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Protect portfolio from pickpockets

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The stealthy pickpocket of portfolio corrosion can cost investors as much as 3.0% a year.

Bear markets savage most portfolios. In severe recessions, stock prices can plunge by more than 50%. Yet, it is not bear markets that cause the most damage to portfolios. Historically, stock markets have always recovered as business cycles swing from contraction to expansion. In fact, there have been 13 punishing bear markets since 1929. On average, stock prices doubled five years after their end.

What really damages portfolios are four corrosive elements that slowly but surely pick away at returns over time, thereby undermining the power of compounding that is so vital to real wealth accumulation. Because this corrosion is imperceptible to most investors, it can go on year after year imposing an ever-weightier drag on their capital growth.

First, emotionally driven decisions reduce returns. Investors' emotions mirror market cycles. Optimism soars as prices rise, only to be quickly replaced by fear and anxiety when markets plummet. Swayed by their emotions, many investors end up "buying high and selling low."
The cost of this behaviour is staggering. Morningstar found that from 2000 to 2009, the returns of U.S. fund investors lagged those of the funds in which they were invested by 1.5% a year — the consequence of untimely "buy and sell" decisions. Our firm has calculated that, over 40 years, in a balanced portfolio this return shortfall will erode real wealth creation by nearly one-half — a horrendous penalty for allowing emotions free rein.

Second, many investors fail to diversify broadly enough across multiple asset classes and thus do not fully capitalize on the "free lunch" of diversification. In illustration, an investor who, in 1998, had allocated modest weights to Canadian real estate investment trusts and emerging- market stocks in a portfolio of bonds and Canadian, U.S. and international equities would have improved his or her returns by more than 0.5% annually over the next 13 years. And with no increase in the portfolio's volatility.

Third, investors as a group overpay for investment management. A litany of studies stretching back to 1966 has concluded that actively managed funds as a group under-perform their benchmark indexes by an amount approximating their fees and expenses. Most investors would be better off using low-cost index funds. In fact, research by Professor Ken French found that from 1980 to 2006, U.S. investors fruitlessly spent 0.67% of their portfolio values each year, on average, by eschewing index funds for active management.

Fourth, many investors, particularly affluent ones, pay unnecessary taxes on their investment returns. Taxes are a massive drag on capital growth. In the United States, Lipper, a fund consulting firm, found that over the past decade, taxes eroded taxable equity-fund investors' in-pocket returns by 0.98% annually. The cost for taxable fixed-income investors was a hefty 2.08% a year.

Our firm's experience is that most investors do not seriously consider taxes in their investment plans. Hence, a plethora of tax-reduction and deferral techniques and products sit unused year after year while needless taxes are paid. Our own "guesstimate" is that unnecessary investment tax bills erode the typical high-net-worth investor's after-tax return by somewhere in the order of 0.25% to 0.50% a year.

In total, the stealthy pickpocket of portfolio corrosion can cost investors as much as 3.0% a year. To a large degree, superior returns from the three decade-long bond bull market have masked this cost from investors. Those days are ending. Protect your hard-earned investment returns from portfolio corrosion with this five-point plan:

Have a written investment plan that is customized to your risk profile.

Build your plan on a foundation of robust asset class diversification.

Ensure the core of your portfolio is made up of low-cost index funds.

Integrate your tax and investment planning and management.

Stick with your plan, especially in trying markets.

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