Lake Wobegon Investing

By Jim Mirenda, CFP®

Every week Garrison Keillor takes radio listeners to the attractive but fictitious Lake Wobegon, where “all the women are strong, all the men are good looking, and all the children are above average.” I enjoy his storytelling and while I won’t dispute the likelihood of those first two statements, it’s clear why **all** the children couldn’t be above average: it’s the math.

Investors often hope that their investment returns will all be above average. But statistically, just like in Lake Wobegon, that cannot happen. So what does ‘average return’ mean anyway? Is it a good measure of investment success? Many would say it is. In fact they sell their products and services based on it. I’m not convinced that it is a good measure of success and I believe its weakness is all about the math.

Let’s take an example where you invest $1,000. In year one, you get a 100% return, so now your investment is worth $2,000. In year two, you're not so lucky, and you experience a 50% loss, so now your $2,000 is worth $1,000, again. You started with $1,000, and after two years, you still have $1,000. But get this: your average percentage investment return is 25%. Yup, you read that right. After two years you made no money, but your 2-year ‘average return’ was a positive 25%. Now go to the store and try to spend your 25% return. Well, you can’t because you can only spend real dollars. So real dollars is what truly matters.

Keeping that in mind please consider this fact: an investment that generates a higher average return can result in less wealth than one with a lower average return. Higher return, less money. How can that be possible? Because real investment returns don't happen in a straight line - they fluctuate. Yet average return, by definition, ignores this. In reality, the pattern of investment returns (when you receive them) can be more important to your wealth than the actual return itself.

Let's check that claim by running the above example again but using 0% and 20% for the annual returns. This time your average return is 'just' 10%, but now you finish year two with $1,200. So, which outcome do you prefer: the one with the higher average return or the one with more money? These examples are simplified so just imagine how much bigger the differences can be over a lifetime and with more dollars. The truth is that the fluctuation of investment returns is a dominant factor in how your financial future will unfold.

Understanding the impact on your unique financial goals and your investing behavior is critical, and here's the kicker – it's unpredictable and largely out of your control.

Average return is a misleading investment gauge because it tells you nothing about your real dollars or how you're progressing towards your actual goals. Yet almost every investment sales pitch uses it as a cornerstone to your financial well-being. I have a different perspective. I believe that the only good measure of investment success is confidently reaching your personal financial goals. Everything else, including average return, is cosmetic.

So be very careful when you're being sold superior investment skill that is explained by an average return calculation. And be equally cautious when someone says your future is safe because your investment returns are 'all above average'. Despite the attractive appearance that may not translate into a richer future for you and your family.

I'll keep on looking but until I find the real Lake Wobegon my advice will stay the same: focus on your plan, your goals, and on the things that are within your control.

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