Time for a New/Old Tool

By: Robert Klosterman, CEO & Chief Financial Officer

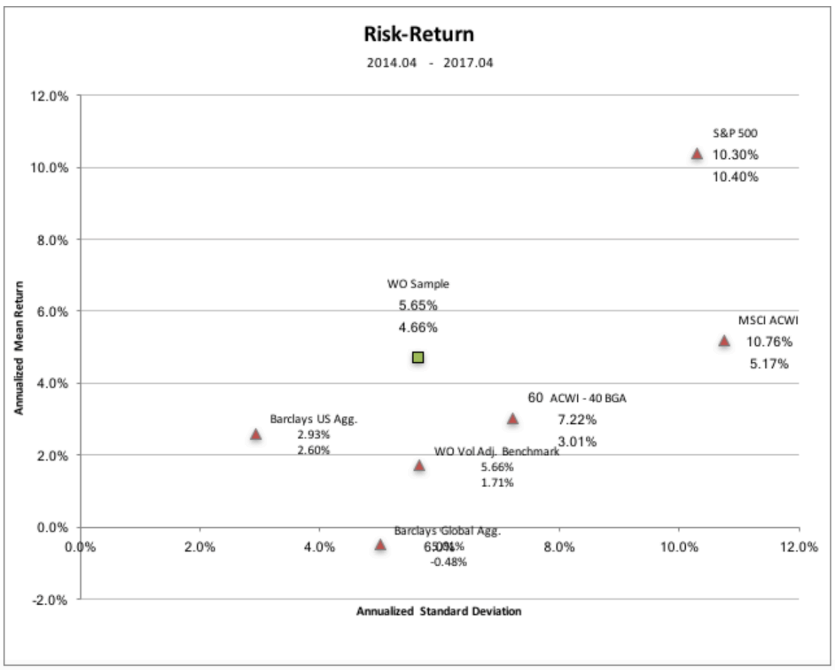
In a recent white paper, "The Investor's Conundrum", the case was made that volatility matters more in many cases than the returns for real people using their portfolios to meet current and expected future needs. Of course, that is not true for everyone- Bill Gates and Warren Buffet do not have a concern about volatility as their portfolios can have a deep downdraft, and they will still have ample funds to meet and maintain their lifestyles.

Yet, for most, volatility is a critical factor to avoid if possible. Too many, when factoring their long-term financial security needs, focus on the question, "how much return can I get to support a desired standard of living?" While it is important to consider, it is too easy to assume a higher rate of return on investments and fool themselves that they have enough. Shouldn't the expected volatility, in light of the expected rate of return, be considered? Not only is it important, I would suggest it is the critical element to understanding a portfolio and how it is expected to deliver a return. Is it effective? Can the strategy roll through various time periods and sustain expected distributions to support a lifestyle?

Clearly, focusing exclusively on returns, the path to financial independence is volatile and uncertain going down this road. What about focusing instead on a relative level of risk and assessing a portfolio strategy on the risk it takes? Using data and performance that shows the best risk adjusted portfolio that fits their needs can provide a more secure level of financial independence and increase the probabilities of success.

By fitting a portfolio strategy to a "best fit" index of common relative indexes can provide a better understanding of the level of volatility and equally important the level of returns relative to that blended benchmark, net of all fees and expenses, of course. Then and only then does an individual have a comparison over time of how they are doing and if there may be choices that can improve the scenario measurably.

For example, in the chart below, a variety of indexes and the actual performance, net of all fees and expenses, are demonstrated graphically, with the horizontal axis showing the relative level of risk as measured by standard deviation, identified as WO Sample. Since this paper is designed to communicate a concept and not to sell a particular strategy, we have merely chosen to identify it as "Sample" rather than its actual name. The further to the right, the higher the level of volatility. The vertical axis measures the historical return, in this case a 3-year time period is used. Measuring portfolios over time makes sense. It is common for indexes to, "have their day in the sun", and looking at multiple time periods help smooth the impact of short-term performance advantages out. For example, the S&P 500 has been on a tear recently. Of course it is not the first time a widely followed index has done well relative to other assets classes. Asset classes have their good times and not so good times. We all know what happens when an asset class does better than expected over a time; it begins to revert to the mean. Asset classes constantly ebb and flow. Better to expect and plan a portfolio design for the eventuality of these cyclical events than suffer the excess volatility of one asset class.



Note that the sample portfolio out-performs a risk adjusted benchmark composed of 37% All Country World Index (ACWI) and 63% Barclay's Aggregate Bond (BGA) by 300 basis points (3% annually over this time period). This relative index of 63% in bonds shows the same relative volatility of the sample portfolio after fees and expenses. Also shown is the very well known 60% equity and 40% bond allocation. It shows more risk/volatility than the sample portfolio and a lower return. One way to ascertain this relationship is a statistical term developed by Nobel Laureate, William Sharpe. I have become a big fan of the Sharpe Ratio over the past few years due to the expectation of lower return expectation for investments. The Sharpe Ratio measures the return as compared to a risk-free assets such as treasury bill for each "unit" of volatility or total risk. In other words, of two assets with the same return, the asset with lower fluctuation (volatility) would have a higher Sharpe Ratios as compared to the investment with higher volatility. Volatility relative to return has never been more important than today.

For those entering a phase of life where the portfolio will be sustaining their needs, risk-adjusted returns have become more and more important. It is far too easy to wish for a higher rate of return to fool ourselves that it will all work out. Better to focus on strategies to mitigate the devastating power of drawdowns in portfolio values during periods of market disruptions. Sound portfolios can be designed to dampen volatility and increase the probability of preserving portfolio values to meet your goals and dreams.

For more on the Sharpe Ratio go to http://www.investopedia.com/terms/s/sharperatio.asp

About the Author

Robert Klosterman, CFP® is Founder, CEO and Chief Investment Officer of White Oaks Wealth Advisors, Inc. and its predecessor R.J. Klosterman & Co, Inc. Bob has been a Certified Financial Planner licensee since 1989. He has a clear vision for the future having worked in financial planning since 1975, and feels a strong need to provide people with expert and independent wealth advisory services. As a Certified Financial Planner and certificate holder for Family Wealth Advising, Bob's expertise and guidance have helped to fuel the steady growth of the firm. Today, White Oaks Wealth Advisors boasts a talented staff of advisory professionals, hand-picked for their financial planning and wealth management knowledge as well as their dedication to client service.

"My mission is to serve our clients through the combined expertise of our advisory team. I want to use my experience to really impact the lives of the people who place their trust in us."

Bob's leadership within the firm's Advisory Committee regularly encourages fresh thinking and new approaches that provide clients with innovative wealth management solutions in the areas of economic and investment market analysis, stock option strategies and wealth transfer techniques.