



# Investment Insights

Kevin Kennedy

## Taking a Trip to Monte Carlo

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Over the past two years, most investors have been shocked and disappointed with the decline in value of their stock investments. This has been one of the toughest periods for the US markets in almost 30 years. Much has been said in the press lately about how “the professionals” should have seen this coming. History tells us that events like this bear market that began in 2000 are a natural part of the economic cycles our country goes through, and although they are unpleasant and disturbing, they have occurred throughout our history and will likely continue to occur in the future. Given that scenario, how should you as an individual investor position yourself to prepare for the next “economic earthquake” so that you can still achieve your financial goals?

One of the common mistakes many investors make is planning their investment strategy and their ability to reach their goals on recent market performance. The annual return of the Standard & Poor’s 500 index in the period 1/1/1995-1/31/2000 was an astounding 25% per year, according to Morningstar, Inc. Investors who counted on a consistent 25% per year return on their investments to achieve their financial goals are now questioning their ability to retire on schedule, or achieve other financial goals they have. Obviously, returns on investments of any type are not the same every year, and there can always be periods of *negative returns* thrown into the mix to further complicate matters. Economic earthquakes happen – the key to your success should not be based on your ability to predict them, but on your foresight to plan for them and include that possibility in your financial plan.

An excellent technique I use with many of my clients is Monte Carlo Simulation. When you hear the words “Monte Carlo”, you instantly think of the famous gambling resort in the Mediterranean. Monte Carlo Simulation

actually incorporates the idea of odds and possible outcomes in the financial markets into financial planning. Although the answers it provides are not foolproof, it may be an enhanced way to view investing as opposed to using a simple long-term average.

Here's a simple example straight from the casinos: your odds of winning a hand in blackjack are approximately 49%. However, you have probably had the experience of losing four or five hands in a row. Hey, I thought I was supposed to win almost half of the time? Well, that is true over thousands of hands of blackjack, but over a shorter period the odds can be dramatically different.

Now think about your financial future. Do you have tens or hundreds of years to invest so that the 75 year average return of the markets will approximate what you experience? More likely you have five or ten years, and the possible outcomes over that time can be much different. You must incorporate into your plan the possibility that you experience returns greater than or *less than* the historical averages. This is where Monte Carlo Simulation comes into play: Monte Carlo Simulation takes into account the thousands of possible combinations of returns over your investment timeframe to give you a set of probabilities of achieving a given return. It illustrates for you the impact of being invested during periods of economic earthquakes on achieving your financial goals.

When I draw up an investment plan for a client, I consider not only the historical average of the portfolio, but also the probability of actually achieving that return over the client's timeframe. In my mind, the client's future economic security is far too important to risk on the long shot that the markets actually return exactly 10% per year (or whatever your target return is). By incorporating Monte Carlo Simulation, I can give a client a likelihood that they will achieve their goals, and adjust their investing and savings plan until they are comfortable with their chance of being successful. Thus, when tough times like the current environment come along, we have already included this scenario into our plan and know generally how it will impact our chances of achieving our goals.

If you were to run such a simulation on your own portfolio, you might be shocked to see that the chances that you achieve your goals might be far less than 100%. If you have a planner who has not shown you real-life likelihood that you will achieve your goals, I would strongly suggest you find someone

who can. Your financial future is far too important to leave open to the chance that you get a few bad blackjack hands in a row.

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