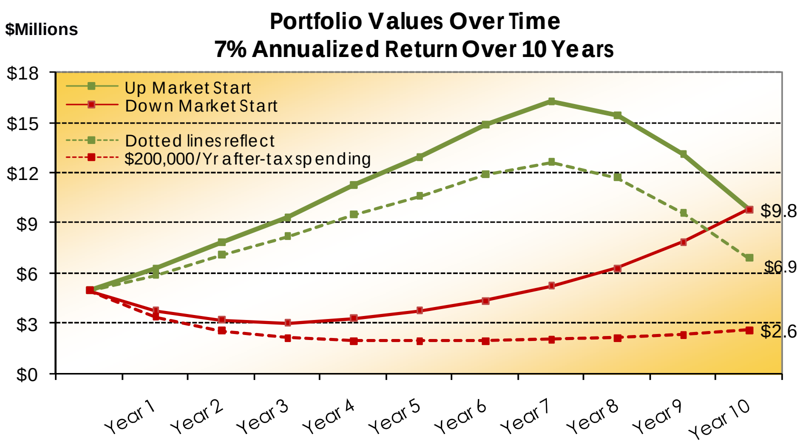
Miracle Mile ADVISORS

Providing Global Opportunities for the Risk-Aware Investor

It’s Not the End (Return), It’s the Journey

When money managers talk about multiple-year returns, they usually quote it as an “annualized” number. If a portfolio gained 30% over the past 5 years, they would say that the client earned a 5.4% “annualized” return, meaning it gained the equivalent of 5.4% every year for 5 years. This is a convenient way to think about performance since everyone can easily conceptualize a one-year time frame. However, it can be misleading. In reality, the path of annual returns does not move in a straight line and the order in which they occur can have a big impact on the value of the portfolio.

Here is a simple example. If the amount of money in the portfolio is untouched, then the order of the returns has no bearing. All of the lines in the chart below show a portfolio with a $5 million beginning value that averages a 7% annual return over ten years. The solid green line shows the portfolio’s path if the best returns happen early in the life of the portfolio: the first seven years are positive, and the last three are negative. The solid red line shows the reverse: three negative years followed by seven positive years. Both lines represent an average annual return of 7%, and result in a portfolio of $9.8 million at the end of 10 years.



"Up Market" return stream:
25%, 25%, 20%, 20%, 15%, 15%, 9%, -5%, -15%, -25%.

"Down Market" return stream:
-25%, -15%, -5%, 9%, 15%, 15%, 20%, 20%, 25%, 25%.

Both represent 7% annualized return over 10 years.

Dotted lines reflect same return streams as above, with $200,000 per year withdrawn from the portfolio, after tax.

The story changes when the amount of money in the portfolio does not stay the same over the 10-year period. This is usually the case after paying taxes and fees, or if all dividends and income are not reinvested. The dotted lines in the graph show the same pattern of returns as the solid lines; however, in these two cases $320,000 is withdrawn from the portfolio every year (equivalent to $200,000 after-tax for a California resident). When the market begins with a series of positive years (green dotted line), the portfolio ends up with $6.9 million dollars in year 10. If the market experiences those three negative years first (red dotted line), however, the portfolio ends with only $2.6 million. This is quite a difference. If the negative returns occur early on, then the amount of money remaining to compound is smaller than if the positive returns occur early on.

The lesson here is not that money should not be withdrawn from a portfolio, but that losses can have a very big and lasting impact. For many investors, avoiding large losses may prove a better strategy than "swinging for the fences" to make big gains. Although the red-dotted line portfolio fell "only" 48% from its original value of $5 million, it will require a gain of more than 92% to get back to where it started. Although obviously no one can control or precisely predict the future pattern of portfolio returns, it is possible to consider the environment and make adjustments to protect your principal.

The Roadmap

The example above uses two series of hypothetical returns which are either very positive or very negative in the early years. We do not believe that either of these situations will hold in the next several years. Our view is that we will be in a positive return environment for equities over the next one to three years, but gains will be lower than historical averages. If our view comes to pass, then the years of double-digit portfolio gains are behind us for awhile. This means that investors may need to take some steps to alter their portfolio withdrawals and possibly increase their saving. The problem that many people face, however, is understanding exactly how much of an adjustment needs to be made.

The cash flow analytics that we perform for our clients at Miracle Mile Advisors address this scenario perfectly. Using our detailed analysis, we are able to give our clients a picture of how their spending and saving patterns could impact their portfolios in the years ahead. We look at our clients' annual spending needs and compare them to the portfolio's expected income generation and gains, and determine at what level withdrawals from the portfolio would become a drain on principal. We are able to customize the analysis year by year, taking into consideration periodic expenditures such as children's college tuition, wedding expenses, new cars and homes, or retirement.

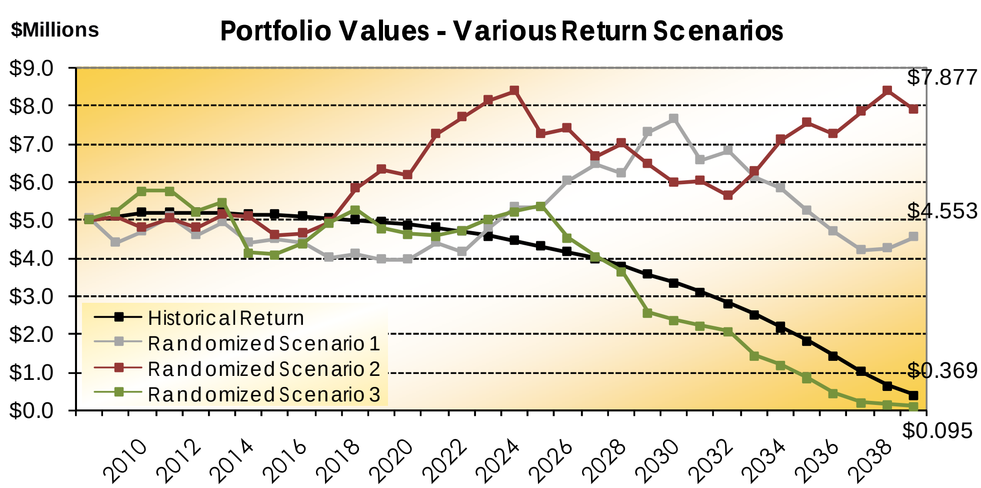
While we have a view on what we think will happen in the markets, the future is unpredictable and becomes even more so the further we move out in time. Instead of imposing our forecasts or a linear average of historical returns on this analysis, we have taken actual historical year-by-year returns and randomized their order. This method gives us many different scenarios for judging the long-term sustainability of portfolio inflows and outflows. Of course, as market conditions change we would recommend tactical shifts in the portfolio allocation, however, in the following example we maintain our Conservative Investor model portfolio allocation over time for simplicity. The analysis accounts for fees and taxes[1].

[1] Miracle Mile Advisors does not provide tax advice. Please consult your accountant for specific recommendations. Our analysis approximates the taxes that would be paid for a California resident in the highest income tax bracket, assuming 75% of taxes were attributable to income and 25% to capital gains.

The Traveler

We begin with a $5 million portfolio. Each year our client, Jane Investor, requires $150,000 of after-tax income to be withdrawn from the portfolio (roughly $240,000 pre-tax for a California resident), to supplement her income as a freelance writer. The portfolio principal is proceeds from several books our client published in the last few years, after her first novel was featured on "Oprah". Ms. Investor is single, but engaged to be married in 2010. She anticipates that her income requirements will remain steady at $150,000 until the wedding. After 2010, she and her new professional surfer husband will need about $250,000 in after-tax income, increasing at an inflation rate of 2% per year. They will also contribute to the portfolio the $50,000 per year he earns teaching private surfing lessons. They will worry about adjusting their portfolio analysis for children at a later date.

Jane has a conservative outlook on investing, and is more concerned with preserving her principal than taking on additional risk to make large gains in the markets. She expects she will publish another 2 to 3 books in the next ten years, and estimates that this will earn her several million dollars to add to the portfolio down the road. She is superstitious, however, and does not want to include the expected book revenues in her cash flows just yet. She is coming in to Miracle Mile Advisors with all cash, and is a perfect fit for our Conservative model portfolio.



The chart at right shows several different scenarios for the evolution of Jane's portfolio given the criteria laid out above. If we use the constant historical **average** returns going back as far as actual data is available for all of our asset classes (20+ years), the black line shows that the portfolio would be depleted in about 30 years. Using streams of annual historical returns in a random order, however, we see that different results are possible. The first scenario, in grey, shows a fairly steady path of returns. Several of the annual returns are fairly large negative numbers, but the portfolio still ends up with just over $4.5 million in 2039. The second randomized scenario shows more optimistic results. The red line ends with a portfolio value of almost $8 million thanks to large positive returns in the mid-life of the portfolio. Finally, the green line shows our third randomized return stream. In this case, we deplete the portfolio within 30 years, closely following the black historical average return line.

The table below summarizes the first ten years of portfolio simulations for the three randomized return scenarios:

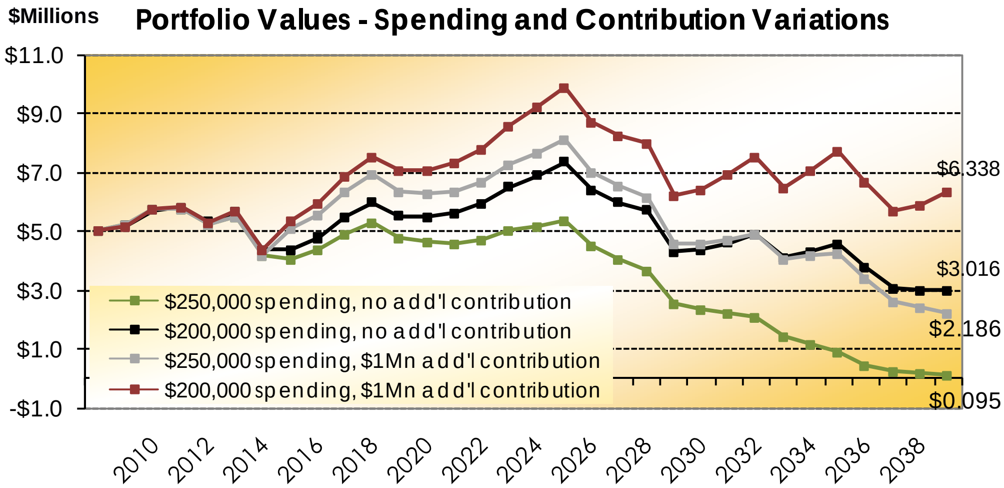
Conservative Investor, Randomized Historical Returns										
Scenario 1										
$Mn	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Beginning Ptfl. Value	$5.00	$4.38	$4.66	$5.08	$4.57	$4.91	$4.39	$4.48	$4.40	$4.01
Ptfl. Income - Pre Tax	$0.17	$0.15	$0.16	$0.17	$0.15	$0.16	$0.15	$0.15	$0.15	$0.13
Taxes Paid	-$0.02	-$0.10	-$0.12	-$0.05	-$0.11	-$0.05	-$0.09	-$0.08	-$0.04	-$0.09
Annual Distrib. Paid Out	-$0.15	-$0.15	-$0.25	-$0.26	-$0.26	-$0.27	-$0.27	-$0.28	-$0.28	-$0.29
Ending Portfolio Value	**$4.38**	**$4.66**	**$5.08**	**$4.57**	**$4.91**	**$4.39**	**$4.48**	**$4.40**	**$4.01**	**$4.10**
Scenario 2										
$Mn	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Beginning Ptfl. Value	$5.00	$5.07	$4.80	$5.03	$4.76	$5.15	$5.06	$4.59	$4.62	$4.94
Ptfl. Income - Pre Tax	$0.17	$0.17	$0.16	$0.17	$0.16	$0.17	$0.17	$0.15	$0.15	$0.17
Taxes Paid	-$0.08	-$0.05	-$0.11	-$0.06	-$0.12	-$0.08	-$0.05	-$0.09	-$0.12	-$0.16
Annual Distrib. Paid Out	-$0.15	-$0.15	-$0.25	-$0.26	-$0.26	-$0.27	-$0.27	-$0.28	-$0.28	-$0.29
Ending Portfolio Value	**$5.07**	**$4.80**	**$5.03**	**$4.76**	**$5.15**	**$5.06**	**$4.59**	**$4.62**	**$4.94**	**$5.80**
Scenario 3										
$Mn	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Beginning Ptfl. Value	$5.00	$5.18	$5.71	$5.73	$5.19	$5.44	$4.14	$4.05	$4.34	$4.88
Ptfl. Income - Pre Tax	$0.17	$0.17	$0.19	$0.19	$0.17	$0.18	$0.14	$0.14	$0.15	$0.16
Taxes Paid	-$0.10	-$0.13	-$0.10	-$0.06	-$0.12	$0.02	-$0.07	-$0.11	-$0.13	-$0.13
Annual Distrib. Paid Out	-$0.15	-$0.15	-$0.25	-$0.26	-$0.26	-$0.27	-$0.27	-$0.28	-$0.28	-$0.29
Ending Portfolio Value	**$5.18**	**$5.71**	**$5.73**	**$5.19**	**$5.44**	**$4.14**	**$4.05**	**$4.34**	**$4.88**	**$5.25**

The Detour

If either Scenario 1 or 2 came to pass, Jane would be happy. She would of course prefer Scenario 2 since her portfolio gains in value, but just preserving the current principal is the goal. On the other hand, Scenario 3 presents a problem. Jane would like to consider her options if something like this were to happen.

There are two ways to prevent this kind of principal erosion: reduce spending, or add assets to the portfolio. Jane believes that her future publishing revenues will add to the portfolio over the next ten years, providing a cushion. She would also like to consider how a reduction in spending would help, just in case writer's block sets in.

In the chart below we consider 4 options. The first is the same as Scenario 3 above: annual spending runs $250,000 post-wedding (adjusted for inflation), and no additional contributions are made (green line). The second option is to reduce the travel budget and keep spending down to $200,000 after the wedding, making no additional contributions (black line). The third is to keep the travel budget in place, spend the $250,000 but contribute an additional $1 million to the portfolio (after-tax) in 2015. Finally, the fourth option is to do both: lower spending to $200,000 and make the $1 million lump sum contribution.



As the chart shows, relatively small changes can make a big difference. Either option 2 (black) or 3 (grey), i.e. *only* reducing spending or *only* making a $1 million contribution, keeps the portfolio above water for the next 30 years. Doing both (red) actually helps the portfolio increase in value over time. Jane feels fairly confident that her book deals will prove lucrative, and therefore has decided to go ahead with the $250,000 spending level for the time being. If the situation changes down the road, we will reevaluate at that time.

The Destination

Over the course of an investment lifetime many life factors will change. This analysis is not meant to be a prediction of results decades into the future, but instead a guide to how small adjustments can greatly benefit a portfolio. Our model is completely customizable, and we are able to incorporate very specific requirements. Please contact us if this would be something of interest. Our goal for our clients is to avoid large losses and manage risk in any way possible during these uncertain and volatile times in the markets.

March 27, 2009

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