CHAPTER 3 - Truths

Truth in Returns

In recent years Crestmont Research has calculated some amazing truths when it comes to the stock market. Crestmont can be found on the web at www.crestmontresearch.com.

We have been told that if we hold on to mutual funds for long periods of time, a decent rate of return is very possible. As stated earlier these "long" periods of time have increased over the years, and now you will see time frames of ten to twenty years when trying to convince investors to buy and hold.

So what happens if the market yo-yo's up and down? Do investors need to worry? My contention is that down-turns or losses have a much greater impact on wealth than the upside. Even if the negative return is the same as the positive return, the negative has a greater impact than the positive.

Case in point: Let's assume an investor invested $100,000 into a mutual fund and had a 20% gain one year and a 20% loss the next. We would most likely argue that this investor has a 0% return and has his original principal back. Let's see:

Year 1: $100,000 + 20% = $120,000
Year 2: $120,000 – 20% = $96,000

WHAT! How did that happen? This investor actually lost 4% or $4,000 of his original investment. The negative return had a much greater impact on his total return. Let's carry it out 2 more years using the same returns, up 20% then down 20%:

Year 3: $96,000 + 20% = $115,200
Year 4: $115,200 – 20% = $92,160

So even though the markets are staying even year after year this investor continues to whittle down his original investment. And it doesn't matter if we reverse the order, in other words have a loss first and then a gain, the same result occurs:

Year 1: $100,000 – 20% = $80,000

Year 2: $80,000 + 20% = $96,000

The moral of the story is DO NOT LOSE MONEY!

In the above example the mutual fund company would average the 2 years and come up with a 0% return, however, you know this is not the case. I will say that deep in the recesses of the prospectus of mutual funds, where very few people read, there is a real rate of return example that would show that this investor actually lost money. But on the outset, if you were only looking at the average rate of return it would indicate 0%.

What I found interesting about the Crestmont Research numbers is that if you were able to eliminate the downside of the stock market (or in other words take away all the years where the stock market went down), all you have to do is get 30% of the market's gains to perform just as well as the guy who rode the roller-coaster up and down. In other words, give me 30% of the upside and none of the downside, and I'll have as good a performance as the buy-and-hold investor.

Along these same lines, what happens if a market drops 40%? Will a gain of 40% put us back to breakeven? No! If the DOW Jones Average were to drop 40%, it would have to gain just over 66% to get back to its original value.

What's more is that the "compounded average" is much worse than even the average suggests. The compounded average takes into consideration the losses, which again have a much greater effect on the total.

Let's look at three different scenarios below. Each one of these has an average 5% rate of return, but because the losses have a greater impact you will see how it affects the compounded average which is the return the investor will actually see on their statement:

Scenario 1-
Year 1 + 15%
Year 2 – 10%
Year 3 + 10%
Average: 5%
Compounded Average: 4.41%

Scenario 2 –
Year 1 + 25%
Year 2 – 15%
Year 3 + 5%
Average: 5%
Compounded Average: 3.71%

Scenario 3 -
Year 1 +30%
Year 2 -25%
Year 3 +10%
Average: 5%
Compounded Average: 2.31%

Now you can see that the losses in the market have a greater impact on wealth than the gains! The larger the losses the less the compounded return will be. Can you imagine what the compounded effect has on the markets due to the downturn in 2008-2009?

Going back to 1900 the stock market to December 2008 has averaged 7%. However, its compounded average is 4.6%! That is a big difference isn't it? Now calculate the tax on that and where are you at?

Crestmont went on to look at time periods for investors. As we know, long term is now nearing 10 years. Over the last 40 years you could usually get a return over a 10-year period, but this past decade has eliminated that statistic. So what if we look at 20 year periods?

Crestmont has analyzed every 20 year period since 1900. There have been eighty-eight 20 year periods. For example from 1900 to 1920 is a 20 year period. From 1901 to 1921 is another and so on and so on.

So what have actually been the returns in the stock market over those 88 periods consisting of 20 years each if we calculate the return after inflation?

The way it breaks down is as follows:

Number of periods with 10% or greater return: **3**

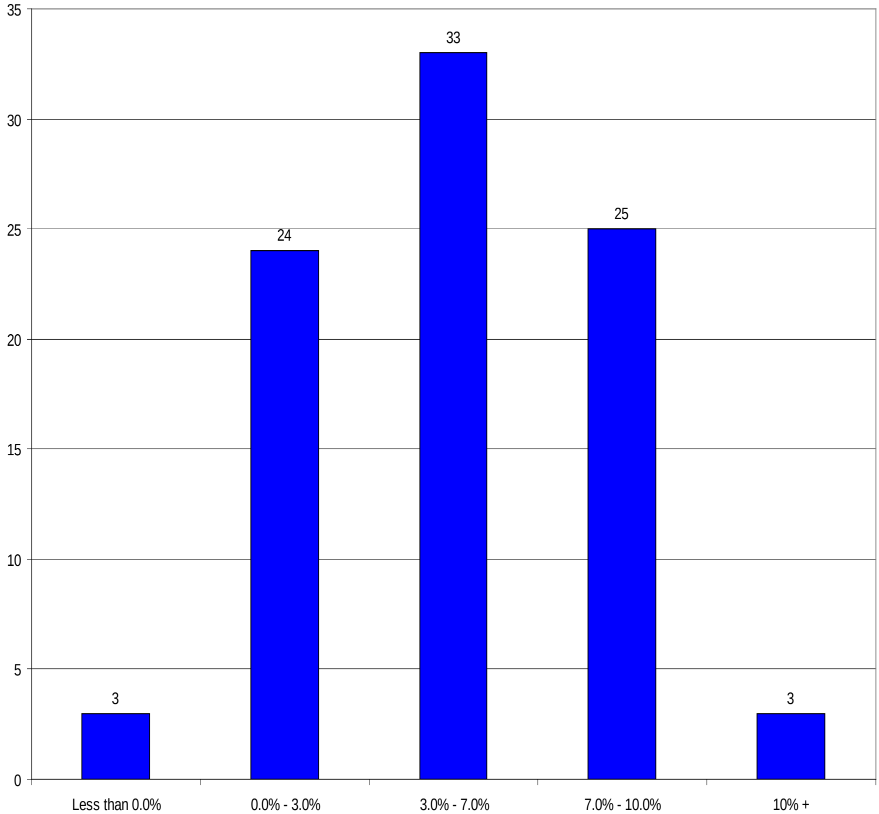
Number of periods with 7% - 9.9%: **25**

Number of periods with 3% - 7%: **33**

Number of periods with 0 - 3%: **24**

Number of periods with less than 0%: **3**

The graph looks like this:



You could essentially throw out the highest return years which were 3 of the 88 years and throw out the worst years which were 3 of the 88 years as well. Now we have more than 50 of the 88 periods returning less than 7%, not including taxes.

The question becomes a risk verses reward proposition. To risk all of the downside (because you have to assume you could lose all of your investment), for what may be minimal upside; is it worth the risk?

Next time you are thumbing through a financial magazine or looking in the newspaper at mutual fund returns, keep in mind that average returns, compounded returns, and actual returns may have completely different results.

Investing

After the previous chapter you are probably wondering if I am completely against investing all together. The answer is emphatically NO!

I know that this country was built upon entrepreneurs taking chances, creating businesses, developing new technologies, giving consumers what they want, and leading the world with new products and services. But that is exactly the point. The entrepreneurs or their investors placed money into businesses and technology that had a potential or an opportunity to grow and create wealth. Did they all make it? No way! In fact many of them failed miserably. I'm not suggesting in any way that the wealthy did not take risks, but they were calculated risks! More importantly they had some sense of control.

When money is turned over to a typical financial advisor, he or she usually has you purchase a packaged product of some sort. They may run some illustrations showing asset allocation and past performance charts, but in reality you are turning your funds over to someone else in hopes that they will get you a better return than you could have gotten on your own. When you save inside of an IRA or 401(k), in many cases those funds are invested into mutual funds or similar packaged products. Many of these products are tied to the whims of the markets they invest in. This is not "bad" per se, but is this the control you were looking for?

For our purposes there are a few other criteria that should be met before making an investment:

1. You should "Understand" the investment.

If someone comes to you and wants you to trade currency on the foreign exchange markets and use 10-1 leverage in a margin account and you have no clue what that means, how it works, or the risk associated with for-ex trading, then maybe you should avoid this type of investment. In addition before you give someone else your money and let them trade it for you, you should fully understand exactly what they are doing and the risk of loss associated with that type of trading.

2. You should have "some control."

Now I know this is not possible in every situation, but if you could analyze a purchase before you make the decision to invest, then you have some control over the decisions made with your money. In other words handing someone your money without having any input as to what will be purchased on your behalf may not be the control you need.

3. A "Time-table" should be discussed.

The holding period for the investment and whether it meets your time table is extremely important information. If you invest in something and you anticipate selling in 3 years, but in reality it turns out to be 10-year hold, that may not meet your time-table. This would be good to know up front. Certainly there are circumstances that are unforeseen that may change the projected time-table along the way; nevertheless, an expectation of time should be discussed in the beginning.

Business Ownership

Where does one typically find many of the above criteria? The answer is in <u>your own business</u>. No wonder one of the dreams of so many Americans is to own their own business. Hopefully before you open the doors, you "understand" the business. You certainly have more "control" by owning the business as to where money is invested and the direction of the company. And you may have a "time-table" as to when you would like to sell the business or pass it on to one or more of your children. None of those are guarantees that the business will succeed, but implementing the three criteria in other investment matters may help you retain the wealth you have created or are in the process of creating.

Interesting Observations:

Millionaires

I have never met a mutual fund millionaire!

Let me clarify. There are millionaires who have purchased mutual funds, but I have yet to meet the person who only invested in mutual funds and became a millionaire. Most wealthy "investors" made their money in their business or some other fashion. Think about all the wealthy people you might know. How did they amass their fortune? I doubt you will find one that just invested in mutual funds.

Risk

Investors have been too risky.

Investors need to come to grips with the fact that exposure to market drops could put their entire fortune at peril. An investor has to accept that they could lose everything they invested. This must be assessed, particularly in the economy we now live in. I think it's fair to say that most of us have been riskier with our investments than we thought we were. In a sense we have been lulled over the past two decades in to thinking that our investments were safe over the long term. That may not be the case any longer.

Another Alternative

There is a strategy referred to as your "Private Banking System." The premise is that a growing business or a family working at achieving wealth will constantly need capital. With your own Private Banking System, everything you need in your business and personal life could be financed through your own banking system.

When faced with a new purchase, you have to decide whether to lease, finance, or pay cash for the purchase. What if there was another way? What if additional wealth could be attained by that method? What could be financed with your own Private Banking System? Here is a short list of what many business owners finance, but the possibilities are endless:

For the business:

Equipment

Vehicles

Payroll

Computers

Buildings/Offices

Furniture

Health Insurance Premiums

Expansion

Inventory

Travel/Award

Machinery

Remodeling

For your personal life:

Cars

Boat

Motorcycles

RV

Remodeling

Appliances

Braces for kids

Medical Deductibles

Vacations

Down Payment on home

And on and on….

What Next?

Here at Becoming Your Own Bank we have been helping businesses owners all over the country implement private banking systems for over 8 years. It may or may not be something that will fit in your particular situation, however the education alone is worth exploring the concept.

As General George Patton said "if everyone is thinking alike, then no one is thinking."

We welcome the opportunity to talk with you about creating your own private banking system, please contact us using the information below at any time.

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