

# How To Calculate Your Investment Performance Expectations



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## Introduction

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What are your performance expectations? The answer should be based on your needs and several variables (expenses, inflation) that impact your net results and the achievement of your goals.

Establishing realistic, achievable expectations is more complicated than you may think. You have three options:

- Develop your own expectations with no input from your advisor
  - Develop expectations with input from your advisor
  - Accept expectations that are based on your advisor's promises for future performance
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## Performance Promises

There are three major problems with performance promises from advisors who want to sell you investment products:

- Promises are inducements to buy
- Vague promises reduce advisor accountability
- Promises are illegal. Advisors cannot predict future results

A performance promise is a frequently used sales tactic because it appeals to your need for results.



## Your Performance

Performance expectations should not be based on a sales process that is controlled by financial advisors. It should be a well thought-out process that has the following characteristics:

- Your requirement matches your tolerance for risk
- Your requirement exceeds all forms of erosion
- Your advisor acknowledges your expectations
- Your advisor is accountable for meeting expectations

## Assumptions

You and your advisor do not have crystal balls that predict the future. Therefore, your performance expectation is based on several assumptions that reflect your needs and the various forms of erosion: expenses, inflation, distributions, and taxes. Your expectation should include a premium return that increases the real value of your assets over time.



- DESIRABLE?**
- FEASIBLE?**
- VIABLE?**

## Advisor Acknowledgment

More sophisticated fee advisors will be able to provide input for your assumptions and help you select an appropriate premium return.

When you have developed your performance expectation require your advisor to acknowledge it is realistic, consistent with your risk tolerance, and reasonably achievable.

## Investment Expenses

If you know your actual expenses, you can estimate the expenses, or your advisor can provide the information. This is an important assumption because it impacts your net performance.



Most advisors and investment products use sliding schedules of fees. That is, the more money you place with them, the lower your overall expense. The following chart shows combined expense percentages for various asset amounts. You select the expense percentage that best fits you and your situation.

These are fully loaded expense assumptions that erode the value of your assets: Planning, advice, money management, custodian, marketing (12B-1 fees), administration, taxes, and transaction charges.

Your Asset Amount	Expense Deduction
Less than \$100,000	3.00%
\$100,000 to \$250,000	2.75%
\$250,000 to \$500,000	2.50%
\$500,000 to \$1,000,000	2.00%
\$1,000,000 to \$5,000,000	1.75%
More than \$5,000,000	1.50%

My expense assumption is: \_\_\_\_\_%

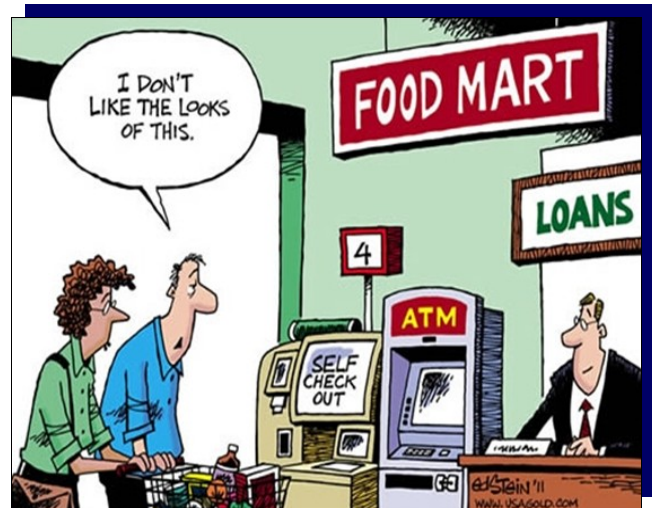
### My Inflation Assumption

Why include inflation in your performance expectation? Inflation erodes the purchasing power of your assets. That is a big deal if you are investing long-term, for example retirement assets. Inflation impacts the amount of goods and services your money will buy when you retire in 10, 20, or 30 years. Therefore, inflation must be offset by performance.

Even if you are currently retired, you are impacted by inflation. For example, you and your spouse are 65 years old. One or both of you have a high probability of living into your 90's. That is 25 or more years of inflation.

Long term inflation assumptions are usually 2% or 3%.

My inflation assumption is: \_\_\_\_\_%



### My Distribution Requirement

If you are retired you may be taking distributions to help cover your expenses. By offsetting distributions with performance, you reduce your risk of prematurely invading your principal. If you are working, your answer will be 0% unless you are currently taking distributions from your assets to pay a son or daughter's way through college.

You should delay distributions for as long as possible and make them as low as possible (3% or 4%). This maximizes the length of time you have to accumulate assets and reduces your risk of invading principal prematurely.

My distribution requirement is: \_\_\_\_\_%

## My Tax Assumption

If all of your assets are held in tax-deferred accounts (IRAs) you can enter 0% for this assumption. If your assets are held in taxable accounts you will incur taxes for dividend and interest income and transactions that produce realized capital gains.



Based on type of account, type of investment (stocks, bonds), and turnover rate (sales), your performance expectation should include a provision for taxes that is based on your historical expense for this category.

My tax assumption is: \_\_\_\_\_%

## Premium Return

So far your performance expectation is based on factors that erode the value of your assets. Now, you should develop a premium return assumption that helps you increase the future value of your assets.

Premium returns increase your performance expectation. The expectation number must still be consistent with your tolerance for risk. For example, you would not select a high premium return unless your tolerance for risk supports the high premium.

A frequently selected premium is 2%. Premiums should not exceed 5%. Lower premiums are more conservative because it takes less risk to achieve them.

My premium assumption is: \_\_\_\_\_%

## My Risk Tolerance

If you want higher returns you have to accept higher risk. If you want lower risk you have to accept lower returns. This risk/reward relationship governs how performance and risk interact with each other over longer time periods.

There are several risk definitions, but the one that matters the most is your willingness to accept large losses to earn higher returns. If you are in your 30's you probably have a high tolerance for risk. If you are in your 50's you probably have a moderate tolerance for risk. If you are in your 70's you probably have a low tolerance for risk.

*"If you want higher returns you have to accept higher risk. If you want lower risk you have to accept lower returns."*

Warning: You may have to accept more risk than you expect due to rising longevity. A higher percentage of Americans will retire and live another 30 to 40 years. Assets have to last a long time, which means expenses, inflation, distributions, and taxes have a greater impact.

## **Volatile Markets**

You may calculate a performance expectation of 10% per year. Markets go up and down so you will not achieve this result every year. It will be higher or lower and some years will produce negative returns.



A better solution is to hold your advisor accountable for averaging a 10% rate of return over a specific time period – for example, three years. This means the advisor can have a bad performance year, but he still has to produce your 10% rate of return requirement over the three years.

Simple math illustrates the problem. Your performance is +10% in year one and -10% in year two. Your performance after two years is 0%. You need +30% in year three to average +10% for the three years.

## My Performance Expectation

The following table is a sample expectation calculation.

Expectation	Sample %
Investment Expenses	2.00% (
Inflation	2.00% (
Distributions	3.00% (
Taxes	1.00% (
Premium Return	2.00% (

My performance expectation is: \_\_\_\_\_%

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## About the Author



Jack Waymire is the founder of [PaladinRegistry.com](http://PaladinRegistry.com) and [Investor Watchdog](http://InvestorWatchdog.com). He spent 28 years in the financial services industry and is the author of *Who's Watching Your Money?*

