One Person's 7% Return is Another Person's Disaster

Investors need to understand the effects of volatility over the years

By Gregory Anderson, CFP®

Most people understand the correlation between risk and reward as those elements relate to their financial investments. Typically, as the risk increases, the potential for reward increases. So does the potential for financial disaster.

And when people establish their financial goals, they determine how much money they will need by a certain time, whether the goal is retirement, vacation or a second home. It is easy enough to say, "I want another $36,874 to pay for my son's college education within 10 years, so the $38,126 that I have available to invest needs to generate a 7 percent annual return (giving me a total of $75,000)."

Let's keep this simple for now, and let's not even get into the issues of tax ramifications. It will be an effortless matter to find an investment whose history of returns over the last 10 years matches that 7 percent goal. Case closed, financial planning chore done, time to head over to Coors Field for a Rockies game, right?

Wrong.

Your 7 percent average annual return might not be the same as the next person's 7 percent return. Here's why:

On that $38,126 investment, if the return over the first three years is 7 percent every year, you will net $8,580. BUT if the returns are minus-20 percent, 7 percent and 34 percent, while the AVERAGE return is still 7 percent, the NET is only $5,606. Quite a difference. That poor kid might not go to college afterall, at least not the one originally targeted.

Investors need to understand that some investments' returns fluctuate more wildly than others. We refer to the history of that fluctuation as the standard deviation, and an understanding of the standard deviation greatly influences the advice that a financial planner will provide to an investor.

You might be thinking, well, a 7 percent average over 10 years is still a 7 percent average, and you don't care how you get there, right? Wrong again.

First, as folks keep telling you, past performance is not necessarily an indication of future potential. Second, there is a timing issue. If you make your original investment on a big "down" year, it is going to take quite a while to climb out of that hole and get to where you are averaging 7 percent. It might not be 10 years. It might be 15 or 20. Whereas, the gal who invests the year after you, who missed the big "down" period, will net more than you in a shorter time.

How do you account for this standard deviation? Many financial planners now have software that can run THOUSANDS of scenarios based on all the information available – including the standard deviation – then add them up and offer a probability of reaching your goal based on the volatility of the investment. This software will never replace the knowledge, instincts and awareness of a good financial adviser, but it is another nice tool to have.

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