

Great Expectations

In the preface to the Fourth Edition of Benjamin Graham's legendary book *The Intelligent Investor*, Warren Buffet wrote, "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework." This guidance sounds so elementary, yet very few investors are confident enough to completely follow this simple advice.

Over the last five years, Welch Hornsby has been exceedingly active in defining the framework used in making investment decisions. These pages will highlight one aspect of the process used to control emotions from "corroding that framework" – **managing expectations**. Understanding this certainly applies to our clients but is critically important to our role as investment advisors - we are certainly not immune to emotional overreactions.

A recent theory on decision-making coined *decision affect theory* (Mellers, Schwartz, Ho and Ritov, *Psychological Science*, 1997) has expanded the traditional research on the human decision process to incorporate expectations. While the theory has many aspects, the most significant conclusion from an investment risk management standpoint is unexpected outcomes have a far greater emotional impact on people than expected outcomes, particularly unexpected negative outcomes. Thus, the first step to building an emotionally stable long-term mindset is to clearly define the portfolio's objective and more importantly have realistic expectations of how bumpy the ride may be.

Client Expectations

Our investment relationship with a client begins with a standard questionnaire that attempts to begin the process of setting reasonable expectations. Portfolio objectives are defined as clearly as possible to establish the amount of risk that **needs** to be taken and from that point emphasis switches to educating clients on how that level of risk impacts potential future outcomes. [Side note – we have found that investors that do not have a clearly defined objective (reason for taking risk) should err on the side of

caution. This “just feels right” emotional approach toward risk tolerance will inevitably feel wrong when markets hit a soft patch.] Depending upon the situation, to ensure client expectations coincide with what **can** happen, we have the ability to provide clients with two reports. The first is a Monte Carlo cash flow analysis (illustrated below), which simulates the “normal” range of market values an investor could experience given a certain risk/return profile.

Monte Carlo Illustration- Inflation Adjusted					
Initial Portfolio Value	\$15,000,000				
Contributions/Distributions	5% Annual Distribution				
60% Equities/40% Fixed Income	1 Year	3 Year	5 Year	10 Year	20 Year
50% of outcomes were ≥ these values	14,910,791	14,834,414	14,763,292	14,540,923	14,206,488
75% of outcomes were ≥ these values	13,761,908	12,863,341	12,314,602	11,393,940	9,917,792
90% of outcomes were ≥ these values	12,832,944	11,406,946	10,420,346	8,987,824	7,318,278
95% of outcomes were ≥ these values	12,345,044	10,616,544	9,560,296	7,941,564	5,929,583

The 50th percentile is equivalent to the median value with 50% of the observations higher than this level and 50% of the observations below this amount. When we present the results of the Monte Carlo analysis we stress the output from the simulation is only a starting point and understanding the range of outcomes, particularly those observations that would be considered worse than expected, is often more important than the median value.

The Monte Carlo analysis only captures 95% of the outcomes, therefore the second report we often review focuses on historical market environments many view as “outliers”.

\$15,000,000 = Portfolio Size Modeled				
Select Allocation		60% Equities/40% Fixed Income		
	Months	Total Bear Market Return	Hypothetical Mkt Value	Return to Breakeven
Jan 62 - Jun 62	6	-11.66%	\$13,251,000	13.20%
Dec 68 - Jun 70	19	-15.87%	\$12,619,500	18.86%
Jan 73 - Sep 74	21	-23.89%	\$11,416,500	31.39%
Sep 87 - Nov 87	3	-15.63%	\$12,655,500	18.53%
Sep 00 - Sep 02	25	-17.97%	\$12,304,500	21.91%
Nov 07 - Mar 09	16	-22.42%	\$11,637,000	28.90%

Ultimately, the primary objective of the analyses is to minimize the risk of negative surprises, which as noted above in the *decision affect theory*, can result in heightened emotions that could potentially corrode the long-term investment framework.

A risk tolerance exercise to set/manage investment expectations is certainly not unique to Welch Hornsby; however, we continue to define expectations throughout the portfolio implementation and portfolio/manager evaluation phases that we often rely on to keep our emotions from overemphasizing our short-term decision/recommendations.

Portfolio Expectations

Once a portfolio objective has been identified, **the implementation decisions are focused on maximizing the probability of success not the magnitude of success**. We do not try to predict what will happen; rather our goal is to be prepared for what can happen. An investment plan is like a jigsaw puzzle. The potential pieces to each puzzle are often similar, driven by the functional risk/return attributes:

- + Debt versus equity
- + Short-term versus long-term
- + Private versus public
- + Liquid versus illiquid
- + Domestic versus foreign
- + Manager versus market
- + Inflation sensitive versus deflation sensitive

However, the shapes and sizes of each piece are different for everyone dependent upon the unique needs/objectives of the investor. As we construct the puzzle, we discuss “what if” scenarios – building expectations of how each piece of the portfolio should perform during various market environments based on fundamentally different return drivers. One of the most commonly heard statements in the Welch Hornsby Research and Investment Committee meetings is if everything within a portfolio is performing well at the same time, the portfolio is probably not appropriately diversified.

This concerted effort to build realistic expectations of what can happen for each component of the portfolio enables us to better understand how the overall portfolio should react to certain events, which is critical as we attempt to shape the overall portfolio’s return profile. As various markets inevitably hit a rough spot, we rely on these expectations to ensure the portfolio’s outcomes are reasonable giving us an emotional foundation to protect our long-term investment decisions.

Manager Expectations

The final piece of the portfolio design phase is the identification and selection of investment managers to implement our investment decisions. We have access to all traditional sources of historical data that we quantitatively use to screen, analyze and identify potential candidates. However, before a manager is selected we conduct a qualitative review that includes establishing investment expectations for each manager. These expectations are more in depth than the standard “Manager X should outperform the benchmark over rolling three-years and rank in the top quartile of its peer universe” language that typically defines performance expectations. We attempt to define market environments we believe the manager will perform well relative to its benchmark and those times we would anticipate the manager will underperform the broad markets.

Short-term underperformance is going to happen. A quick review of Morningstar’s Large Cap Value Universe shows 240 products having ten-year track records. Evaluating the twenty-four products (top 10%) with the highest return over the entire ten-year period, you will find that every one of the funds had a three-year period in which they underperformed the Russell 1000 Value Index with underperformance ranging from -0.37% to a remarkable -9.6% annually.

While we are certainly not blind to relative underperformance, we are much more focused on how the manager performed versus our expectations given the market environment. We believe this approach to evaluating short-term performance will enable us to keep our emotions under control and make better decisions when a manager underperforms a benchmark.

Conclusion

With 2008 still fresh on investors’ minds combined with extremely volatile markets; it is challenging to keep emotions from corroding our decisions framework. However, having realistic expectations of and diligently preparing for what can happen, will better prepare an investor to maintain his/her course when the waters become choppy.

Written by Jim Underwood, CFA, Chief Portfolio Strategist, Welch Hornsby



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INVESTMENT ADVISORS