

Quality Asset Management

Grow Your Wealth with Peace of Mind

The Imaginary Line

By Gil Hanoch, December 6, 2005

Updated Data December, 2009

Note: This article refers specifically to the portfolio Long-Term Component by Quality Asset Management, but may be applied to certain other portfolios, as described in the end of the article.

How would you like to never worry again about your investments? You already know that your portfolio grows at a pace that is hard to believe, doubling its value every 4-5 years. This is based on the simulated average yearly returns of 17.2% since 1970. This is the *average* pace. How would you like to put a *minimum* to the rate of growth? Let's see how this can be done:

Stretching the Imaginary Line: You can view your long-term portfolio as growing at all times at the *higher* of the following two rates:

1. Its actual growth rate.
2. The all time highest peak value of the portfolio plus 5% of this value, adjusted for inflation, for each year that passed since reaching it. Your portfolio is likely to keep up with this Imaginary Line of growth within a few years, as explained below. Since this is a long-term investment, you shouldn't care about temporary disparities.

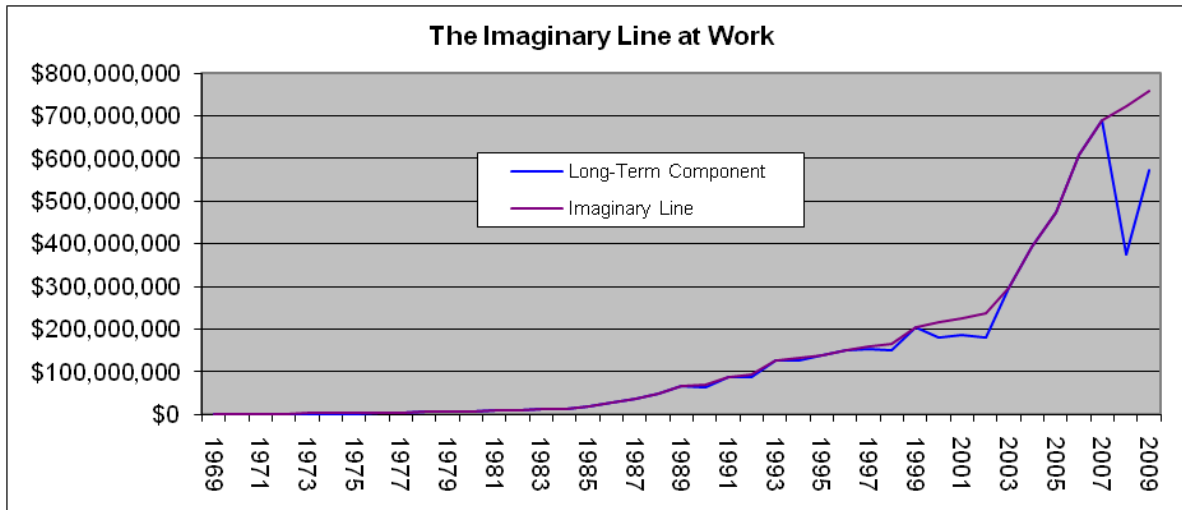
Why does this work?

1. **It stood the test of time.** In the worst possible scenario since the portfolio was simulated (beginning in 1970), the portfolio value outperformed the Imaginary Line within little over 4 years when measured from the highest peak. Most cases were much better.
2. **It's logical.** This portfolio represents ownership of thousands of companies all over the world. The companies provide the products and services that we need, more cheaply and efficiently than we do on our own. Companies are expected to stick around and grow unless we will prefer to work harder for our needs. The diversification reduces the decline periods and the inclusion of rapidly developing countries and companies increases the average growth.
3. **High average growth.** The average growth of the portfolio (17.2% as simulated since 1970) includes all of the worst recessions. In order to keep such a high average, the portfolio has to rise steeply after any significant or prolonged decline. The longer and steeper the decline the quicker the recovery is expected to be.
4. **Conservative measure.** The Imaginary Line was intentionally chosen to be conservative, letting the portfolio keep up with it in a few years, even in recessions worse than the worst we've seen in simulated history.

Example: Assume that you invested \$1,000,000 in the portfolio Long-Term Component, in 1970. The graph below presents the portfolio value and the Imaginary Line from 1970 to 2009. In most of the years, the portfolio has the same value as the Imaginary Line, meaning that it grows faster than the 5% inflation adjusted additions of the Imaginary Line – normally *much* faster. In the few years when the Imaginary Line grew faster than the portfolio, it was limited to less than 2 years in most cases, and about 4 years in the worst case.

By expecting a minimum of 5% annual additions at all times, you were right most of the time, and, when measured over more than 4-year periods, you were right at all times!

By tracking the Imaginary Line, you stayed positive at all times, while your portfolio grew from \$1,000,000 to \$571,000,000, doubling on average every 4 years and 6 months.



Let's view the details of the worst recession period since 1970. The following data is highlighted:

1. Portfolio value: actual portfolio value.
2. Total Value: the value of the Imaginary Line.
3. Distance: the percent gains needed for the portfolio to match the Imaginary Line.

Year	Portfolio		Inflation	Imaginary Line		
	Value	Annual Change		Additions (5%+inflation)	Total Value	Distance
1972	\$2,234,135	-	-	-	\$2,234,135	-
1973	\$1,851,830	-17%	8.8%	\$111,707	\$2,345,842	27%
1974	\$1,362,410	-26%	12.2%	\$121,515	\$2,467,356	81%
1975	\$2,066,789	52%	7.0%	\$136,339	\$2,603,696	26%
1976	\$2,552,547	24%	4.8%	\$145,897	\$2,749,593	8%
1977	\$3,937,099	54%	6.8%	-	\$3,937,099	-
1978	\$5,879,782	49%	9%	-	\$5,879,782	-
...
2008	\$376,123,749	-45%	0.09%	\$34,406,388	\$722,534,141	92%
2009	\$571,433,528	52%	2.7%	\$34,437,698	\$756,971,839	32%

As you can see in the table, the portfolio declined by 41% over 2 years (1973-1974), while the Imaginary Line grew over 10%. In order to reach this target, the portfolio has to grow by 81%! You might say, "It would never recover plus keep up with 5% inflation-adjusted annual additions!"

But since the average growth of the portfolio including the decline years is so high (17.2% simulated since 1970), it is most likely to grow at a very high rate. In 2 years it nearly recovered and kept up with the Imaginary Line. In 2 more years it doubled again!

Bonds for security? If you consider an investment offering about 5% per year *on average* just to avoid losing money, think twice. Investments like government bonds and fixed annuities may be great for short-term security but do not offer real long-term security.

Can the approach work for other portfolios? The approach presented can be applied only to portfolios that lack stock picking or market timing, are highly diversified and have long-term historic performance data (at least a 30-year simulation).

If a portfolio fits this profile, it will require adjusting the imaginary growth according to its long-term behavior. Many portfolios are more volatile and have lower average growth, and will require lower imaginary additions. Please contact QAM regarding specific portfolios.

Note that past performance does not guarantee future returns. Each individual should have a personal plan to deal with cases worse than those seen in the past.

Past performance may not be indicative of future results. Simulated data was used for periods prior to the inception of mutual funds (see [Performance Data Disclosure](http://www.qualityasset.com/disclosure.htm) at <http://www.qualityasset.com/disclosure.htm>). Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this article, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Note that services are limited to investment advice and do not include financial planning and/or non-investment related consultation services. You should not assume that any discussion or information contained in this article serves as the receipt of, or as a substitute for, personalized investment advice from Quality Asset Management. If you have any questions regarding the applicability of any specific issue discussed above to your individual situation, you are encouraged to consult with the professional advisor of your choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.