

# WESCAP MANAGEMENT GROUP

1314 W. Glenoaks Blvd., Suite 204  
Glendale, CA. 91201  
(818) 552-2130

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*Items of Interest to WESCAP Clients and Other Interested Readers*

## **Statistics and Liars**

The phrase “Lies, damn lies, and statistics” says it all for many when it comes to investment returns and related statistics. Examples abound: the firm that performed about 2% “better” than the S&P 500 index, but did not tell you that S&P 500 dividends were not included, and which would have put them 1% behind the normal index.

It is not difficult for a “bond” fund to look superior when it also owns some stocks during this stock “bull” market. How about an equity fund, that hedges away most of the stock market risk? Should it be compared to the average stock mutual fund? Investment style miscategorization is a common occurrence, creating evaluation problems.

Then you have many varieties of “truths”, such as what is the yield of a bond or bond fund? “Current” payment yield, often used, is not a true long-term earnings yield. Yield-to-maturity, yield-to-call, or yield-to-average-life are often better measures. Bond mutual funds have an additional issue: Is the fund’s dividend yield more than what the underlying bonds are actually paying (current yield versus SEC yield)? If so, a future dividend cut is probable.

The latest misstatement is from the Beardstown Ladies Common-Sense Investment Guide, a recent best seller, partly because of its claim of a 10-year, 23.4%

annualized rate of return that “anyone” can emulate. Upon audit however, it turned out the total return was only 9.1% per year due to an error of counting contributions as investment returns.

We believe the authors claim that it was an honest error. Others ask “how can they be so far off?”

Most people have no idea what their investment returns are, or how to calculate them. If they don’t know how they are doing, how can they know whether they are on track to meeting their long-term goals?

The total rate of return calculation gets complicated when funds or securities are added to or taken from accounts. Also, many people do not take into account ordinary and--for mutual funds--capital gain dividends paid when calculating returns.

Most investment firms (e.g., WESCAP) are obligated to follow the “AIMR standards” for reporting performance. This specifies which portfolios must be or cannot be included in composite performance reports. Also, it dictates that cash flows into and out of accounts must be accounted for and that a *time-weighted* return must be calculated (also called the *mutual fund return* method, since this is what mutual funds use).

For example, assume \$1,000 in a mutual fund grows 50% (\$500 gain). At this point \$10,000 is added to the account, after which the fund drops 10% (\$1,150 loss). As a result, the time-weighted rate of return is

35% (150% X 90%, minus 1). The returns are calculated *independently* of contributions or withdrawals (these are presumed to be beyond the mutual fund's control).

There is another return measure that is generally not used by mutual funds or investment managers, but is useful for those who do control cash inflows or outflows. The *internal rate of return* (IRR) measure is *dependent* upon cash inflows and outflows. In the prior example, \$500 was made in the first time period and \$1,150 was lost during the second period, primarily because more money was invested just before the decline. IRR in this case can be calculated by solving the following formula:

$$\$1,000(1+IRR)^2 + \$10,000(1+IRR) = \$10,350$$

The IRR solution is a negative 5.4%. This reflects making a large additional investment at just the wrong time. The mutual fund's reported performance would be +35%, but the investor lost 5.4%. Both returns are valid, but it is important to determine what you want to measure and why.

Two mutual fund analysis firms, Dalbar and Morningstar, have found similar results for the unsophisticated average mutual fund investor. While equity mutual funds themselves have had good returns, the average equity mutual fund investor did much worse--in effect putting too much money into hot stocks or mutual funds *after* they had already done well (see our 1995, First Quarter newsletter for details). This "driving by the rear view mirror" approach to investments has about the same efficacy as with motor vehicles. Past performance is not a good indicator of future performance.

Chasing performance is a recipe for high-risk underperformance.

A better approach is to determine what rate of return you need, and then to design a portfolio that appears best in minimizing the chance of *not* reaching that all-critical threshold return.

Let's say you need a 7% average annual return (determined by sophisticated software or other means). It may be that a portfolio with an expected return of 9% might be best. The chance of making less than 7% is very small. Seeking a lower 8% return cuts the margin for error too much. Aiming for a higher return--let's say 14%--could actually increase the risk of not making 7% due to the higher overall risk of the portfolio.

Getting a higher return on average would be nice--who wouldn't want it--but if the chance of failure to reach your goals is greater, should you really take that chance?

### Trust as IRA Beneficiary

A recent change by the IRS makes it more useful to allow a revocable living trust to be the beneficiary of an IRA. No longer is the required minimum distribution for a trust based on a single life expectancy, but rather on joint life expectancy, as is typical when an individual is named as beneficiary.

There may be additional estate planning benefits, but careful drafting of the trust is a prerequisite. Consider contacting your estate planning attorney for a trust and IRA beneficiary review.

If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom at (818) 552-2130 or fax to (818) 552-2133. WESCAP Management Group has obtained information from sources believed to be reliable, but no guarantee can be made as to its accuracy. WESCAP Management Group provides high quality, personalized, objective financial and investment advice to individuals.