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# Avoiding Portfolio Losses: Key to Effective Estate Planning\*

*By Steven Holt Abernathy*

Steven Abernathy explains why estate and retirement planning demands decreased risk in the investment portfolio. It is not the rate of return that is the most important consideration in this type of planning, but the amount at risk.

A CFP® friend came to me with a problem recently. A client for whom he had created an estate plan wanted to shift a significant portion of his investment portfolio to a “hot” manager he heard interviewed on television. It seems the manager’s equity portfolio had outperformed the client’s by some 25 percent the previous year. He wanted some of that action.

“Did your client ask what the manager’s capital at risk ratio was?” I inquired.

“I doubt it,” said my friend. “He said the guy was 25 percent better with a portfolio of similar large-cap growth stocks, so how much difference could there be in the risk equation? He says he will take his chances with a down year here and there if the manager can outperform the market by 25 percent in good years. He checked the manager’s 10-year history, and while the guy had an equal number of up and down years, he never lost more in a year than he made the previous year. It was a hard argument for me to counter at the time. However, a second look at the numbers revealed the fallacy of his thinking. There was a negative side to this that we had both overlooked.”

Like most investors, the client’s focus was on returns. If his portfolio wasn’t beating the market averages by a substantial amount, he felt he was losing ground. By embracing a more aggressive investment strategy, he figured he could outperform the indices by enough in

up markets to offset any losses during down markets. That rationale has been the cause of many estate plan retirement portfolios being ravaged.

Investment rates of return are important, of course, but a far more critical consideration is how much of the portfolio is at risk? In other words, regardless of the potential gain, how much can you lose? If a stock or an investment strategy makes money 75 percent of the time, that’s what investors tend to focus on. What they ignore is that 25 percent of the time, they will lose money. If it is possible to lose money, it is a statistical certainty that it eventually will happen.

What response do you think you would get if you asked your clients how much of their estate plan’s investable assets should be at risk at any given time? Twenty-five percent? Fifty percent? It would probably be nowhere near that high. And yet, it is not uncommon for investor portfolios—even those specifically designed to fund approaching retirement—to have 100 percent or more of their capital at risk.

When you scan the skyline of any major American city, you will see the largest buildings belong to banks and insurance companies. Why? Because they understand risk better than anyone else. When they assess an investment opportunity, their first consideration is how much they stand to lose, not how much they might gain. Only after they are comfortable with the potential for loss will they analyze the potential for gain. Financial advisors would serve their clients well by suggesting they emulate the same formula. The first question regarding a financial or estate plan’s asset allocation should be, “How much of my core assets will be at risk with this investment strategy?”

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Consider two portfolios:

**Portfolio A**

- Return: 10%
- Capital at Risk: 30%
- Standard Deviation: 15%
- Correlation: 40%

**Portfolio B**

- Return: 12%
- Capital at Risk: 100%
- Standard Deviation: 40%
- Correlation: 70%

Your clients might intuitively choose Portfolio B because of the apparent 20-percent higher return, overlooking the higher numbers for capital at risk, standard deviation and market correlation. However, the impact of those three elements can render the 20-percent higher investment return virtually meaningless. Portfolio A, with just 30 percent of its capital at risk, is far less likely to suffer a crippling loss than Portfolio B. Even seemingly modest losses, if frequent, can eviscerate the financial assumptions of the most carefully crafted estate plan.

Let's consider a wealthy client with a high tolerance for risk. She wants the investment portfolio in her estate plan to reflect her personal career in which she succeeded by taking some risks. She moves her portfolio to the hot manager with the aggressive approach that better suits her temperament. The first year, she makes a killing. The stock market is up eight percent but she makes 50 percent. The following year, the market is down eight percent, her strategy takes a nosedive and she loses 50 percent. Well, she's not very happy but at least she is no worse off than she was at the start of year one.

Not so fast. Assuming she began with a \$1 million portfolio, she has \$1.5 million at the end of year one. But her 50-percent loss in year two leaves her with just \$750,000. Now she has to get even before she can think about outperforming the market. If she rethinks her aggressive posture (as she well might) and decides a more conservative approach would be better, even if she earns a consistent six percent annually, getting even would take five more years (see Chart 1). Overall, she suffers through a seven-year span with less than net zero performance once inflation is factored in. Just one bad year can be devastating.

Meanwhile, a conservative investor who chooses a conservative strategy that gives back much of the upside in order to protect against large losses, plods along at a steady if unexciting six percent annually.

By the end of the seventh year, our first investor has finally recouped her losses from year two, while our conservative friend's portfolio has grown over 50 percent. He can't brag that he made 50 percent last year, but he never had to worry about recovering his losses, because there weren't any. He can also sleep at night, knowing his core assets are safe; how much is that worth?

**Chart 1**

Year	Return	Value	Return	Value
0		\$1,000,000		\$1,000,000
1	50%	\$1,500,000	6%	\$1,060,000
2	-50%	\$ 750,000	6%	\$1,123,600
3	6%	\$ 795,000	6%	\$1,191,016
4	6%	\$ 842,700	6%	\$1,262,477
5	6%	\$ 893,262	6%	\$1,338,226
6	6%	\$ 946,857	6%	\$1,418,520
7	6%	\$1,003,670	6%	\$1,503,631

Now let's assume our same hypothetical investor moves her portfolio to an aggressive manager at a time when market volatility is less severe. What happens if she does not have any huge gains or losses in the early years, instead alternating up and down years, with her up years outperforming her down years by 50 percent (see Chart 2)? That seems like a recipe for success and even though she still doesn't like losing years, she is making pretty good headway.

Or is she? Let's move the timeframe for the more volatile years—the 50 percent up and 50 percent down years, which are almost inevitable at some point in an aggressive strategy—off for a few more years. For comparison, let's assume the more conservative chap is only able to earn four percent on his money over the same period. Let's call these two the Hare and the Tortoise and see what happens to their portfolios (see Chart 2).

The Hare's aggressive strategy produces an equal number of up and down years. Cumulatively, the Hare is +200 percent and (-)150 percent, an apparent gain of 50 percent over the 12-year period, which sounds pretty good. But despite the Hare's average annual return of +4 percent (identical, incidentally, to that of the Tortoise) and her up years outperform her down years by 50 percent, she actually loses money and ends up underperforming the steady Tortoise by some 80 percent!

**Chart 2**

	Hare		Tortoise	
0		100.0		100.0
1	30%	130.0	4%	104.2
2	-20%	104.0	4%	108.5
3	30%	135.2	4%	113.0
4	-20%	108.2	4%	117.7
5	30%	140.6	4%	122.6
6	-20%	112.5	4%	127.8
7	50%	168.7	4%	133.1
8	-50%	84.4	4%	138.6
9	30%	109.7	4%	144.4
10	-20%	87.7	4%	150.4
11	30%	114.1	4%	156.7
12	-20%	91.2	4%	163.2
	Avg Return	4%	Avg Return	4%

The avoidance of losses cannot be overemphasized in estate planning. As demonstrated by the previous chart, a portfolio can have considerably more gain than loss yet still lose money over time. That can throw off financial projections by huge amounts.

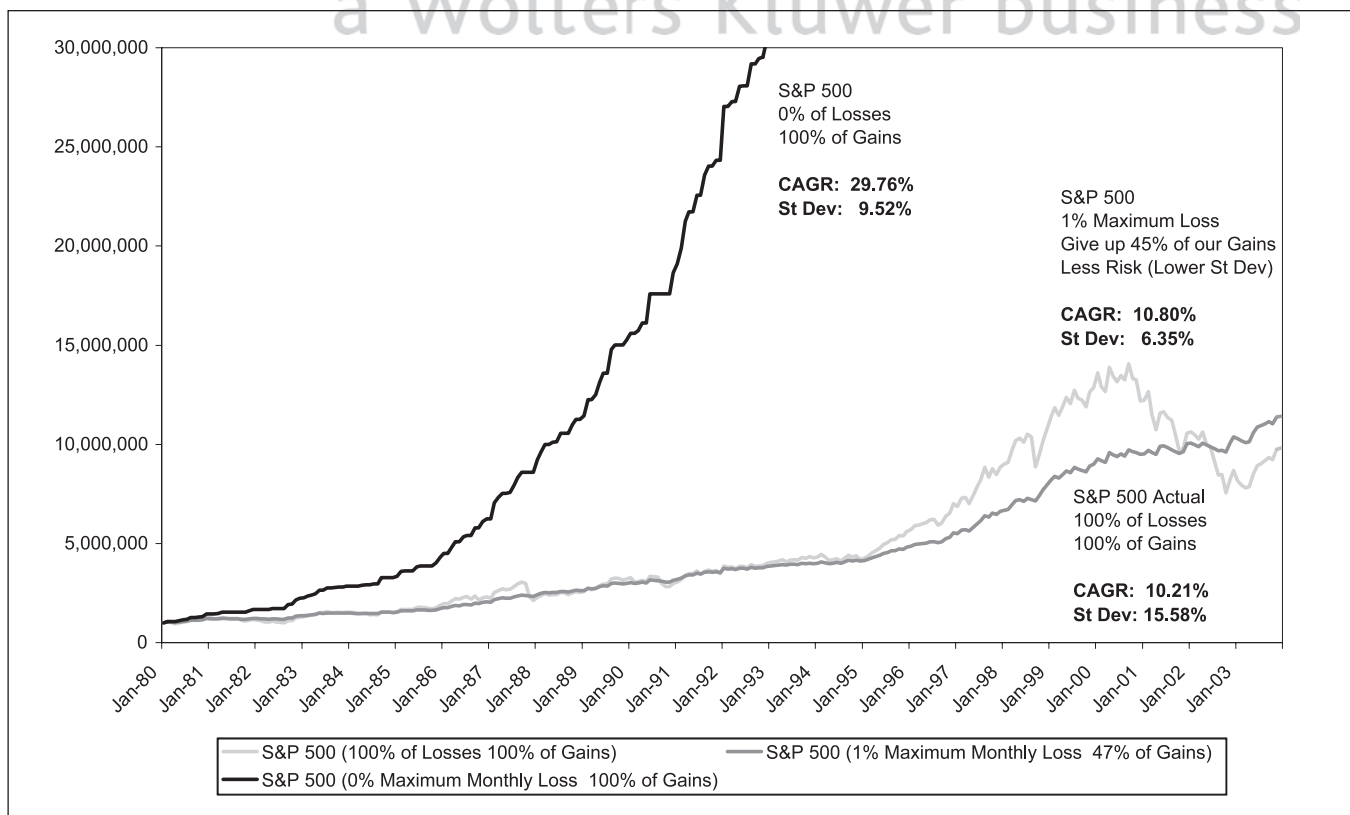
To further illustrate the impact of even smaller losing years, look at Chart 3. It depicts three variables of a \$1,000 investment in the S&P 500 index since 1980.

The dark black, top line is a projection of the S&P gains since 1980 without any of the losing months. Of course, it's a purely hypothetical assumption since the S&P did have many losing months over the past quarter century, but it illustrates how much is given up to losses.

The lighter gray line depicts the actual S&P performance, including both gains and losses. A \$1,000 investment in 1980 would have grown to about \$10,300—an average compounded gross annual return (CAGR) of 10.21 percent. Standard deviation (risk measurement) is 15.58 percent. That's important.

If you studied statistics in college, you will recall that normal deviation, doubled by the mean, encompass 95 percent of all outcomes. So to calculate the probable returns on the S&P, double its standard deviation of 15.58 percent (which equals 31 percent) and subtract that from the S&P average annual return of 10.2 percent, which equals -20 percent. On the high side, add the same double standard deviation of 31 percent to the 10.2 percent and you get +40 percent. The inference tells you that 95 percent of the time, the S&P will range between down 20 percent and up 40 percent. What it also should tell you is that S&P indexed portfolios spend

**Hedged Portfolio vs. Unhedged Portfolio**



way too much time in the negative area. That's not where you want to be.

The medium gray line represents a hedged portfolio that mimics the S&P index but with two important differences. First, when the S&P has a down month, the hedged portfolio might also be down, but not more than one percent because of the protection provided by hedging. In exchange for avoiding large losses, the hedged portfolio gives up 45 percent of the gains!

Wait a minute. We're giving back 45 percent of the gains? That seems like a staggering amount to surrender to protect your core assets, doesn't it? But look at the hedged portfolio's standard deviation and average annual returns. Despite giving back almost half the gains, it actually outperforms the S&P slightly while reducing the standard deviation by some 60 percent.

In other words, the strategy to avoid monthly losses above one percent not only outperforms the S&P, it does so while reducing risk by 60 percent. The conclusion is that you can give away almost half of the index upside and still outperform by hedging against big losses.

The Tortoise wins again.

## **Speculation, Fees, Expenses and Taxes**

With the possible exception of estate plans where a fortune already exists and the principal investment objective is to preserve wealth *via* government or municipal fixed-income strategies, most estate plans are predicated on the assets within the plan generating a rate of return that outpaces inflation and creates real growth. Even where significant wealth already exists, if the performance of the investable assets falls dramatically short of projections, the impact on the client's intentions for distribution to heirs or charities may have to be dramatically altered. Assets originally intended for future generations may have to be diverted to fund retirement needs.

But inappropriate investment strategies and disappointing performance are not the only culprits when it comes to retirement requirements. Another affliction is investor speculation, that is, the belief they can outperform the market index. The reality is that over any extended period, virtually no one outperforms the S&P index; few even manage to match it.

The primary reason is that investors typically pay annual management fees of roughly 1.25 percent, plus expenses—transaction costs that may be buried but nonetheless are deducted—of another 50 basis points or 0.5 percent. So even if an asset manager can generate returns comparable to the S&P—historically about nine percent annually—investors only realize about 7.00 to 7.25 percent after fees and expenses. Taxes can claim as much as 35 percent of that, leaving a net gain of perhaps five to six percent annually. That is the raw reality. Most investors expect to be much better but they are only fooling themselves with such hopes.

Using a net annual return calculation higher than six percent in planning client retirement portfolios is unwise because the chances that their returns will exceed the historical averages are remote. The sooner they accept this fact, adjust their expectations downward and adopt a strategy that avoids losses by lowering capital at risk, the sooner advisors can construct a financial plan that accurately reflects what their investable asset base will be at retirement. Clients who expect to earn 15-percent returns next year because they did it once back in the late 1990s should be brought back to reality. We have already seen what happens when clients chase returns by adopting an aggressive investment strategy: It opens the door to big losses the recovery from which takes much longer than anticipated, if it ever occurs at all.

## **Reducing Capital at Risk**

A portion of every retirement portfolio should be in vehicles that do well in down markets. In recent years, even conservative institutional investors have shifted huge amounts from mutual funds and long-only managers to those who can hedge and profit in down markets. According to a front-page story in the November 27, 2005, *NEW YORK TIMES*, "Pension plans and other large institutional investors are expected to invest as much as \$300 billion in hedge funds by 2008, up from just \$5 billion a decade ago."<sup>1</sup>

Hedge fund managers typically have less capital at risk than traditional or long-only managers, but do hedging strategies really lower the risk of losing capital? A simple example of a hedging strategy would be buying a stock at \$100 and also buying a "put" at 90. If an unforeseen event occurs—a terrorist attack, oil embargo, the CEO goes down in a plane crash, *etc.*—and the stock plummets to 30, investors only participate in the drop down to 90. The exposure or

capital at risk is limited to 10 percent of the portfolio versus 100 percent for an unhedged portfolio that bought the same stock at the same price.

Certain hedge managers scan the market looking for companies likely to outperform or underperform within each sector, going long on stocks they believe will outperform and shorting an equal amount on stocks they expect will underperform their counterparts. If a catastrophic event causes the market to collapse, no matter how smart you are or what you have done to protect it, the long portion of your portfolio is going to decline in value. The stocks that were shorted also decline, but since they were shorted, they make—rather than lose—money, so the portfolio is stabilized and there is little or no overall loss.

Obviously, there is no one “correct” investment strategy for everyone. Managers with large amounts of money under management may seem like a safe choice for clients, but the more money a manager takes in, the harder it is to deliver performance above broad market returns. A record of minimizing capital at risk may be the most important consideration in choosing an investment manager partner because you must safeguard your client’s investable asset base. There is no opportunity for future returns without investable assets.

In most cases, seeking superior returns should be a secondary priority in retirement and estate planning; capital preservation should be the primary priority.

Here are two things you can do to help your clients begin to put their financial and estate plans on track:

1. Where appropriate, suggest they adopt a long-term investment approach, a strategy that lowers the potential for crippling annual losses. If they are assuming annual returns above six percent, point out that historical data refutes their assumptions. The sooner they accept and implement a strategy embracing more realistic calculations, the better.
2. Reduce your client’s portfolio capital at risk. Urge your clients to carefully consider how much of their capital is at risk.

In most years, it’s better to have a six-percent return with 30 percent of their capital at risk than a 10-percent return while risking all their capital. The portfolio with the least capital at risk is best insulated against inevitable down years.

Big losses, even occasional ones, decimate investment portfolios and render even the most meticulous estate plan projections invalid. Core assets must be preserved, even at the cost of giving back some upside performance. Without downside protection, the investable asset base available for retirement will be eroded. Since retirees no longer generate personal income, a diminished asset core means choosing between a less desirable lifestyle or tapping into funds intended for future generations.

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### ENDNOTES

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