Target Return for My Portfolio

Many years ago now I first learned the importance of having a plan. I had worked for a multi-national company and one of the essential disciplines was to write a marketing plan for each product. That plan was in a format that I found had stood the test of time and which I have utilised myself in my own business and in my investing in particular.

Later I kept reading about research that identified the reasons that most new businesses and especially small businesses fail. One reason that was always near the top of the list was the failure to formulate a business plan before they started up. When I began to work intensively on ways to improve my investing, this came back to me. Trading may be a hobby or entertainment, but investing is a small business. As such, I realised that I should have a business plan for my investing. I call it an investment plan, but the full name might be a plan for the investment business that I was running.

At that point, I began to ponder just how to structure such an investment plan. My ruminations took me back to the marketing plans I had written and executed years ago. The format of those plans was in three basic parts that flow logically one from the other:

- The objective
- The strategies for achieving the objective
- The tactics for executing the strategies

Notice that the key words "objective" "strategy" and "tactics" are familiar from the military world, where plans a drawn up and executed constantly.

It seemed to me that this format would be highly appropriate as a starting point in developing a format for my investment plan. Most of my early drafts were in this form. However, as time went on, I began to appreciate that something else is very important in investing.

This is that investing is a process of managing uncertainty. Investing is uncertain because we have no way of knowing what all the possible outcomes are, let alone have any ability to assign even rough probabilities to them – if we don't know all of the possibilities, we cannot assign useful probabilities even to those we are able to guess at.

In this situation, I began to grasp that what I could do, though, was to manage risk. Risk is defined by the academics as the range of fluctuation in prices. Risk is not defined that way by ordinary investors – for them risk is one-dimensional: the possibility of loss. What I needed to have in my plan was the risks that I had to manage and how I would do that.

I therefore added another section to my investment plan, so that it now had this basic architecture:

- My objective
- My investment philosophy (the simple big idea behind my plan)
- Risks and strategies
- Managing investments (tactics and risk management)

This is the basic form of my investment plan today.

My investment plan begins with a choice of asset class. I invest only in Australian stocks and hold uninvested capital in cash ready to be employed at the appropriate time and as opportunities emerge.

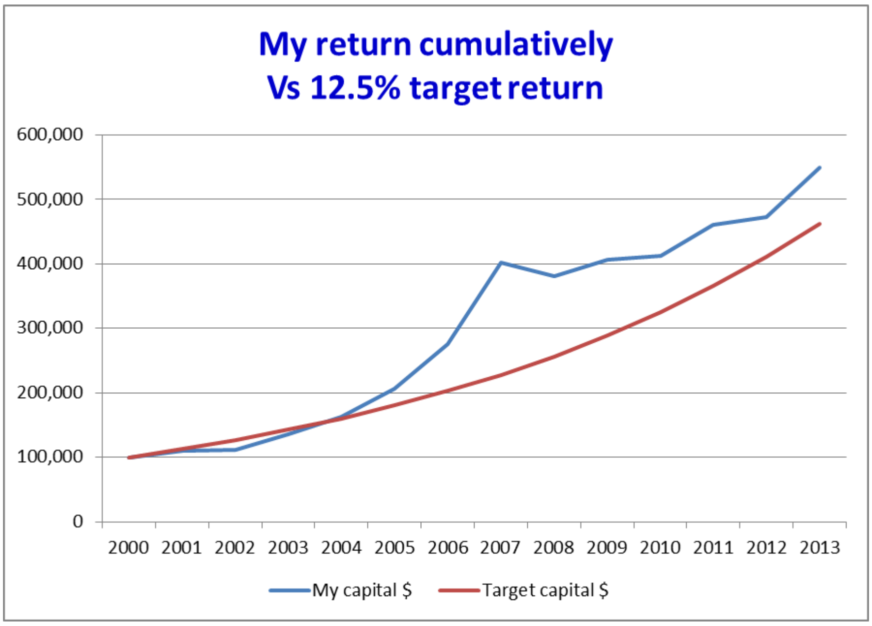
Over the 20 years to 2007, Vanguard calculated an 11% average annual return from stocks. They also calculated that over 50 years the average annual return was 12.8%. Elsewhere, I have seen estimates for 100 years around 12 to 12.5%. That was what I had as a base rate return for Australian stocks at the time.

I therefore stated my investment performance target was ***to exceed an average annual return of 12.5%.*** This was stated as a pre-tax return, as were all the various calculations used as a basis. Stating it as a pre-tax rate of return also facilitated comparison to other asset classes that are commonly measured as pre-tax returns.

It is very important to appreciate that this is a cumulative target return – best seen as a compound annual growth rate for my capital. The way I state it in my plan is this:

This does not mean that I will make 12.5% or more every year. That is not possible in some years. In other years I will exceed it significantly.

I go on to discuss the need for my investment plan objective to be specific (it is), measurable (it is) and realistic (so far I am ahead of it as shown on the graph below that is published on my website):

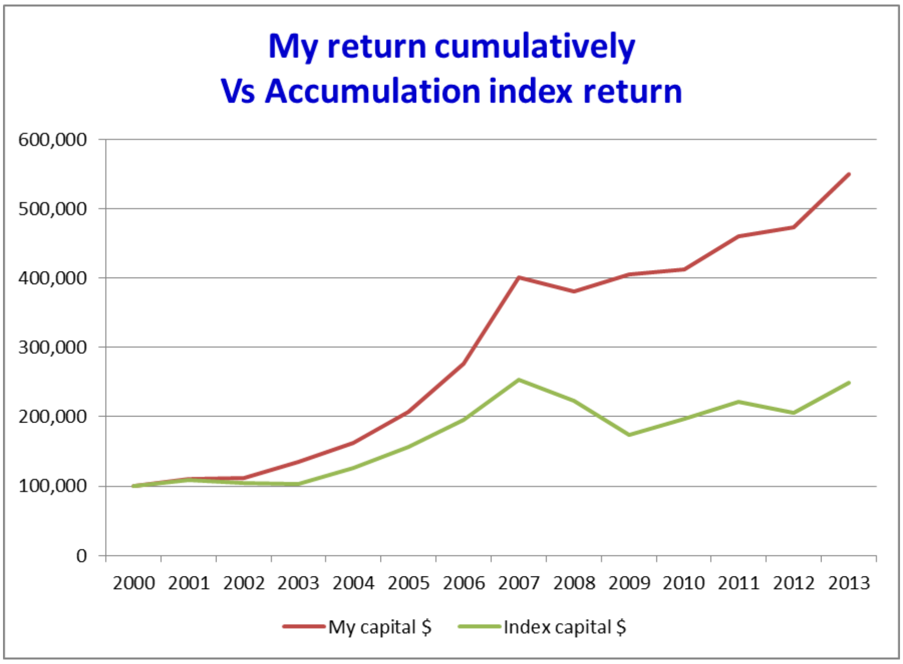


This covers the thirteen year period from 2000. Prior to that I did not record and measure my return in a rigorous manner. To keep it simple, I rebase both lines to $100,000 at 30 June 2000.

The other way that I might have set my objective would be to use the method adopted by Warren Buffett, who aims to beat the US S&P 500 by a percentage (which he has reduced over time as his portfolio capital has grown exponentially). Again, his objective is to do this over time, so some years he will be short of that target and other years well above of it.

One reason for adopting such an approach to setting the target return is that research shows that most investors do not consistently beat the market return.

Out of interest only, because it is not my target return, I also show my return compared to the ASX All Ordinaries Accumulation index that assumes the reinvestment of dividends:



Again, both lines are rebased to $100,000 at 30 June 2000.

The question that I want to address here is why it is important to have a target return. It seems obvious to me that having a target return allows me to:

- Measure whether I am meeting my investment objectives, which in turn will generate a capital sum that is sufficient to fund my desired standard of living for the rest of my life (remembering that longevity is the biggest risk we have to manage).

- Identify when I am not meeting my investment objective and analyse why that might be so. That will prompt me to question why I am falling short and consider ways in which I might modify the plan to bring it back on target.

In short, without a target return I don't know how I am going and may blissfully carry on without the realisation that I have problems to address.

Have you calculated how much capital you need to accumulate to fund the lifestyle you desire in retirement and that takes into account the risk that you may live beyond 100? Have you an investment plan to meet that objective?

The two charts in this article are as they were when the article was written. The updated charts are available on my website on the *Investment Returns* page on the About Colin menu.

To read more of my work:

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All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

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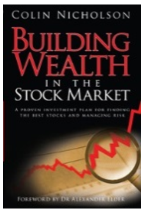

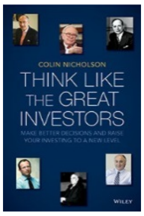

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