example to illustrate why I don’t like the smooth line of an MC simulation.

The investments I’m going to run the comparison on are a 60/40 mix of stocks and bonds and the S&P 500. The MC simulation will simulate the rate of return on investment.

On the next page, you’ll see the charts. Let’s first look at the classic smooth lines. I say lines because we put three lines on the OnPointe charts.

The **blue line** illustrates the 50th percentile value. In other words, it’s the 2,500th best simulation of 5,000 ending results.

The **green line** is the 75th percentile value. In other words, it’s the 3,750th best simulation of 5,000 ending results. You would only beat this in 25% of the simulations.

The **red line** is the 25th percentile value. In other words, it’s the 1,250th best simulation of 5,000 ending results. You would generate returns of at least this amount in 75% of the simulations, and your returns would be similarly dismal 25% of the time.

While most of the industry ONLY shows clients the **blue line**, I wanted software that was more real world so investors have a better idea of the good, and, more importantly the bad outcomes. So, 25% of the time the investor in my example might get lucky and get the **green line**, or 25% of the time the investor could get unlucky and get the **red line**.

The lines are smooth on the following chart because they represent the median value for each interval of the simulation. See the following side note for a discussion about calculating the median value.
The red line in the OnPointe chart should do more than make people sad. It should be a real wake-up call when they discuss retirement planning with their advisor.

While we think the OnPointe Software with the three smooth lines is already doing more than any other program in the market to show what can happen in the real world, it’s the next set of charts that I really like.

The next set of charts not only have three different lines, but you’ll also instantly notice that they are NOT smooth.

Why NOT smooth? Because money does not grow or decline in smooth lines. Most investments don’t grow or decline at a linear rate of return. They go up and down in very unpredictable ways.

Every time you run the MC simulator using the OnPointe Software, it will randomly illustrate three different lines. Sometimes the green line will turn out best (which is what you would expect) but sometimes not. Sometimes the red line turns out the best, which on its face doesn’t make sense until you understand just how random returns really are.

Remember, when you run 5,000 simulations, some are really good, and some are really bad. Most are somewhere in the middle but almost none of them would be illustrated with a smooth line.
Why show the squiggly lines in outputs? To illustrate that no investor or advisor can predict what will happen and that the investor not only needs to understand this, but they also need to plan for randomness (especially negative randomness like the 2000-2002 crash or the 2007-2009 crash).

Summary on Monte Carlo

Monte Carlo is a useful tool in the financial services industry. The problem is that the results may not always be used correctly by advisors. Selling off one smooth 95% probability line may be the easiest way to make a sale, and consumers need to be aware of this so they can choose to work with an advisor who wants to put forth a more realistic plan for them to consider.

INVESTMENT PLATFORMS

As I indicated in the beginning of this material, in order to fully understand investment risk, you also need to look at investment returns. Your advisors should be seeking out investments that have the best risk adjusted rate of return that also fits in with their clients’ risk score. So far I have talked about quantifying risk. The other side of the coin that needs to be discussed is the platforms advisors use to generate investment returns.

The first four investment platforms I’ll discuss in the upcoming pages are what I consider passive investment strategies. Let’s start out with the granddaddy of them all—the Modern Portfolio Theory.
Modern Portfolio Theory (MPT)

This is the oldie but goodie that many large brokerage firms use. All I had to do was go to Google and type in the words and all sorts of information came up.

One prominent financial planning website stated the following with respect to the MPT:

*According to MPT, a portfolio of non-correlated assets — distributed across the risk spectrum — can lower the overall risk of a portfolio.*

TD Ameritrade also came up and had pages of information about this investment platform. To read the full summary, please click here.

The TD Ameritrade site stated the following as it pertains to MPT:

If you decide to invest your hard-earned money, you naturally want to minimize your risks and maximize your potential returns. This is the basis of Modern Portfolio Theory (MPT). Developed by Nobel Laureate Harry Markowitz and refined by other noted economists over the years, MPT suggests that you can limit the volatility in your portfolio while improving its performance by *spreading the risk among different types of securities* that don't always behave the same way.

I’ve underlined and italicized parts of the above that I think are interesting.

So, MPT is designed to minimize risk and maximize returns by “spreading the risk.”

The TD Ameritrade site goes on to show the following chart as an example of spreading the risk.

In “theory,” and to some extent in practice, the above model will work. The client, if following the above chart, will have U.S. Large and Small Cap stocks, Emerging Market stocks, U.S. Bonds, Cash, etc.
The “theory” is that, when one sector of the economy tanks, hopefully, the other will not; and the investor will be partially protected against that loss. Also, when one sector of the economy booms, while the others do not, at least the investor will have X amount of the money in the booming investment.

The risk is then spread between no-risk investments like cash/CDs and riskier international or private equity investments.

The advisor helping clients grow wealth with MPT will use certain data to choose the investments in each sector.

**What’s wrong with MPT?**

It depends on whom you ask. There are many critics of MPT. The following are some of the reasons certain “experts” do not like MPT:

- **It’s outdated.** It’s a theory from the 1950s; and while the market conditions from approximately 1982-1999 made MPT look like the best way to invest money, if you followed MPT since then, your returns would not be as promised.

- **It’s too rigid.** MPT is too focused on diversity for the sake of diversity. There may be times that it is prudent for clients to be so diversified in a portfolio, but the real question is whether it’s necessary at all to be this diversified.

Then there is the question about reallocating the portfolio (changing the investment mix). Who is responsible for that, and how do they know when to reallocate and more heavily weight one sector over another?

In other words, how does MPT deal with the unexpected (like the stock market crashes in 2000-2002 and 2007-2009 as well as the most volatile year in many years (2011 when there were six mini-crashes within the year))?

- **It depresses gains.** Because MPT forces investors to put X amount of their money into fixed- or low-return investments, the overall performance of an MPT portfolio will underperform other investment platforms.

- **Drawdown risk of individual investments is all but ignored.** For me, this is the biggest problem with MPT. It is **NOT set up to limit drawdown risk** in the manner that I would like to see drawdown risk mitigated. When the platform calls for Small Cap funds, options, international equities, etc., the drawdown risk of such investments is significant. MPT seems to offset this by having X amount in fixed return investments, but this is not my idea of mitigating risk in a manner that truly protects a client and helps them achieve their wealth-building goals.

**Standard Deviation (SD)**

While I chose not to explain SD in this material (it’s quite confusing), what I did state is that I DO NOT like SD as a risk metric. Why? Because it deems an investment volatile even if the volatility is to the upside.

Again, I’ve never heard an investor complain that their investments had a sudden upward spike (positive return). SD punishes investments that have
volatility to the upside; and, as such, we don’t even use it as a metric in the OnPointe Risk Software.

Guess what MPT uses for its primary metric? Yep, SD.

Let me leave you with this thought about MPT. Do you remember what happened in 2008? There was panic selling that led to widespread liquidation of asset holdings. As a result, equities, bonds, and commodities were ALL pushed down at the same time.

Spreading risk as MPT suggests left millions of investors crying in their soup. MPT failed them at the time when a risk-averse platform was needed most.

Does the following chart showing the 2008 crash look like an MPT portfolio made up of 60% stocks to 40% bonds (a typical MPT mix) do a good job protecting investors (losses were in excess of 30%)?

In my opinion, portfolios need to be nimble and be able to react to an ever-changing environment; and MPT simply is not capable of doing so. MPT forces clients to stay in the market (vs. being able to move into all or mostly cash); and, as so, it is an investment platform incapable of truly protecting clients from market risk.

**Buy and Hold**

It’s sort of odd to hear financial planners call this an investment platform. If investors want to buy and hold, it’s hard for a financial planner to justify an annual fee for services rendered (and, therefore, a strict buy-and-hold strategy is not one usually recommended by a financial professional).

This is more of an investment philosophy of a consumer who doesn’t know what to do but has read something in *Money Magazine* or a book telling the reader that the market usually will correct itself; and if you “stay the course,” you will earn long-term growth.
History has sort of proven this to be true. In the 2019 version of the DALBAR Study, it indicated that the S&P 500 index averaged 11.70% going back five years ending in 2020.

However, the DALBAR Study also indicated that the “average” equity investor (mutual funds) earned 5-year returns of only 7.79% (3.91% less than the benchmark index).

The statistics support the concept that buy and hold works. If that’s the case, why does the average investor earn returns that are significantly less than what a buy-and-hold philosophy would generate?

It’s simple. The average investor doesn’t buy and hold (even though they think this is their strategy). They “panic” sell when the market tanks (statistical data backed up in the annual DALBAR Study). In fact, investors have proven to be terrible market timers and usually get out near the bottom of bear markets.

Even if we give the benefit of the doubt to a buy-and-hold investor, why still does buy and hold not work for most investors?

Let me ask this question: When should a retired person or someone nearing retirement get out of the market (this assumes that a senior/retired person shouldn’t be in equities forever)?

For example, say someone was thinking of retiring in 2008 or 2009. When should that person have removed his/her money from a buy-and-hold equity position? The day he/she retires? A year early? Two years early? A year after retirement? At a specific age like age 65?

What if the person did what many people do which is to go conservative right at retirement? If my example person retired in 2009, how did that work out? He/she would have gone through a major stock market crash, and their retirement would have been forever altered in a very negative manner.

Indexing

What is an index fund? An index fund describes a type of mutual fund whose investment objective typically is to achieve approximately the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

In layman’s terms, an index fund is invested in the companies listed in the index. So the S&P 500 has 500 stocks, and the index would invest in those stocks to achieve its return.

Ever since Vanguard rolled out and started heavily marketing index funds, many clients and, surprisingly many so-called experts like John Bogel, the founder of Vanguard, think this is the only way to grow wealth in the stock market.

Why grow wealth with index funds? There are three main reasons.
1) **They are cheap.** Like many investors, index funds are cheap. The cost of an index fund is a fraction of what it costs to invest in a mutual fund and much less than that of tactically managed funds.

2) **Most mutual funds don’t beat indexes.** We’ve all seen the Motley Fool data that indicates that 80% of the mutual funds (now closer to 85%) don’t beat their corresponding indexes. Given that fact, why wouldn’t a client want to use mutual funds vs. index funds?

3) **Risk mitigation.** Because an index fund invests in a large number of stocks, if one or a handful of the companies in the index don’t do well, their poor returns do not significantly affect the returns of the overall index.

   It sounds great, right? Low fees, beating mutual fund returns, low risk, etc. But what’s the problem with indexing?

   Indexing can be seen as a buy-and-hold strategy or can be seen as a market-timing strategy. Either way you categorize it, using index funds to grow wealth has the same problem as outlined in the buy-and-hold strategy. When do you get in and when do you get out of the fund? The average consumer has NO idea; and as the DABLAR Study indicates, the average investor is terrible at market timing (investors are professionals at buying high and selling low).

**Tactical Money Management**

   Tactical money management is simply another term used for active management (vs. passive management).

   As indicated in the new DALBAR Active vs. Passive Study, most of the time, passive investing has done better than active investing **IF the client buys and holds.**

   However, those who buy and hold and who do NOT sell at the right time can get slaughtered.

   As stated, mutual funds have significant constraints (like being forced to be 80% invested in the market at all times which prevents them from avoiding large drawdowns in market crashes).

   Tactical money managers do **NOT have the same constraints** as most mutual funds.

   Many tactical managers can **go to all cash** if they think the market is due for or in a correction or crash period. Some tactical managers can **invest in an inverse manner** when the stock market is going down in an attempt to generate returns in the down market.

   Generally speaking, tactical money managers do well when the stock market has direction (such as when the market is in a significant downturn or has a large upswing). Tactical managers typically do **not try to beat benchmarks** like the S&P 500. Most have a particular style that they strictly adhere to with their most important goal, which is to avoid large drawdowns in the stock market.
There are a number of different styles of tactical managers (too many to cover in this material). Some use indexes to drive returns. Some have rotating high yield bond portfolios. Some go in and out of the government bond market. Others invest, for example, in the top 10 dividend paying stocks in each sector of the market. And others invest in what they perceive as the best 30-stock of the S&P 500.

No matter the strategy, tactical means active which means that the managers use their proprietary models to mitigate drawdowns in the stock market.

**Comparing Tactical to Asset Allocation and the S&P 500**

While I just stated that tactical managers do not try to beat the indexes or any particular asset allocation model, the fact of the matter is that investors want to see a comparison.

For this comparison, I’m going to use a grouping of tactical managers offered by an RIA I recommend advisors use.

The following chart is from the OnPointe Risk Analyzer program. The comparison is between the S&P 500, a 60/40 mix of stocks to bonds, and a group of tactical managers (a sleeve of managers) made up of five tactically managed strategies. The time frame for the comparison is March 2007 to March 2017. Why this time frame? I wanted to pick a 10-year window that has a market crash and several good bounce-back years.

What you’ll notice is the following:
- Risk score of the S&P 500 is **72** (scale to 100).
- Risk score of the sleeve of tactical managers is **28**.
- Risk score of the 60/40 blend is **43**.
- The **compound annual growth rate** (CAGR) for the S&P is **7.43%**.
- The CAGR for the sleeve of tactical managers is **12.9%**.
- The CAGR for the 60/40 blend is **6.11%**.

It’s interesting to note that the CAGR for the tactical manager is “net of fees.” I did NOT take a money management fee or wrap fee out of the returns of the S&P 500 or the 60/40 blend. If I did, the returns would be less.
The left graph above is the CAGR chart (how money actually grows).

The chart on the right is the drawdown chart. That’s the chart that really gets your attention when you look at the historical drawdown of the S&P 500 and a typical 60/40 blend of stocks and bonds. To most clients (and to many advisors), this is a real eye opener.

If we go back to the baseline question I think every investor should be asked (should you be taking more risk than you need to in order to reach your retirement planning goals?), it’s tough to make an argument for why high quality tactical money managers shouldn’t be used as part of a client’s portfolio.

Performance and Risk Metrics

One of the nice things about the OnPointe Risk Analyzer program is that it lists several performance and risk metrics in the same output as the chart from the previous page.

The risk metric that most investors care about is maximum drawdown (maximum loss). But as discussed earlier in this section, Beta and correlation are also important. Remember, Beta is a volatility indicator; and correlation measures how in sync an asset is with the market as a whole.

As you can see, the S&P 500 has a Beta and correlation of 1.00. That makes sense since it’s the benchmark most investors use.

The tactical sleeve is only 51% correlated to the market and has much less volatility.
A 60/40 blend has much less volatility; but because bonds are now very correlated to the market as a whole, the correlation of the entire blend is 99% (not very diversified).

<table>
<thead>
<tr>
<th>S&amp;P 500</th>
<th>Tactical Sleeve</th>
<th>Stocks/Bonds (60/40)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Max Drawdown</td>
<td>-50.78%</td>
<td>-11.45%</td>
</tr>
<tr>
<td>Beta</td>
<td>1.00</td>
<td>0.33</td>
</tr>
<tr>
<td>Correlation</td>
<td>1.00</td>
<td>0.51</td>
</tr>
</tbody>
</table>

**Summary on Tactical Money Management**

The point with the section of this material on tactical money management isn’t to make anyone an expert in the many different tactical strategies and how they work.

The point is to let advisors know that these investment strategies are out there, and that the good ones can be extremely helpful when trying to put together a “suitable” mix of investments to help you reach your investment goals with the least amount of risk.

**MITIGATING INVESTMENT RISK USING FIAs**

In the Fixed Indexed Annuities (FIAs) section of the annuity module (page 10), I illustrated why FIAs, when used as an asset in a portfolio, don’t harm the rate of return over time by much, or can even help with the rate of return depending on the time frame.

If you didn’t read the annuity material yet, FIAs are annuities with the following characteristics.

- **100% principal protection** (your money will never go backwards due to negative returns in the stock market).

- **Gains** in a stock index are locked in every year.

Many FIAs come with the following characteristics:

- A guaranteed rate of return (accumulation value) between 5-7%* on an accumulation value (not walk away value) that is used to calculate/provide for you a guaranteed lifetime income* you can never outlive.

  *Any guarantees mentioned are backed by the financial strength and claims-paying ability of the issuing insurance company and may be subject to caps, restrictions, fees and surrender charges as described in the annuity contract

However, as I discussed in the Bad Advisor section of this course, many advisors are not familiar with and/or do not use FIAs (which is an outrage).

For this section of the material, I want to show a simple comparison example of how an FIA can help mitigate investment risk.

I will compare the S&P 500 to a mix of 70% of the money in the S&P 500 and 30% of the money in an FIA with a 5.5% annual point-to-point cap on the growth.
Which one do you think should have a greater rate of return over the time? The S&P or the S&P with 30% in a product that locks in gains annually but where gains are capped at 5.5% a year (meaning that, if the S&P returns 20% in the FIA, the return is still 5.5%).

Most people would say the mix with the FIA should lag or significantly lag behind putting 100% of the money in it because there is no cap on the gains. Let’s take a look going back 10 years. I’ll use the OnPointe Risk Analyzer Software for the comparison.

<table>
<thead>
<tr>
<th>SPY with 30% FIAs</th>
<th>50</th>
<th>-11.56%</th>
<th>12.94%</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPY</td>
<td>70</td>
<td>-16.22%</td>
<td>13.33%</td>
</tr>
</tbody>
</table>

The CAGR (how the money actually grew over the ten-year time frame) was almost the same (12.94% vs. 13.33%).

But look at the risk score and the maximum drawdown. The risk score of the S&P is 70; and when you layer in 30% FIAs, it drops to 50. The maximum drawdown with 30% FIAs was 4.66% less (meaning it was 29% less risky).

If I asked the same repetitive question…should you ever take more risk necessary to reach your investment goals, why would you NOT use FIAs in some capacity in your investment portfolio?

Most consumers would say it makes sense. Unfortunately, far too many advisors say no or don’t even know what an FIA is.

Let’s take a look at one more example. I’ll run the comparison back to 2000 (right before the first of our last two major stock market crashes).

<table>
<thead>
<tr>
<th>SPY with 30% FIAs</th>
<th>50</th>
<th>-38.56%</th>
<th>6.88%</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPY</td>
<td>70</td>
<td>-50.78%</td>
<td>5.85%</td>
</tr>
</tbody>
</table>

Now the mix with 30% FIAs had a higher rate of return over time. The following performance chart says it all. The green line is the portfolio with 30% FIAs. The black line is the S&P 500.
The point of this section of the material is to make readers aware that there are more options to grow wealth than stocks, mutual funds, index funds, tactical money management, etc.

The goal of this educational course is to have readers come away from it armed with enough knowledge so they can make “informed” decisions about the best ways and tools to grow wealth in the least risky manner possible.

**Summary on Investment Platform/Philosophies**

I’m not a big fan of the way business has always been done in the financial services field. Asset allocation (MPT) is not my idea of a way to both avoid risk and generate the expected returns the client is looking for.

Buy and hold sounds good in theory; but as the DABLAR Report indicated, the average investor is incapable of buying and holding (they instead panic sell near the bottom which costs them significant returns in the short and long term).

Buy and hold is still a market-timing platform where either the client (who is definitely not qualified to decide when to sell) or some local money manager/financial planner is deciding when to sell. No offense to the local money manager; but if he/she were that good, he/she would be running a hedge fund.

I’d prefer to leave the buy-and-sell decisions to a tactical money manager and, preferably, one who has an actual track record of successfully being able to do so. Ideally, I’d prefer to see clients use tactically managed funds that have a low maximum drawdown risk coupled with a successful track record of sustained positive growth.

Finally, I think there is a great mathematical argument to make for the incorporation of FIAs into a portfolio to drive down risk without sacrificing much, if any, yield.
PERSONAL RISK SCORE

As you’ve been reading this material and looking at some of the charts from the OnPointe Risk Analyzer Software, you might be wondering to yourself what this “Risk Score” thing is.

The risk score of an individual asset or an entire portfolio is calculated by a number of different factors by our OnPointe Risk Analyzer Software. The calculation is somewhat complex, but the point is that the software scores investments on a scale of 1-100 (1 being low risk and 100 be very high risk).

The S&P 500 (the benchmark used often) has a risk score of 70.

A 60/40 mix of stock to bond has a risk score of 42.

So, it’s nice for advisors to use the software because it helps them get a feel for the risk and return of various assets or portfolios of their clients.

But the risk program also will determine the risk score of a consumer.

Consumers go through a client questionnaire and in less than five minutes will get to the end of the questionnaire and will be given a risk score.

FYI, the average risk score of most consumers is between a 30 and 45.

And if you wondered, most portfolios we see tested in the OnPointe Risk Analyzer Software score at 50 or higher (many come in above 60).

What do you do with your personal-risk score?

It should be used when comparing your current investment portfolio.

If your personal-risk score is not in alignment with the score of your investment portfolio, then your financial planner can use the OnPointe Risk Analyzer Software to design a portfolio that more closely aligns with your personal-risk score.

It is my opinion that no financial plan can be complete without assessing an investor’s personal risk and that of the recommended portfolio.

Topics not Fully Covered in this material

Taxes

I have not discussed how taxes can reduce the net return of the funds discussed in this material. Most of this material focuses on traditional mutual funds (which have fairly high annual taxes as the funds buy and sell stocks),
tactically managed funds (which will also have high taxes on the growth due to the ability to sell quickly when indicators point towards a market downturn), and the S&P 500 index (which have lower taxes if the investor doesn’t “panic” sell often when the market goes through what are ever increasing mini-crashes in the market).

My point is that taxes need to be taken into consideration when determining the expected rate of return of an investment.

**Cash Value Life (CVL) Insurance**

As you will read, if you haven’t already, in the life insurance section of the course, a “good” CVL policy can be a useful wealth-building/retirement tool.

The following are aspects of a “good” CVL policy:

- Money is allowed to **grow tax free**.
- Returns on cash should be **between 6%-8%**.
- Gains are **locked in every year** and **can’t be lost** due to a downturn in stock market.
- Money can be removed **tax free in retirement** (or before (no 59.5 penalty issue)).

I consider a “good” CVL policy to be an asset class that should be incorporated into financial plans for clients under the age of 60; but because they have no risk of loss, they were not discussed in this part of the course.

Finally, when I say “good” cash value life policy, I am talking about an Indexed Universal Life (IUL) policy not a Whole Life (WL) or Variable Universal Life (VUL) policy.

**OVERALL SUMMARY**

Over the years, I’ve heard countless stories about investors losing 50% or more of their retirement nest eggs in the stock market because of bad advice from a local financial planner, CFP, money manager, etc., I am determined to help change the discussion about how to look at risk vs. investment return.

It’s not enough to look at 5-, 10-, 20-year track records of an investment. Looking at year-end numbers isn’t enough. In today’s wickedly unpredictable stock market, it is more important than ever to use investments that can identify market troubles and avoid mini and major crashes in the stock market.

The old days of buy and hold are over (or they are over for anyone who wants to invest in the stock market and mitigate risk).

This is a new era that requires new and better models to help quantify risk so a full-disclosure discussion about risk can be undertaken. If there is a new golden rule of investing, it should be the following:

*Thou shall take no more risk than is necessary to meet your investment objectives.*