The Arithmetic of Portfolio Losses

By E.J Smith

Can you reliably double your money in the stock market? How about generating a return of 66%? Or even 43%? The S&P 500 hasn't generated a return of over 40% in one year since 1958. So, if someone tells you they can regularly produce returns like that in the stock market, skepticism would be warranted.

Since 1958, the stock market has twice lost more than 20% in a single year (1974, 2002) and once lost over 35% (2008). Those investors with their entire portfolios at the mercy of the stock market were left hoping to make back what they had lost. That isn't easy.

In November of 1995, my father-in-law Dick Young warned investors about the dangers of portfolio losses. He explained that, when you lose money, the math is real bad on getting it back. He wrote:

> *The Largest Private Residence in America*
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> Biltmore Estate, located in bucolic Asheville, N.C., is not just a national treasure, it's a terrific example of how to run a profit-making business at its highest efficiency. No government grants and subsidies here. Constructed between 1889 and 1895 by George Vanderbilt, grandson of shipping and railroad tycoon "Commodore" Cornelius Vanderbilt, Biltmore Estate, still privately owned and operated, is a stunning architectural achievement inextricably linked with The Gilded Age.
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> In the library, Vanderbilt's scholarly interests are evidenced by 10,000 bound volumes covering history, art, architecture, landscape gardening, and classical literature in eight languages (all in which Vanderbilt was fluent). Adorning the library is a Pellegrini canvas ceiling painting, which graced the Pisani Palace in Venice during the 18th century and is all the more important today since little of Pellegrini's work escaped destruction during World War II.
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> Visitors from around the world flock annually to the unmatched estate tour. Allow a complete day to see it all. You do not want to miss the Estate Winery opened in 1985. It embodies Vanderbilt's original concept of a self-supporting European estate and features the Estate's own award-winning Chardonnay.
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> Biltmore Estate is the linchpin of what has fast become a favored retirement area for discerning Americans seeking a vibrant, moderate weather, four-season community.
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> <u>Dick Young's 10-Point Guide to High-Yielding Retirement Income</u>
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> Put a trip to America's largest private residence on your schedule. To assist you in funding your vacation or retirement shopping trip, I've assembled a strategic 10-point guide to high-yielding retirement investing (current or future). If you firmly follow this 10-point guide to maximizing income, you will greatly enhance your prospects for getaways to the great estates of the world, including an American classic like Vanderbilt's Biltmore Estate.
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> When you invest for future or current retirement using conservative income-producing securities, your odds for success will improve *immediately* when you focus on item #1 and #2 in my 10-Point Guide to High Yielding Retirement Income.
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> **Risk Analysis Always First**
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> #1 It only makes good sense to recognize that when you work hard and save for a lifetime to retire in comfort, you do not want your life's savings evaporating in some speculative venture. I can't tell you how

often I hear heartbreaking, first-hand stories from investors who have been virtually wiped out in some limited partnership scheme or other ill-advised sales-pitched nightmare.

In a recent book review, *The Wall Street Journal* commented on a big brokerage firm's disaster with limited partnerships. "(XYZ) went for the whole enchilada when it adopted a policy of defrauding its customers. The firm sold $8 billion in limited partnerships spread over 701 entities to more than 600,000 investors. Only a handful of those investments ever performed as promised. (XYZ) continued to pressure its brokers to push new deals long after it knew that many of the previously sold ones were all but worthless."

What do you think of that sorry mess? Stunning, isn't it? Thousands of investors took the pipe. And I'd bet big bucks that the vast majority did not bother to read carefully the prospectus for those deals nor ponder the element of risk before committing hard-worked-for lifetime savings.

Always remember, when you lose 50% (not to mention *all* your money) on an investment, you have to make 100% next time out just to get even. And at that, you have made a zero return on your investment over perhaps an extended period of time. The math is bad, real bad. In my three decades as a professional investor, I've found that there are surprisingly few opportunities to *actually double your money* on any single investment.

Counting on a double-your-money bailout is long odds at best. So first and foremost, make sure you understand the risks of any investment *before you invest*. Do your prospectus homework well, and ask questions—plenty of questions.

The Arithmetic of Portfolio losses is not on the side of the money-loser. You can see in the chart below just how much an investor would need to simply recover his losses and get back to zero. The moral of this story is: reduce risk, maintain your principal, and avoid portfolio losses.