



RELATIVE RETURNS AND INVESTOR PSYCHOLOGY

by Glenn E. Atkins, CFA

When thinking in advance about future investment performance, there are only two possible decisional-based outcomes. One is the decision to be in the market (stocks or bonds) in the first place. The second is how did my manager perform, in light of my previously chosen asset allocation, relative to the market as a whole? Thus begins the irreversible separation of absolute and relative investment returns. In simple terms, to ultimately reach your stated goals, absolute and relative returns must be thought of separately, but at the same time managed in harmony.

ABSOLUTE RETURNS

Absolute returns (i.e., "my account was up 12% last year") are clearly what pay the bills, but as we have discussed in the past, multi-year absolute average returns do not occur year in and year out at 10% every year. Instead, returns come as up 40% and down 40% and everywhere in between from year to year, they simply have averaged about 10% per year since the mid 1920's.

Let's examine the first decision, the one of deciding to be in the market or not. The fact that individuals consider investing at all is testament to the decision, conscious or not, to seek a higher return than that of hiding your money under a mattress. Higher returns come with higher risk – that is an inalienable fact of the market. There are no free lunches. Being in the market says I will accept higher risk for the prospect of higher return.

This brings us to our next premise, that of relative versus absolute returns. To earn consistently higher returns, one must commit to be in the market for the long term. If you need your money next year, stay out of stocks and most bonds. One must accept the prospect of potentially negative returns for the overall average of year in and year out earning a higher return than that of mattress money.

RELATIVE RETURNS

Relative returns are simply that: How did my account do when compared to the

market? If your account was up only 2% one year and the market was down 1%, your manager did a good job of adding value to your account. Granted, you probably did not earn enough "absolute return" to pay your bills during that year, but only that year. If your manager continues to add that kind of "relative value" (versus the market) over the years you stand a much greater chance of retiring happy, even though in a few specific years your absolute return was not what you might like it to be. Again, the decision to be in the market must be separated from the decision to stay in the market. Absolute performance pays the bills year to year, *relative performance (beating the market consistently) pays for your lifestyle throughout your retirement horizon.*

The typical disconnect we see is when accounts are up 3 or 4% and the market is flat to down. Investors will say, "gee I didn't do too well this year, I think I will get out of the market." Let's think through this for a second.

"...absolute performance pays the bills and relative performance keeps you in the hunt."

INVESTMENT ALTERNATIVES

What are your investment alternatives? If you had been in an **index fund** you would have been even at best, but you probably lost money. Cash **under the mattress** earns nothing and loses value to inflation. **Paying off the mortgage** may be an idea, but your after-tax cost of funds is probably in the 4% range, equivalent to what the manager earned, but with no upside when the market might be expected to earn 10% on average over time. Granted, there are some valid "it helps me sleep better at night" reasons to pay off the mortgage, but not many long-term investment ones. If you have the prospect of earning more than your after-tax cost of borrowing, that should be a factor in your decision. Yes, you could,

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after the fact, pick an investment that was up more than 3 or 4% last year, but there are no guarantees that the investment will be up again next year and I'll bet you lunch that your higher-returning alternative investment has more inherent risk than a diversified portfolio of high-quality stocks long-term. There has never been a rolling 20 year period since the mid 1920's that you would have lost money in stocks.

TOTAL RETURN

Don't forget the concept of total return, too. Returns are not measured just by the income or dividends your bonds or stocks generate. Returns also include capital gains (and losses) in your portfolio. For example, the current dividend yield on the S&P 500 is 2.00%. If that's the average over time, 80% of the 10% return in stocks over time comes not from dividends, but from capital gains.

Remember, absolute performance pays the bills and relative performance keeps you in the hunt. 🐾

HEDGE FUNDS

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CONCLUSION

In short, despite some drawbacks such as higher management fees (about 2% while those of mutual funds are frequently 1% or less) and withdrawal restrictions, it seems that, even as hedge funds differ in shapes, sizes and strategies, they tend to have some common traits: low correlation to the stock markets, lower volatility and much higher risk adjusted returns than those of many equity indices. These attributes may make them an attractive investment to diversify a long term portfolio for accredited investors. 🐾

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¹A security, such as an option or futures contract, whose value depends on the performance of an underlying security or asset.

²Short selling (or "selling short") is a technique used by those who try to profit from the falling price of a stock. It consists of borrowing a security from a broker and selling it, with the understanding that it must later be bought back (hopefully at a lower price) and returned to the broker.

³An individual investor is accredited if he or she has a net worth (including one's home and furnishings) in excess of \$1,000,000 or has had an individual income of more than \$200,000 for the past two years or joint income with one's spouse in excess of \$300,000 in each of these years and has a reasonable expectation to reach the same income level in the current year.

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