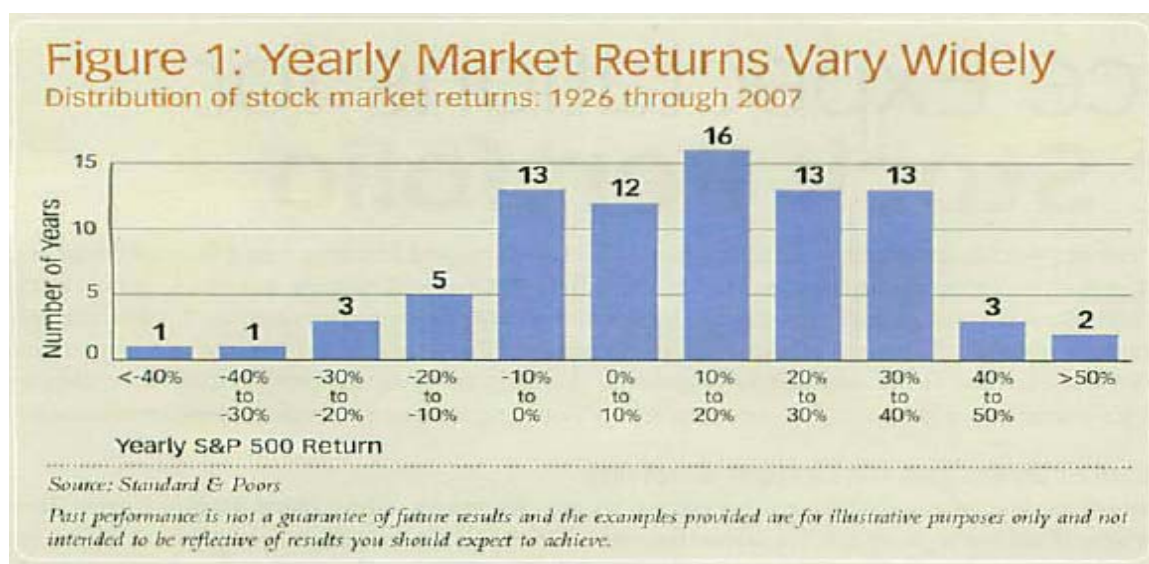


Overview

How do you feel when your stock portfolio has dropped in value since the last quarter or an individual stock you own has fallen 20% from its peak? Do you get mad, or just shrug it off? Reaction to market events is predicated on our prior expectations. Unfortunately, investor expectations are often overly optimistic. Particularly troubling are commonly held beliefs that stock market investments should rarely under perform or lose money. In this article we'll show you how to keep your performance expectations reasonable.

Market averages mask high volatility

Investors are often drawn to investing in stocks when they learn that equities have returned an average of 10.7% annually since 1926. But many fail to appreciate the huge variability in short-term returns underlying long-term market averages. For example, Figure 1 below shows the distribution of stock market returns between 1926 - 2007. Not only do returns vary widely, they've been negative in 28% of all years. So if you expect your stock portfolio to "never lose money" or "grow steadily at 10% per year, your expectations are unsupported and you're bound to be disappointed.



The volatility of individual stock returns within a time period is even more dramatic, and in my experience, even less appreciated by most investors. A Study by Schwab illustrates this in detail. In the study, the 52-week period ending December 3, 2005 was selected where the average stock with a Schwab Equity Rating returned 10.76%, similar to the long-term market average of 10.7%. But among the 3,013 individual stocks within the study, returns ranged from -98.9% to +531.2%, and 1,229 stocks (40.8% of the total) actually lost money! This return variability is typical for one-year time periods. So again, if you expect all the stocks in your portfolio to "move with the market," your expectations are again unsupported. Even worse, if you expect all your stocks to "go up when the market goes up," you may be disappointed with almost half of your holdings, even in a decent market year.

Can experts prevent losses?

Rather than tempering expectations, you may believe an investment expert can keep portfolio losses to a minimum. Is this belief reasonable? Imagine you "hired" Warren Buffett to manage your stock portfolio back in 1969. We know with hindsight that buying and holding Berkshire Hathaway stock would have been a brilliant decision that earned 23.6% annually vs. 10.5% for the S&P 500 Index. But would you have stuck with the unknown Buffett when he trailed the market four of six years beginning in 1970, or when he lagged three of four years in 1984 to 1987 or for three consecutive years in 2003 to 2005? The table below shows that Berkshire stock has lost money almost as often as the market and lagged the market in one-third of the years. If your expectations are that Buffett, or any other investment expert, will never lose money or always beat the market, you surely will be disappointed.

	Annualized Return (1969 – 2007)	Years with Negative Returns	Years Berkshire Trailed the S&P 500
Berkshire Hathaway		7 of 39 (18%)	13 of 39 (33%)
S&P 500 Index	10.5%	9 of 39 (23%)	

Manage your expectations

Psychologists say the pain humans feel from losses is two to three times as intense as the pleasure they feel from gains. As a result, people tend to have strong and often emotional reactions to losses. Compounding this effect, overly optimistic investors often misperceive ordinary market and stock price drops as losses, compelling them to act in self-defeating ways. For example, historical outflows from under performing mutual funds have often been highest right before performance turns around. Here are some steps you can take to avoid letting unrealistic expectation hurt your investment results.

1. **Accept that investment losses are inevitable.** Don't live and die with every price move up and down. The more often you look at your portfolio, the more "losses" you'll see and potentially misinterpret. Don't get angry at the market or a stock you own, as emotional investment decisions are rarely sound decisions. Focus on the long-term. Figure 1 reflects that historically, the stock market has risen in most years, just not every year.
2. **Accept that even the best portfolio managers beat the market only 55% to 65% of the time.** Expect your portfolio to often lag over short evaluation periods. If you've bought a fund or hired a manager/advisor with a strong long-term track record, don't bail out the next time your portfolio trails the market or has a down year.
3. **Accept that only 50% to 55% of stocks recommended by even the most reliable stock selection strategies and skillful analysts have historically outperformed the market in a given year.** Expect to pick lots of losers. Diversify by owning lots of stocks (at least 40) and stick with your selection strategy through time so that any small short-term selection edge compounds into solid long-term portfolio returns.