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Let's Bury The Myth Of Averages

John Girouard 02.23.09, 2:30 PM ET

If we've learned anything from one of the worst years in financial history, the most important has to be the myth of averages.

No single factor has played a greater role in the destruction of people's wealth and retirement plans over the past quarter century than the investment return assumptions on which most advisers and financial services firms base their clients' portfolios and their product pitches.

The biggest myth is that the stock market returns, on average, about 10% a year. This figure was baked into so many retirement plans that you'd think it was a scientific fact, like the chemical composition of water. Turns out the actual long-term average annual return of the stock market from 1926 to 2008 (as measured by Standard & Poor's) comes out to an inflation-adjusted 6.2%, with dividends reinvested but before taxes and transaction costs.

That's just the beginning of the myth. A chart of the S&P 500 for the 10 years ended last month produces an inflation adjusted average annual loss of about 5%. A similar phenomenon occurred between 1966 and 1982, when stocks bounced around for 16 years without breaking through a 1960s high on the Dow Jones Industrials of 1,000.

Average annual return after inflation: roughly -4%.

There has been an equally strong mythological belief in the concept of average and total rates of return on mutual funds and similar investments. These are the two most significant measurement tools used in the investment industry to promote mutual funds.

Nearly all mutual fund marketing materials brag about rates of return, with fancy graphics and upward-trending charts. They show the returns for one year, five years, 10 years and sometimes even longer.

But these numbers should not be used in financial planning because they confuse the average investor. For example, Morningstar Research reported that the Vanguard Index 500 Fund rose 134.18% in the 10 years ended Aug. 31, 2007. When I ask clients what they think that translates into as an average annualized compound return, almost all of them immediately divide the total return by 10 to come up with 13.42%. Their jaws drop when I show them that the actual compound annual return was 6.67%. It's basic eighth grade math that the financial services industry would rather not talk about because it conflicts with their marketing claims.

This erroneous thinking has been around for years and has been perpetuated by the press. When Individual Retirement Accounts first became available, there were many articles projecting that an investor could end up with a million dollars over 36 years just by investing $2,000. But the assumption was an annual return of 12% and did not take into account the cost of taxes.

As this is written, money-market rates are below 1%. What a disaster for the poor soul who believed in that tooth fairy! Inaccurate math wreaks havoc on a financial plan.

Making matters even worse, we humans are programmed to make terrible choices when it comes to money and investments. There have been many studies, and there are plenty of data, that show beyond doubt that we are for some reason emotionally programmed to buy high and sell low.

A study entitled "Dumb Money," conducted by professors at University of Chicago and Yale University, found that between 1983 and 2003 the hottest mutual funds--those experiencing the greatest inflows of money--performed much worse than mutual funds that investors were dumping.

Last year left a lot of people feeling bewildered and betrayed, with good reason. Their expectations were predicated on a quarter-century of mathematical mythology coupled with an exponential growth in financial "news" that turns out to have been mostly noise.

The more we thought we learned, the less we understood and the quicker we were to make choices based on an ever-shortening time frame and an ever-widening expectation that the rate of wealth creation could be accelerated if we just pressed hard enough on the gas pedal. That's how we got the Internet bubble of the 1990s and the real estate bubble that followed.

Here are some old lessons for the new post-mythology era:

1. Stocks and bonds are not investments to be judged on a daily, monthly or even yearly basis. The question should be: Is this a good decision for 10 or 15 years from now? That's true financial planning.

2. Stock and bond investments should not be made with money you might need in the next three to five years. That money should be socked away in a cash-equivalent vehicle, which can range from plain-vanilla bank CDs to cash-value mutual life insurance.

3. Buying a home should be seen as a long-term forced savings plan that grows at about the rate of inflation, not as a speculative investment.

4. Like the proverbial watched pot that never boils, our addiction to television financial news and online portfolio tracking does not help us grow wealth. It distracts us from the rest of our lives at best; at worst it makes us vulnerable to making emotional decisions fanned by fear or greed that could invariably sabotage our futures.

5. It is educational to look at statistics, past performance, charts and other tools that measure where we've been. But it's important to remember that you can't drive a car while looking in the rearview mirror.

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