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Portfolio Perspectives

Monthly Insights for Investors

What Many Investors Get Wrong About "Average Returns"

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You come to the edge of a fast-flowing river and want to get to the other side. You read the sign conspicuously posted at the water's edge — "average depth 3 feet." Feeling confident, you begin to wade across the river. Midway across you fall into a deep hole and get swept down the river.

What Went Wrong?

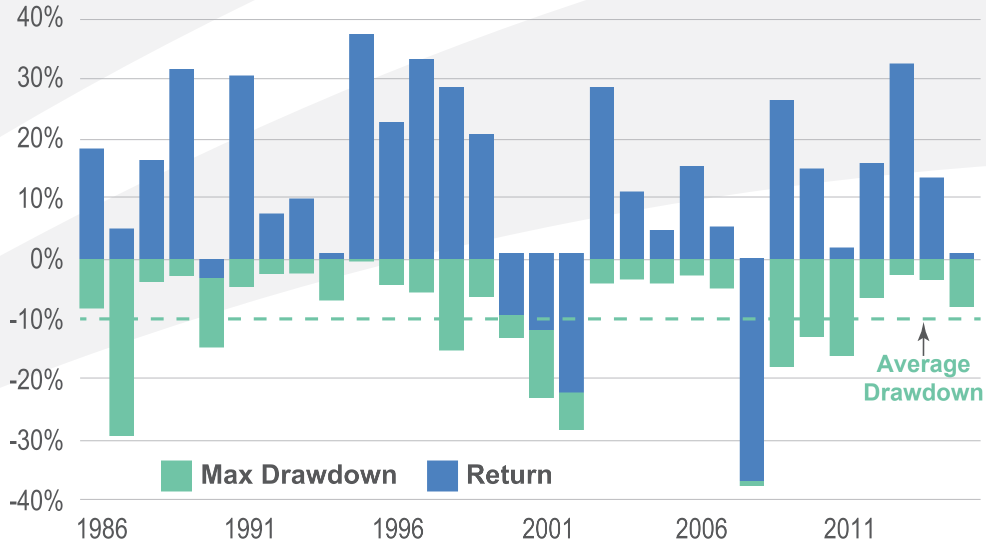
Unfortunately, your understanding of the word "average" was incorrect. This is what Stanford University Professor Sam Savage calls the Flaw of Averages.[1] He explains, "Plans based on the assumption that average conditions will occur are usually wrong."

What does this have to do with investing? If you are expecting to earn a return from your investment each year that is close to "average" you will be disappointed. Short-term investment returns almost never equal their long-term average, landing well above or below their historical average from year to year.

Take the U.S. Stock Market for example.[2] Over the last 30 years it's averaged a compound annual return of 10% per year. Yet, remarkably, it earned 10% in only 1 out of the 30 years (1993). In fact, it lost as much as 37% in 2008 and gained as much as 38% in 1995 — quite a range of outcomes.

Part of a great investment experience is having the right expectations. Setting your sights on a return target can be disappointing, especially given the fact that we can't control investment returns. Part of those proper expectations is expecting intra-year declines.

Intra-Year Declines of the U.S. Stock Market 1986 – 2015



Source: Morningstar Direct 2016. Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. All investments involve risk, including loss of principal.

The chart above shows the annual return for the U.S. Stock Market for the last 30 years and the maximum intra-year decline for each year. As you can see, most years include some sort of decline, with the historical average decline landing around negative 10%. To put that in dollar terms, you should expect your U.S. Stock Market investment to be down $10,000 at some point during the year, assuming you started the year with $100,000 invested.

A temporary decline is not the same as a permanent loss. And as we see in the chart, temporary declines are commonplace when it comes to investing. Despite 30 years of intra-year declines, the U.S. Stock Market was able to earn a positive rate of return. One dollar invested at the beginning of 1986 would have grown to almost $20 by the end of 2015.

Although they may be temporary, declines are painful. In fact, Nobel Laureate Daniel Kahneman and his partner Amos Tversky explained in their research that investors typically feel the pain of financial loss much more intensely than the pleasure felt from financial gain of the same size.[3] This may be one reason why investors find it so difficult to stay invested during market declines. The good news is that investors have been rewarded for their pain.

It is important to understand the risk and uncertainty of investing. You should expect a bumpy ride, as we experienced at the beginning of this year, but if you are able to withstand the pain, history has shown that investing can reward the resilient.

[1]Savage, Sam, The Flaw of Averages, San Jose Mercury News, October 8, 2000.

[2]U.S. Stock Market represented by the S&P 500 Index.

[3]"Prospect Theory: An Analysis of Decision under Risk;" Kahneman, D. and Tversky, A. (1979). Econometrica