

# PORTFOLIO WATCH



Email: [Jerry.Verseput@veripax.net](mailto:Jerry.Verseput@veripax.net)  
 Phone: 916-358-5635  
 Website: [www.Veripax.net](http://www.Veripax.net)



Fee **FO** Only

## The Flaw of Averages\*

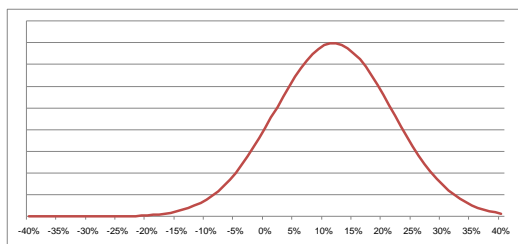
Anyone who has a discussion with a financial planner will eventually talk about asset allocation. This is a large reason why we don't get invited to many parties, but it's an important discussion to help set the right risk level for a portfolio and hopefully meet the goal of retiring some day. The conversation usually centers around what mix of stocks and bonds makes sense, and the ultimate question, "what return can I expect?" Financial professionals have a highly technical term for this called "expected return".

### What Is "Expected Return"?

It sounds pretty simple. Expected Return refers to the return you should expect for taking risk in your portfolio. If you take no risk, you get no return. In the 1950's, a thing called Modern Portfolio Theory standardized a way to calculate Expected Return based on a given amount of risk. Fifty years later it's still called "modern", but at least we can calculate it a lot faster now that we have computers and no longer use slide rules.

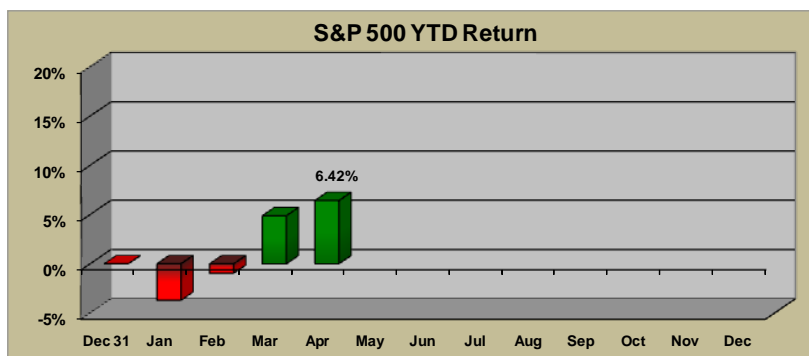
### The Flaw

It was pretty tough calculating much of anything in the 1950's. I remember the novelty of getting my first four-function calculator, and I wasn't even born in the 1950's, so those math guys had it tough. To come up with anything reasonable, they had to make some assumptions to make things easier. One assumption was that market returns fit on a regular bell curve like the one below.

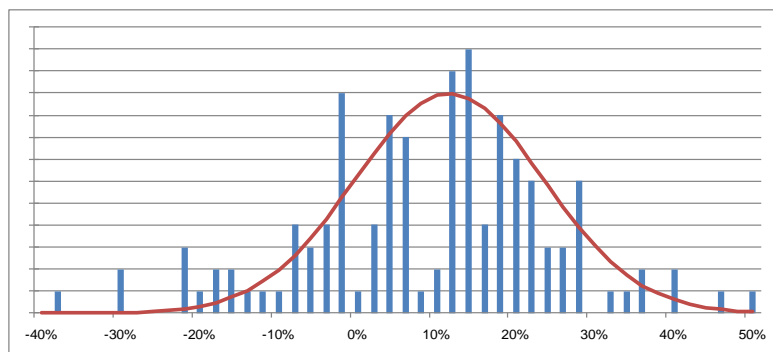


This allowed standard deviation to be used to measure risk, which is fairly easy to calculate (or so I'm told), and led to a nice "average" expected

2006 return: 13.62%    2008 return: -38.49%  
 2007 return: 3.53%    2009 return: 23.45%



return. For stocks, this average over a long period of time is about 11%, which can now be used for all of those retirement projections. The only problem is that market returns aren't distributed like this. Not even close. Something more typical would look like this (the blue bars):



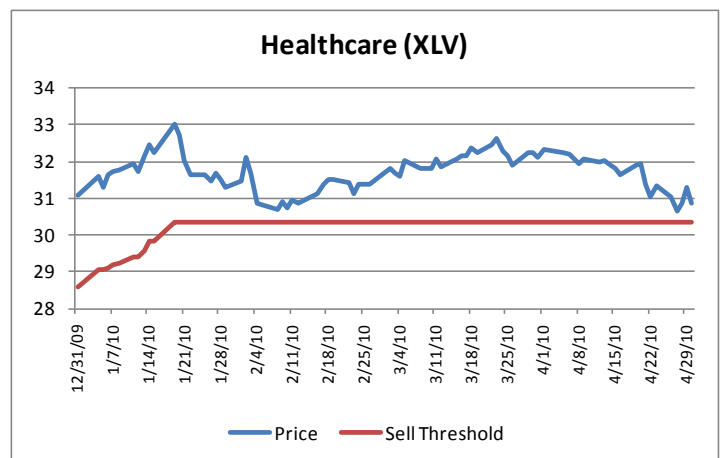
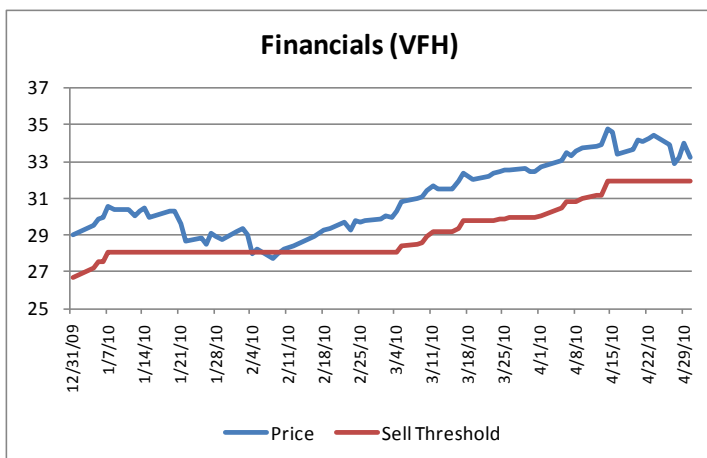
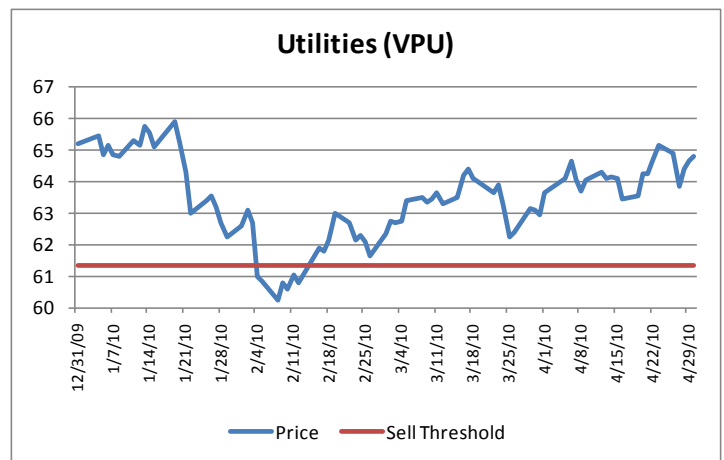
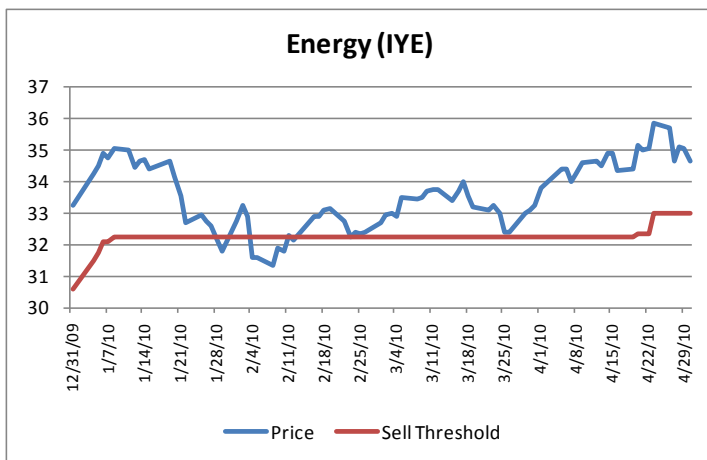
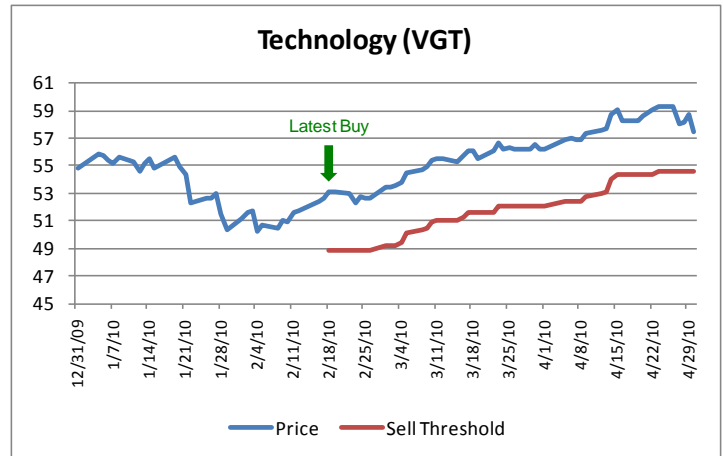
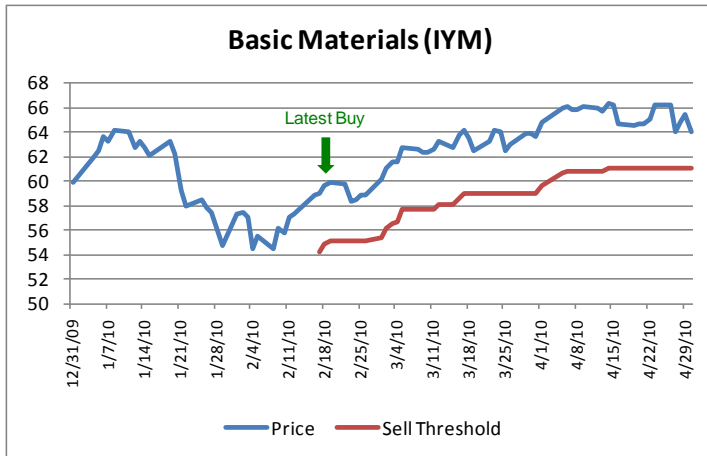
The reality is that returns that should fall in the 1% likelihood area occur about 6 times more than what would be predicted using traditional methods. That can mean the difference between a "once in a hundred years" event and something you're likely to see at least a couple of times during your lifetime. It can also be devastating if one of these extremely poor return years happens in the vicinity of retirement.

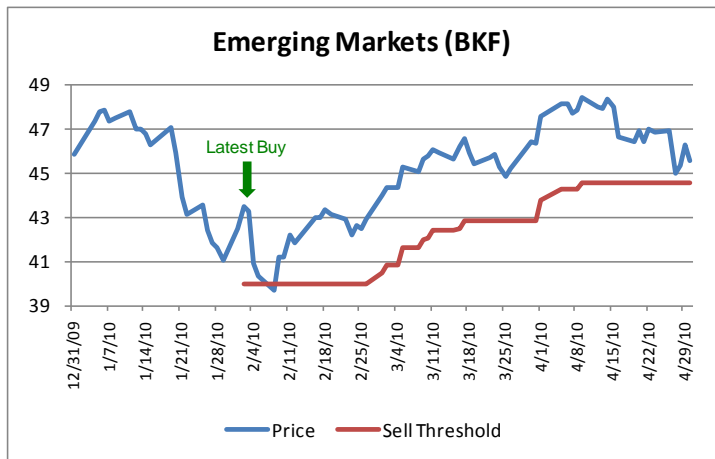
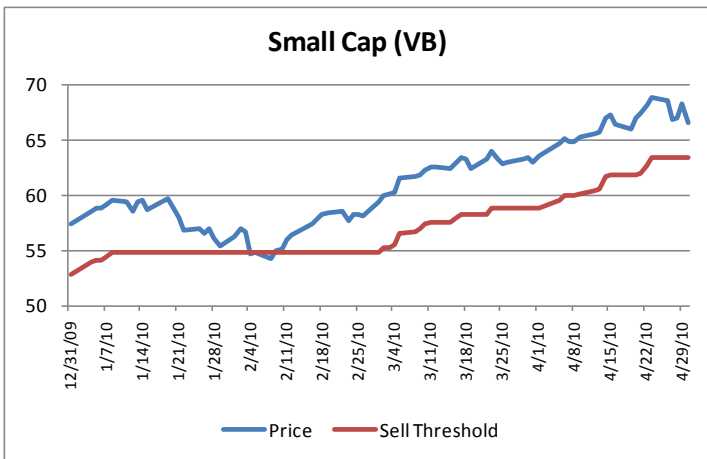
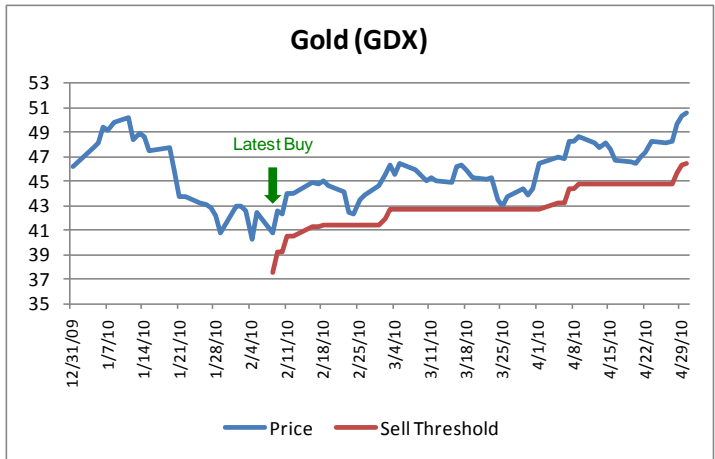
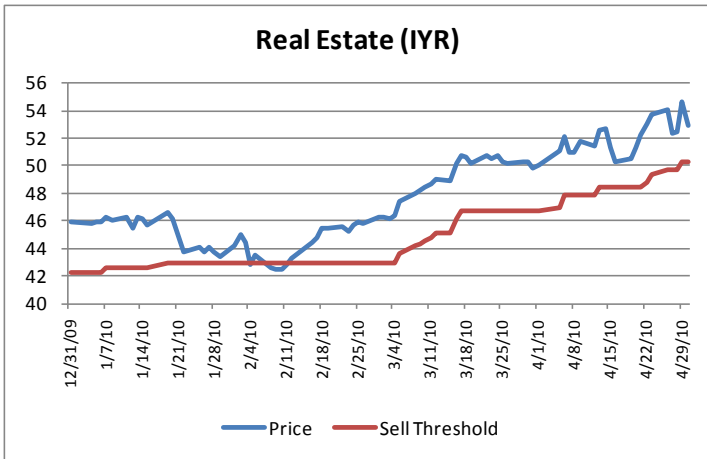
In my opinion, too many advisors rely on the average return number. The argument is that since the average return has been 11% over the last hundred years, you just need to hang on long enough through the dips and eventually stocks will come back. But most investors don't have 100 years, and if you believe that markets may be more volatile in the future, the likelihood goes up that we will see more negative market returns that fall outside of the predicted values.

\* Unfortunately, "the flaw of averages" is not my phrase. It's taken from a book by Dr. Sam Savage.

## Market Sector Performance (where did the Model Portfolios go?)

The following performance charts show the individual sectors that Veripax Financial Management uses in its portfolios, as well as the Sell or Buy threshold that is currently being watched. Because of increasing regulation and rules regarding performance reporting, Model Portfolio performance has been replaced by Sector performance. This should still provide a glimpse into how client portfolios are being managed, but avoid any danger of performance advertising, which is against the rules





**Market Sectors:** Market sector data is based on the Sector ETF shown on each chart. Buy and Sell decisions are based on Veripax Financial Management’s proprietary algorithm. The Buy and Sell thresholds shown on the charts are a component of this algorithm, but are not used as the sole decision criteria.

## Portfolio Comments

The market is starting to get a little shaky as debt issues have been piling up in Europe. The oil spill in the Gulf of Mexico hasn't necessarily affected markets yet, but there is concern that it could interfere with shipping, which in turn could drive up prices. I'm hoping the debt issues in Europe are not a precursor of a future U.S. crisis.

Most sectors hit new highs early in the month, but have since pulled back. The Emerging Markets sector (Brazil, Russia, India, China) is the closest to its sell threshold and is being watched extremely closely. Healthcare is another sector that hasn't really done much since the beginning of the year. This is probably because there is still quite a bit of concern about how the healthcare bill will affect insurance and other healthcare stocks. Some sectors are still doing fairly well. Gold Mining (GDX) is up 13.7% for the month, and Real Estate continued to plug along at 7.2%. This brings the Real Estate sector up to 16.9% for the year, compared to 6.4% for the S&P 500.

For now, market behavior is concerning, but it's not time to panic. If the European Union is able to put together a package that will keep Greece solvent, and Greece is able to throttle back its public spending and get its debt under control, the market will probably breathe a sigh of relief and we'll be back in business. If not, things could get ugly and gold could be ready to take another jump. This just means it's time to watch things closely.

Veripax Financial Management, LLC is an independent Registered Investment Advisor and is not affiliated with any mutual fund companies or broker/dealers. Financial planning and investment management services are provided on a fee-only basis, so Veripax Financial Management does not earn commissions on anything we recommend. Nothing in this newsletter should be taken as investment advice. If you know of anyone who would be interested in this newsletter, or if you would like to be removed from the mail list, please send an email to [Jerry.Verseput@veripax.net](mailto:Jerry.Verseput@veripax.net).