061308 Your Target Rate of Return
By Gary Case

In my last column, I discussed the use of an Investment Policy Statement to guide the management your investment portfolio. Your purpose in investing is to reach your financial goals, and a critical component of reaching your goals is to understand how much you should invest and what rate of return you require to meet your objectives. Real returns are more important than returns relative to a benchmark, since the benchmark isn't going to use your money!

The required rate of return you will need in order to attain your financial goals should drive much of the portfolio design process. Determing the target rate of return can be done only after performing what is commonly referred to as a "capital needs analysis." In effect, measuring the projected inflows and outflows of your financial existence, (based on your goals), through an extended life expectancy, such as to age 100.

How do you determine your required rate of return? Methods may include custom spreadsheets and prepackaged financial analysis programs. One problem with linear projections (the same assumed rate in all years) is that life does not work in a linear fashion. The additional aid of Monte Carlo simulation and the variables in those sets of calculations can often provide a much clearer picture of the probability of your target rate of return leading to success.

What a client tells their planner should not suffice in identifying a return objective. Financial planners have a professional obligation to ensure that the expected investment returns will satisfy the client's goals and that accompanying portfolio volatility is within the client's risk tolerance. Meeting this obligation requires the planner perform an analysis. If the returns and risk are not aligned to satisfy the goals, then something has to give. The planner has to spend some time educating the client about the conflict and the implications and perhaps in finding necessary compromises.

If it is determined that the investment plan will be inadequate for the client's long-term needs and yet the planner implements the plan as is, then a disservice is done and the planner has failed to satisfy his or her professional obligations. Once a realistic target rate of return has been determined and agreed to by all parties, the stage is set for ongoing monitoring and adjustment of the portfolio. Further, evaluating your portfolio becomes more an exercise in measuring progress towards your goals rather than a short term investment performance. More on this in my next column.

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