

# The Maximizer

## Reach For Double Digit Investment Returns While Protecting Your Principal

Would you like to nearly double the return of the S&P 500 while at the same time 100% principally protecting 90% of your invested dollars?

### What are your investment goals these days?

Are you still of the opinion that the stock market will average double-digit returns? Did the dismal investment returns of 2000-2003 serve as a wake-up call to you and remind you that the stock market actually does go backwards?

### What are your investment goals these days?

I would submit to you that your investment goals should be to protect principal and go for growth when you can do so in the least risky manner possible (or in a manner that meets your risk threshold).

This is not meant to bash the use of post-tax investing as a nice option for clients. It is meant to make you aware of another way to try to reach for 10%+ rates of return with less risk.

How do clients usually manage risk? By sacrificing yield when investing in CDs, money markets, and treasuries (which are annually taxable investments). By outsourcing risk when giving money to a stockbroker or money manager where there is no principal protection.

Mutual funds provide no downside protection. Everyone seems to think Merrill Lynch is a great money management firm. Look what happened to some of their funds in 2001. What kind of protection did their clients receive? The S&P 500 was down 17% but that would have been much better than what happened at Merrill.

Merrill Lynch Mid-Cap Growth Fund –	<36.6%>
Merrill Lynch Premier Growth Fund –	<52.6%>
Merrill Lynch Focused Twenty Fund –	<70.1%>
Merrill Lynch Fundamental Growth Fund –	<19.4%>
Merrill Lynch Global Growth Fund –	<26.3%>

The following are some of the problems with actively managed mutual funds: No downside protection, underperform the market, very expensive (whether the funds go up or down), lack of consistent results

Studies show that most mutual funds underperform the market:

- 1,226 actively managed funds with 5-year track record – 1.9% less than S&P 500\*
- 623 actively managed funds with 10-year track record – 1.7% less than S&P 500\*
- 406 actively managed funds with 15-year track record – 1.5% less than S&P 500\*

-Adjusted for “survivorship bias” – 1.5% worse.

“With returns corrected for survivorship bias, the average actively managed fund trails the market by about 3 percentage points per year.”\*\*

\* Morningstar Principia Pro, data through Dec 31, 2001. Funds identified were all domestic stock funds, excluding index funds and funds holding more than 20% in bonds.

\*\* *The Great Mutual Fund Trap*, Baer and Gensler, 2002.

“The sad truth of the matter is, that over time the vast majority  
– approximately 80% - of mutual funds underperform the overall stock market.”  
The “Motley Fool”

What are the odds of beating the house? 46% if you play craps, 48% if you play blackjack. 44% if you play roulette. **20% if you are in actively traded mutual funds instead of index funds.**

Mutual funds can be very expensive: sales charges, 12b-1 fees, management fees, fund expenses, transaction costs, capital gains, and dividend taxes.

To say mutual funds are not consistent would be a dramatic understatement. The following is a mind-blowing example of how little we know about when to invest in the right mutual funds (or a better statement is when to get out of the wrong mutual funds).

Top Ten Rank 1996-1999	Same Fund's Rank 1999-2002
1	841
2	832
3	845
4	791
5	801
6	798
7	790
8	843
9	851
10	793

Is it a fair statement that your broker is telling you to buy funds ranked in the top 10 because those are the “good” funds to buy at any given time? What happened to your money if you got into one of the top 10 funds at the tail end of 1999? You would have lost a bundle.

Another simple example of how little we and our brokers know:

Which of the following companies would you have been recommended and wanted to purchase back in July 2003?

**Wal-Mart**: One of largest companies in the world; consistent earner; pays dividends.

**K-Mart**: Just emerging from bankruptcy; big marketing tie to Martha Stewart (who was looking at jail time); no anticipated dividends

-In July 2003, Wal-Mart stock was valued at \$56.08

-In July 2003, K-Mart stock was valued at \$24.20

Be honest. You and your broker would have chosen Wal-Mart all day long.

What happened?

-In July 2004, Wal-Mart stock was valued at \$51.76

-In July 2004, K-Mart stock was valued at \$76.80

If we are honest, do any of us really know what is going to happen with individual stocks or mutual funds? Not really. We simply know that the market as a whole will go up over time.

Many clients who want to get out of the stock and mutual fund picking game have switched to **index funds** with growth pegged to the S&P 500 or other indexes. Index funds are less expensive, but there is NO DOWNSIDE PROTECTION.

We should all keep in mind the three “Rs.” No, not reading, writing and arithmetic. The three “Rs” we need to keep in mind are: Less “R”isk, more “R”eward, and quicker “R”ecovery. Wouldn’t it be nice to invest in something that had less risk, reward power in upside potential, and was set up to have a shorter recovery time after a down year?

### **The Maximizer: How does it work to reduce risk and rewards when investing?**

The Maximizer is not a difficult concept to grasp. Clients use two investment vehicles: 1) equity indexed annuities (EIA)s, 2) call spread options on the S&P 500.

The stability of the concept comes from the EIA which has 100% principal protection. EIAs provide principal protection; so no matter what the measuring index returns (usually the S&P 500), the investment will never go backwards. The client participates in upside growth of the S&P 500, but there is a “cap” on that growth.

For our examples, let just assume the cap is 7.5%. Therefore, if the S&P 500 returns 10% in one year, the client’s return in the EIA is 7.5%. If the S&P 500 goes negative in a year with its return, the EIA does not lose money. This is stable and safe but will cap a client’s growth if the S&P 500 does well.

The upside in the topic comes from “options” which are purchased on the underlying investment index (typically the S&P 500). Options are not the easiest investment to understand, so let’s use an example.

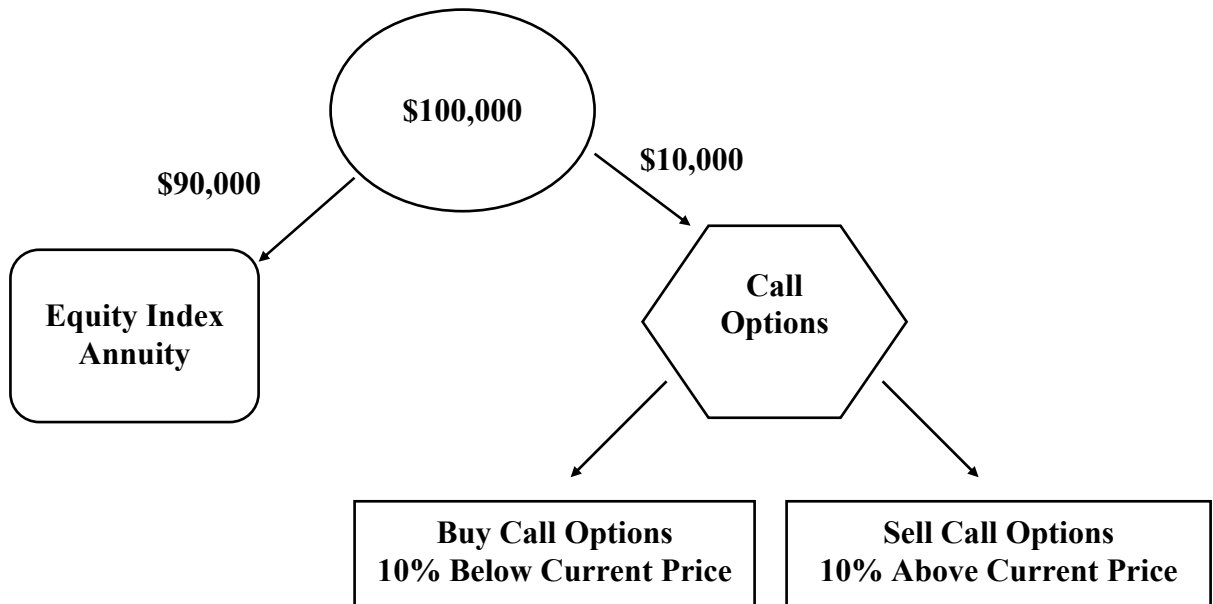
Assume a client buys a \$100,000 option on the S&P 500 index. Assume the cost of that option is 10% and that the client has the “option” to sell it at a strike price at 10% above and 10% below the purchase price. Further, assume that the client will realize an investment gain of approximately 85% of the growth of the index up to that strike price which is 10% higher than where it started.

Assume the index is at 1000 when the client purchases the options. On December 31<sup>st</sup>, the options are valued. If on that date the S&P 500 value is 1100, that would mean that the index increased 10%. Therefore, the gain on the option is approximately \$8,500. The client is returned the option cost of \$10,000 plus the gain of \$8,500.

What if the S&P 500 goes down? If the S&P 500 goes down more than 10%, the entire cost of the option is lost. That's why options are considered a risky investment.

Getting back to how the Maximizer works—the client invests approximately 90% of money allocated to the plan in a principally guaranteed EIA. The client allocates 10% to purchasing options on the S&P 500. Let's look at an example.

**Assume: \$100,000 portfolio 10% Risk**



Examples: Assume a \$100,000 portfolio, risk 10% in options, and an EIA with a 7.5% cap.

What if the S&P 500 goes up 5%?

Annuity Grows 5.00% or	\$4,500
Option Grows 4.00% or	<u>4,000</u>
Total Return	8,500
Percent Return	<b>8.50%</b>

What if the S&P 500 goes up 10%?

Annuity Grows 7.50% or	\$6,750
Option Grows 8.0% or	<u>8,000</u>
Total Return	14,750
Percent Return	<b>14.75%</b>

In the previous examples, the S&P 500 went up and the Maximizer returns were significantly higher than what the S&P actually returned (**with 90% of the money protected in the EIA**).

What if the S&P 500 went up 20%?

Annuity Grows 7.50% or \$6,750  
 Option Grows 8.00% or 8,000  
 Total Return 14,750  
 Percent Return **14.75%**

What if the S&P 500 goes **down** 5%?

Annuity Stays Flat or \$ 0  
 Option Loses 6.0% or -6,000  
 Total Loss -6,000  
 Percent Return **-6.00%**

Let's look at a few hypothetical examples of what might happen over the next 10 years.

Comparative Returns				Comparative Returns			
End of Year	Projected S&P Performance	Maximizer Approach	Mutual Fund Matching Index	End of Year	Projected S&P Performance	Maximizer Approach	Mutual Fund Matching Index
1	10.00%	115,200	110,000	1	-15.00%	90,000	85,000
2	-4.00%	109,440	105,600	2	-15.00%	81,000	72,250
3	12.00%	126,075	118,272	3	-20.00%	72,900	57,800
4	7.00%	141,078	126,551	4	9.00%	83,398	63,002
5	6.50%	156,667	134,777	5	6.50%	92,613	67,097
6	-18.50%	141,000	109,843	6	-5.00%	87,056	63,742
7	8.50%	160,740	119,180	7	8.50%	99,244	69,160
8	-22.50%	144,666	92,364	8	-18.00%	89,320	56,712
9	7.50%	163,111	99,292	9	5.00%	96,912	59,547
10	12.00%	187,904	111,207	10	11.00%	111,642	66,097
Avg Return	1.85%			Avg Return	-3.30%		

Comparative Returns				Comparative Returns			
End of Year	Projected S&P Performance	Maximizer Approach	Mutual Fund Matching Index	End of Year	Projected S&P Performance	Risk Averse Approach	Mutual Fund
1	9.00%	114,400	109,000	1	20.00%	115,700	120,000
2	7.50%	128,986	117,175	2	20.00%	133,865	144,000
3	-24.00%	116,087	89,053	3	20.00%	154,882	172,800
4	8.00%	131,875	96,177	4	20.00%	179,198	207,360
5	6.50%	146,448	102,429	5	20.00%	207,332	248,832
6	12.00%	168,708	114,720	6	20.00%	239,883	298,598
7	8.50%	192,327	124,471	7	20.00%	277,545	358,318
8	6.50%	213,579	132,562	8	20.00%	321,120	429,982
9	9.00%	244,334	144,493	9	20.00%	371,535	515,978
10	11.00%	281,473	160,387	10	20.00%	429,866	619,174
Avg Return	5.40%			Avg Return	20.00%		

As you can see from the examples, the Maximizer will work in our random investment environments (which is reality in and of itself) and outperforms investing in the stock market unless the market really does exceptionally well.

Where is the crossover point with the Maximizer where the returns in the stock market will out perform the returns of the Maximizer? The answer is slightly higher than 15%. See the following chart which uses a non-real world return of the same amount ever year (the Maximizer will significantly out perform the below model if the client has a down year or two starting the ten year window).

The following example assumes an initial amount invested of \$100,000 (and does not take into account money management fees, capital gains taxes or dividend taxes).

<u>End of Year</u>	<u>Projected S&amp;P Performance</u>	<u>Total Value</u>	<u>Mutual Fund Matching Index</u>
1	15.00%	115,200	115,000
2	15.00%	132,710	132,250
3	15.00%	152,882	152,088
4	15.00%	176,121	174,901
5	15.00%	202,891	201,136
6	15.00%	233,730	231,306
7	15.00%	269,257	266,002
8	15.00%	310,184	305,902
9	15.00%	357,332	351,788
10	15.00%	<b>411,647</b>	<b>404,556</b>
Avg. Return	<b>15.00%</b>		

## How Fast Can You Recover From Down Years?

While it might make sense that, if the stock market goes down 20% in one year you only need 20% to recover your loss, this is not the case. See the following numbers.

One of the unique things about the Maximizer approach is how much easier it is to “recover” from a bad year. Look at the following chart.

	To recover with equities	
If the market falls	The following year	Recover with the Maximizer
20%	25%	6.50%
30%	46%	6.50%
40%	66%	6.50%
50%	100%	6.50%

## Summary on the Maximizer

The Maximizer is truly a unique plan to help clients accomplish some of their most important financial goals. If your goals revolved around looking for an upside in the market with tremendous earning capabilities but still principally protecting the vast majority of your invested assets each year, you should take a strong look at incorporating this strategy into your long-term financial plan.

There are only a handful of advisors in the country who are familiar with the Maximizer. If you would like help with this topic, please feel free to e-mail [info@thewpi.org](mailto:info@thewpi.org); and I will forward you the information on your local CWPP™ advisor who can help you with this topic.

The Maximizer concept was created by Jeff Cohen.