



## Defining Expectations and Creating a Personal Investment Philosophy: Step 2 in the Financial Planning Process Continued

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### Expectations

Counseling clients on return expectations is the most difficult part of any financial service professional's job. In the hundreds of financial planning scenarios in which I've been involved, an estimated 95% of the clients had unrealistic return expectations, which would inevitably lead to disappointing results. To have a realistic expectation of investment returns you need to have a historical perspective of returns and base your expectations on "real" returns assumptions.

Two of the fundamental definitions taught in an introductory investment class are the "riskless return" and the "equity premium." The riskless return is what you can earn on the safest investments without any risk of loss of principal. The riskless return is evidenced in a 6-month U.S. Treasury bill. The equity premium is the amount of return you can expect if you invest in a diversified portfolio of U.S. stocks. By adding together the riskless return and the equity premium, you can calculate a long-term expected return in the stock market.

Over the 200+-year period from 1802 to 2007, the U.S. equity premium averaged approximately 4.0% annually. From the period of 1925 thru 2005, the 6-month U.S. Treasury bill yield averaged approximately 3.7%. Not apparent in averaging these yields is the substantial variation in returns from year to year.

When you add the historical averages of the risk-free return to the historical average of the risk premium, you get approximately 7.7%. So, based on a long-term historical perspective you can expect approximately a 7.7% return in the U.S. stock market. That's a great deal less than the 10% return that some have come to expect.

### Creating a Personal Investment Philosophy (PIP)

A personal investment philosophy should define your:

1. Time horizon
2. Income or spending needs
3. Expected return
4. Risk tolerance
5. Asset Allocation guidelines
6. Allowable investments
7. Prohibited investments and transactions
8. Benchmarks to which you will compare your returns to the average market returns
9. Definition of risk
10. Schedule of the frequency reallocation of assets based on an asset allocation guideline
11. Schedule of periodic reviews
12. Delegation of investment authority to another party or qualified investment professional
13. Liquidity needs

A sample Personal Investment Policy statement can be downloaded from the wfla website at [www.wflains.org](http://www.wflains.org). Click on financial planning and then Personal Investment Policy or call me at 877-935-2467, ext. 137 and request a copy to be mailed to you.

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