FINANCIAL ROAD WORK

BY KEN BELLAVANCE

DECISIONS, DECISIONS:

PICKING INVESTMENTS IN COMPANY SPONSORED RETIREMENT PLANS

For novice investors, the most difficult part of investing is gathering enough information to make informed decisions about building a portfolio. Most people don't have enough time to watch MSNBC 6 hours a day, neither do I. And if you do, you often times end up more confused after a week of research than before you started.

The idea when selecting investments is to understand the key variables that make an investment suitable for your needs. Everyone is different, and unfortunately I, nor anyone else, has found the magic formula to always pick winners. What I can tell you is that evaluating an investment goes far beyond the historical percentage return. And it's okay. You aren't the only one. We are all in awe of the shiny double digit return numbers posted as you pick your 401(k) investments. 10%. 12%. 15%. But let's look past those numbers for a minute and see what's under the hood.

As we hopefully know by now, our markets tend to perform in cycles. The 1990's brought us a technological revolution that sparked widespread growth in our investment markets. That period of prosperity was followed by about a three year long market decline starting in late 2000 and ending in early 2003. Our markets rebounded from 2003-2007, only to hit the financial recession from late 2007-2009. Given our cyclical economic environment, how did your investment options fare, and how will they presumably fare during the drastic upswings and downswings of the market?

Let's start with a hypothetical example of two portfolio's that had different experiences during market swings.

Portfolio A **20% Average Annual Rate of Return**

Age of Portfolio	Starting Balance	$ Gain/Decline	Ending Balance	% Gain/Decline
Year 1	**$10,000**	+ $6,000	$16,000	+ 60%
Year 2	$16,000	- $9,600	$6,400	- 60%
Year 3	$6,400	+ $3,840	**$10,240**	+ 60%

Portfolio B **3.33% Average Annual Rate of Return**

Age of Portfolio	Starting Balance	$ Gain/Decline	Ending Balance	% Gain/Decline
Years 1	**$10,000**	+ $1,000	$11,000	+ 10%
Years 2	$11,000	- $1,100	$9,900	- 10%
Years 3	$9,900	+ $990	**$10,890**	+ 10%

The two hypothetical portfolios have the same starting balance. Portfolio A ends up with less in Year 3 than Portfolio B even though A has a higher average annual rate of return. The illusion comes from the difference between the fall and the recovery. For example, if an investment declines in value by 60%, it will have to then grow by 250% just to get back to where it started.

An investor seeking a positive return of capital should consider many more things. Here are a few helpful points.

- Beta – measures how the investment responds to swings in the market. A Beta of positive 1 means the investment will move with the market. If the market is up 10%, the investment will be up the same amount, on average. Here are a few examples of different Beta numbers and what they mean.
    - Beta of 1.2: On average, the investment is 20% more volatile than the market. If the market is up 10%, the investment is presumably up 12%. And don't forget vice versa.
    - Beta of .8: On average the investment is 20% less volatile than the market. If the market is down 10%, the investment is presumably down 8%. And vice versa.
    - Beta of -1.0: On average, the investment moves in the exact opposite direction of the market. If the market is up 10%, the investment is presumably down 10%. And vice versa. Investments related to commodities like Gold and Silver are examples that may have a negative Beta.
- Fund Inception Date: For Mutual Funds, look at how long they have been around. The average annual return or Beta figures mean very little if the fund has only existed a few years. A long track record will at least help you better evaluate what you are investing in.
- Internal Expenses: For Mutual Funds, the internal expenses of the fund typically range from close to 0% all the way up over 2%. Internal expenses can be a drag on portfolio returns. Keeping the internal expense reasonable is the goal for most investors. The largest component of internal expenses is the fee paid to a fund's portfolio manager. Other costs include recordkeeping, custodial services, taxes, legal expenses, and accounting and auditing fees. Some funds have a marketing cost referred to as a 12b-1 fee, which would also be included in operating expenses.
- Other variables to consider:
    - Fund Objective: This statement will declare what kinds of investments the manager can pick from. Selection will be narrowed by geography, economic sector, and company size.
    - Standard Deviation: Standard deviation is a statistical measurement that sheds light on historical volatility. A volatile investment will have a high standard deviation while the deviation of a stable investment will be lower.

Most of the data you will find during your evaluation comes from the history of the investment. Historic investment results do not indicate future results. You have to combine your knowledge of the past, your outlook for the future, and your understanding of risk to make the best possible decision.

Any questions, whether they be situationally specific, hypothetical, or completely off the wall, can be directed to my email at ken@investplanadvise.com or call me 770-205-4394. When emailing, please include appropriate contact information.

MEET THE AUTHOR

Ken Bellavance

Ken Bellavance studied Finance at the University of North Georgia as a student/athlete. Ken graduated at the top of his class from the Mike Cottrell School of Business and received the Excellence in Finance award for his academic efforts within his field. After four years of college baseball, Ken ended his playing days as an Academic All-American.

As a professional, Ken worked at Provident Funding Associates as a Credit Analyst in the wholesale mortgage industry. He was able to develop a unique skill-set by participating in the mortgage lending process.

Ken and his wife Danielle live in Cumming, GA. They take full advantage of the beautiful North Georgia mountains by kayaking, hiking, and fishing. Being from Stone Mountain, GA, Ken is a Georgia Bulldawg, Atlanta Braves, and Atlanta Falcons fan. He also enjoys losing less than 10 golf balls when he plays a round of golf.