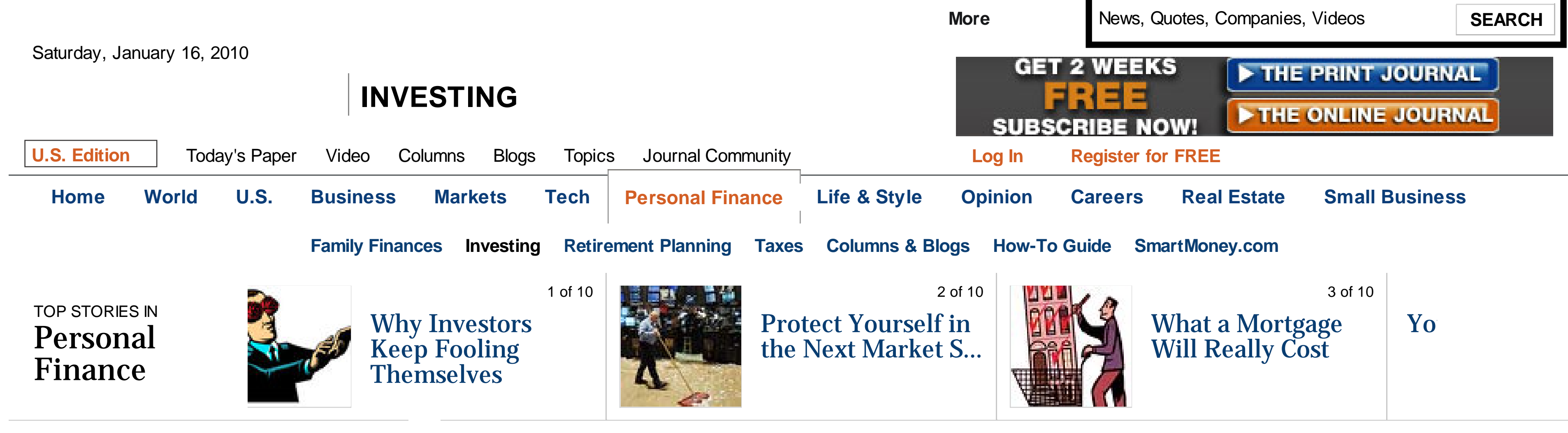

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Why Many Investors Keep Fooling Themselves

By JASON ZWEIG

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Heath Hinegardner

What are we smoking, and when will we stop?

A nationwide survey last year found that investors expect the U.S. stock market to return an annual average of 13.7% over the next 10 years.

Robert Veres, editor of the Inside Information financial-planning newsletter, recently asked his subscribers to estimate long-term future stock returns after inflation, expenses and taxes, what I call a "net-net-net" return. Several dozen leading financial advisers responded. Although some didn't subtract taxes, the average answer was 6%. A few went as high as 9%.

We all should be so lucky. Historically, inflation has eaten away three percentage points of return a year. Investment expenses and taxes each have cut returns by roughly one to two percentage points a year. All told, those costs reduce annual returns by five to seven points.

So, in order to earn 6% for clients after inflation, fees and taxes, these financial planners will somehow have to pick investments that generate 11% or 13% a year before costs. Where will they find such huge gains? Since 1926, according to Ibbotson Associates, U.S. stocks have earned an annual average of 9.8%. Their long-term, net-net-net return is under 4%.

All other major assets earned even less. If, like most people, you mix in some bonds and cash, your net-net-net is likely to be more like 2%.

The faith in fancifully high returns isn't just a harmless fairy tale. It leads many people to save

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About Jason Zweig

Jason Zweig writes The Intelligent Investor every Saturday for The Wall Street Journal. He is the author of Your Money and Your Brain, on the neuroscience of investing, and the editor of the revised

too little, in hopes that the markets will bail them out. It leaves others to chase hot performance that cannot last. The end result of fairy-tale expectations, whether you invest for yourself or with the help of a financial adviser, will be a huge shortfall in wealth late in life, and more years working rather than putting your feet up in retirement.

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Even the biggest investors are too optimistic. David Salem is president of the Investment Fund for Foundations, which manages $8 billion for more than 700 nonprofits. Mr. Salem periodically asks trustees and investment officers of these charities to imagine they can swap all their assets in exchange for a contract that guarantees them a risk-free return for the next 50 years, while also satisfying their current spending needs. Then he asks them what minimal rate of return, after inflation and all fees, they would accept in such a swap.

In Mr. Salem's latest survey, the average response was 7.4%. One-sixth of his participants refused to swap for any return lower than 10%.

The first time Mr. Salem surveyed his group, in the fall of 2007, one person wanted 22%, a return that, over 50 years, would turn $100,000 into $2.1 billion.

Does that investor really think he can get 22% on his own? Apparently so, or he would have agreed to the swap at a lower rate.

I asked several investing experts what guaranteed net-net-net return they would accept to swap out their own assets. William Bernstein of Efficient Frontier Advisors would take 4%. Laurence Siegel, a consultant and former head of investment research at the Ford Foundation: 3%. John C. Bogle, founder of the Vanguard Group of mutual funds: 2.5%. Elroy Dimson of London Business School, an expert on the history of market returns: 0.5%.

Meanwhile, I asked Mr. Salem, who says he would swap at 5%, to see if he could get anyone on Wall Street to call his bluff. In exchange for a basket of 51% global stocks, 26% bonds, 13% cash and 5% each in commodities and real estate—much like a portfolio Mr. Salem oversees—the institutional trading desk at one major investment bank was willing to offer a guaranteed rate, after fees and inflation, of 1%.

All this suggests a useful reality check. If your financial planner says he can earn you 6% annually, net-net-net, tell him you'll take it, right now, upfront. In fact, tell him you'll take 5% and he can keep the difference. In exchange, you will sell him your entire portfolio at its current market value. You've just offered him the functional equivalent of what Wall Street calls a total-return swap.

Unless he's a fool or a crook, he probably will decline your offer. If he's honest, he should admit that he can't get sufficient returns to honor the swap.

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So make him explain what rate he would be willing to pay if he actually had to execute a total return swap with you. That's the number you both should use to estimate the returns on your portfolio.

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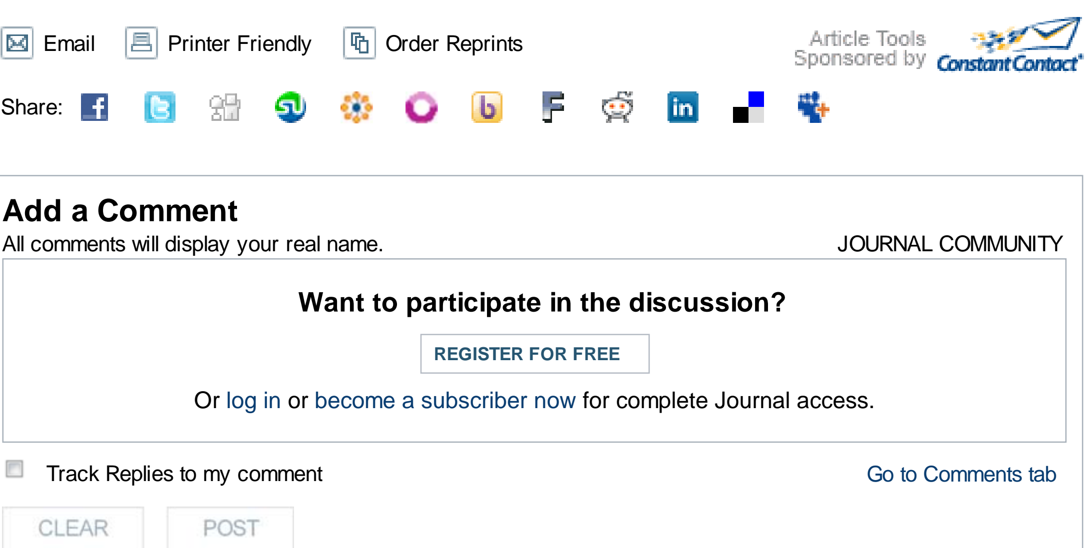

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