



jeff@tpwc.com

THE PERSONAL WEALTH COACH®

An SEC Registered Investment Adviser

Jeffrey W McClure CFP® *Jacob A McClure CIMA®*

Serving Investors Since 1982

PO Box 1029 / 918 North Main Street, Salado, TX 76571

(254) 947-1111 / (800) 914-7526

www.thepersonalwealthcoach.com



jake@tpwc.com

Market and Economic Update

By Jeff McClure

Jeff@tpwc.com

September 7, 2011

The (Retirement) Income Conundrum

The stock market is behaving irrationally. On Tuesday the Dow dropped several hundred points and then on Wednesday retraced the majority of that back upward. If you carefully followed the daily reasons the market went up or down according to the media reports, you would have to ultimately conclude that Mr. Market was a delusional paranoid schizophrenic. If we are to believe the somber and confident assertions that "Today the market (surged, collapsed, rose, fell, crashed... etc.) because of (fill in whatever you want here)," then we have to conclude that Wall Street is an insane asylum being run by the inmates. Why would any rational person entrust their future to a mob of traders who are rushing to and fro in a manner that makes chickens in a barn yard seem to be acting with the essence of cool-headed wisdom? That question deserves asking, and deserves an answer.

In order to answer that question we have to start far from the trading frenzy of Wall Street, and for that matter the various bourses and exchanges around the world (they all act pretty much the same way). It is important to stop and consider what we are doing and why we are doing it as we plan how to employ our investment portfolios in a manner that will hopefully sustain us through decades of retirement. We must start by examining our assumptions.

Over the last half of the 20th century we Americans developed some rules of thumb, or if you will, assumptions, concerning portfolios orienting on retirement. One of them was that an ideal portfolio would be composed of a percentage of equities (stock related investments) equal to 100 minus one's age. Another was the more or less standard 60% equities and 40% bonds mixture. Alternatively, one could always use FDIC insured certificates of deposit (CDs) in bank accounts. Yet another option would be to purchase an immediate annuity from a life insurance company.

How well do those options, and the assumptions behind them, hold up today?

Let's start with a standard scenario just as a benchmark. In our model I am going to assume that we are considering a couple who will have Social Security as part of their income. In this case I am going to assume that both the husband and the wife will receive about \$1,400 per month in Social Security payments for a total of \$2,800 per month. That dollar amount, by the way, is based on a person born in 1950 who retires and begins drawing Social Security at age 66 and who was earning about \$50,000 per year in the years leading up to retirement. That makes the combined earnings of the couple before retirement about \$100,000 per year.

Their combined Social Security then equals \$33,600 per year. Using another old "rule of thumb" we will assume that they can get by on about 60% of their pre-retirement income, or about \$60,000 per year. To do that we will need to generate \$26,400 per year to make up for the difference. This scenario may or may not be applicable to yours, but it gives us a point to start from. It might be

In jurisdictions where securities licenses are held, securities may be offered through NEXT Financial Group, Inc., member FINRA/SIPC. *The Personal Wealth Coach®* is not an affiliate of NEXT Financial Group, Inc. Information contained herein has been obtained from sources believed to be reliable but is not warranted as to accuracy or completeness. Past performance is no guarantee of future returns. For tax or legal issues consult with a qualified tax advisor or attorney.

interesting to note that the median annual household income in the United States, as of 2010, was just over \$50,000, so our retired couple is still making about 20% more than the median working household.

The question that comes to mind is just how much money does our retired couple need to have invested to earn that extra \$26,400 per year?

Safety of Principal

Let's start with a very outmoded concept that originated in the 1930s, that of, "Keep my principal secure." It is not at all unusual for people to ask to get a relatively high return on investments while at the same time insisting that their "principal" not be put "at risk." Since upon further questioning that generally means that they do not want to see any fluctuation in their invested dollar amount to the down-side, that leaves only bank certificates of deposit. There is another alternative, which is an interest-payout only immediate annuity, so we will take a look at that as well.

FDIC insured certificates of deposit are the only vehicle that provides the kind of security that most people mean when they say, "Don't risk my principal." Insurance companies may offer a "guaranteed" principal, but that normally means only if you leave it with them for 15 or more years. If you attempt to recover the "principal" before that time it is not unusual for them to subtract as much as 15% or in other cases to simply tell you that you can't have it! There is also the risk with an insurance company, no matter how secure it is today, that in 15 years it may not be there, and you may simply be an unsecured creditor of the company. During the financial meltdown of 2008-2009, quite a few major insurance companies, many of them rated AAA just months before, had to turn to the government to avoid insolvency. It is unlikely that if a scenario like that happens again that the Treasury will have the ability to "bail out" those companies.

According to Bankrate.com the highest Jumbo, 5 Year CD in the nation today will pay a whopping 2.32% of income per year. So, if our hypothetical couple didn't mind that they would not be able to make any adjustments for inflation, to get that annual income of \$26,400 all they would need to do is deposit \$1,137,931. Of course, the FDIC only insures up to \$250,000 per account so they would need five of those CD accounts and two of them would probably need to be at a different bank. The money would be safe from just about everything except inflation and the penalty for early withdrawal would only be six months interest, or about \$13,200.

Even though an insurance company inherently carries a risk, at least our couple would not see the value fluctuate, so they would *feel* secure if their money were held there. Some of the better companies are offering as much as 3% per year and some of the less well-capitalized companies are offering up to about 3.5%. At the 3.5% rate, in order to get that \$26,400 per year, the couple would only need to entrust the insurance company with about \$754,286!

The big issue here is two-fold. First, interest rates (and thereby annuity rates) are at record lows. Getting a guaranteed low interest payout in exchange for a total loss of any ability to recover your money in the meantime may well be a decision you will live to regret. The second issue is that rising interest rates are very damaging to bond portfolios. Insurance companies mainly hold bonds. The next few decades may well see more than a few insurance companies in the same kind of trouble as we have seen in other financial institutions over the past few years.

Before we move on, a word of warning is in order. As I searched for fixed annuity rates, I found that there is apparently a market for "Secondary Market Fixed Annuities." The advertisements I saw stated they were "currently as high as 7.5%." Don't be taken in by that number. Those higher interest fixed annuities are priced with a yield-to-maturity that is actually a bit lower than the new annuities. What that means is to purchase one of those "7.5%" annuities, you would need to pay a lot more than the maturity value of the annuity. At maturity, you would get back a lot less than you invested. There is no such thing as a free lunch. Any time that you see a higher than standard interest rate on *anything*, there is a hook, and sometimes it is a really big hook.

It is probably unnecessary to mention this here, but do be aware that there are many, many people who will offer you a higher interest rate than anything I am going to discuss. If they do, then you can be assured that you stand to lose money, and quite conceivably *all* of your money. Ten year Treasury notes are currently yielding around 2% per year. In the final analysis that is the base-line for "safe and secure." It is possible to achieve a *long-term* return as much as 6% to 8% above that but there is a price to pay in terms of market volatility, and there are no guarantees. Anyone who offers more than the local CD rate and at the same time guarantees safety, security, and stability is either lying or a fool. Run, don't walk in the other direction.

Guaranteed Return of Principal

The next best thing to "safety of principal" for some is a guaranteed "return of principal." That is what the bank CD and immediate annuity promise too. Unfortunately, there is a problem with that promise. Inflation is a real issue. Currently we are in an economy that has little or no inflation and we are probably in a period of time when inflation will remain quite low. If we have 2.25% inflation over the next 15 years and you had that \$754,286 back in your hand at that point, you could buy with it about what \$536,000 buys today. You would have effectively seen a loss of over \$200,000 in buying power in return for the guaranteed return of your principal.

You could avoid that problem by purchasing Treasury Inflation Protected Securities or, "TIPS." The most recent set of 10 year TIPS sold by the Treasury were auctioned at 2.15%. The nice thing about TIPS is that the underlying principal value rises (or falls) with the Consumer Price Index. The only problem is that you would need about \$1,228,000 to generate that extra \$2,200 per month! Note too that your income will be paid out every six months, and it *will not* increase with inflation. Only the principal will rise with inflation. If the low interest rate was not enough of a deterrent for using TIPS it is important to realize that the additional dollar amount of your principal accumulated to keep up with inflation is fully taxable *each year* or when you remove it from an IRA or other retirement account. Ouch!

The problem with an insurance company guaranteeing your return of principal, even after inflation has reduced it by 1/3, is the same one I mentioned above. There is no guarantee that the insurance company will be there to return the principal. With a Treasury security or FDIC insured CD you may lose value because of inflation, but your dollars will be returned. Is there a risk that the U. S. Government will not pay you back? Actually no. It is in the Constitution. If the government does not honor that obligation, then the dollar becomes worthless and it really doesn't make any difference where you had it saved or invested. By the way, I consider that particular scenario so unlikely that it is not even worth considering. It falls in the same category as the risk that an asteroid will fall out of space and wipe us all out: extremely unlikely and something that we can do nothing about. So, don't worry about it.

What Should We Then Do?

Now let's get back to the stock/bond scenario. As I wrote earlier, one of the supposedly "tried and true" portfolio allocations that newspaper writers like to repeat is that a person should have a percentage of stocks equal to 100 minus his or her age. Our hypothetical couple is 66, so if we assume that aphorism to be true they should retire with a portfolio composed of about 66% bonds and cash and 34% equities (stock).

Again we need to take a hard look at what we can reasonably expect in the way of long term returns in those categories. The Barclay's Aggregate Bond Index has a yield to maturity of about 2.59% currently. Standard & Poor's currently estimates the growth in earnings (profits) of S&P 500 component companies to average 10.76% per year. The dividend yield on that Index is 2.08% per year.

For starters, if we combine 66% Bonds (using the Barclay's Index as a proxy) with 34% S&P 500 (again as a proxy for stocks) we get an actual cash yield of about 2.42% per year. If we were to "not touch the principal" in accordance with the old saying, once again we are going to need to have well over a million dollars to generate that \$2,200 per month. The good news is that even at the relatively low price to earnings ratio of the market today, we could reasonably expect that portfolio to appreciate at about an average rate of 3.66% per year. The net result is that the overall portfolio has a reasonable probability of being able to generate a combination of income and appreciation of about 6% per year. In fact, it would not be at all unreasonable to draw about 3.5% per year from that portfolio over the long haul, and still have a very high probability of keeping up with inflation.

Our couple still needs about \$750,000 to generate that \$2,200 per month, but (and this is important) they have a very good chance of being able to increase that income with inflation. There is no pretense of a guarantee here other than the fact that by diversifying so broadly they are, in effect, investing in the entire economy of the United States. Again, if that fails, then all bets are off anyway. More, their portfolio has a very good chance of being worth as much, in buying power, fifteen years from now as it is today.

I don't know how you see those figures, but to me having to invest \$750,000 just to generate \$2,200 per month is not a pleasant idea. More, along the way if (or perhaps I should write "when") interest rates rise, that 66% of the portfolio invested in bonds is not going to do very well. Yes, it will still generate income, but the market value of low interest bonds as interest rates go up is very likely to decline, and to do so a lot.

Let's move on to the 60/40 scenario. That produces an expected return of about 6.46% per year. Now our hypothetically retired couple can probably draw about 4% per year from the portfolio over the very long term. That means the investment needed to earn that \$2,200 per month (and increase for inflation) is reduced to \$660,000.

The Price that Must be Paid

There is no free lunch. In our hypothetical retirement scenario we have managed to reduce the amount of investment needed by half as we have moved from certificates of deposits and TIPS to a mixture of 60% Large Cap U.S. Stocks and 40% high grade domestic intermediate term bonds. Had our retired couple had that portfolio over the past 34 years or so, they would have seen eight or nine bear markets. The average decline in value they would have seen in those bear markets would have been just over 16%. In the worst of them, at least in terms of depth, they would have seen their total portfolio end-of-month value drop by over 37%. Having started 35 years ago at \$2,200 per month, their monthly draw today would have needed to rise to \$8,158 just to keep up with inflation, but their portfolio value at the end of July would have been ten times that of when they started. Now before you get too excited, most of that gain was inflation. The real purchasing power of their portfolio would have risen to a bit more than twice what they started with.

The price we must pay to have a return that can support us over the long term, unless we have millions to invest and want to live at a relatively low standard of living, is something we in the investment community call "variance." That is a nice way of saying that in order to get a good-long term return, an investor must be willing to tolerate some really, really scary bear markets and not bail out.

Over that 34 year period the S&P 500 Stock index (including dividends) averaged 6.85% per year after accounting for inflation. Bonds averaged about 3.85% per year after inflation. Those are relatively pleasant numbers, but it is critical to understand that the next 34 years will be different. Interest rates were declining over most of that time. That meant that bonds were performing well above "par." Interest rates, as I mentioned earlier, are at record lows today. That means that bonds will *underperform* relative to their historic norms over the next several decades as interest rates return to a more normal level.

The Choice Before Us

In short, we have a choice. We can accept the wild swings of the stock market as the price we must pay to have a reasonable return, or we can accept a 2% to 3% return in less volatile asset classes and just live at a lower standard of living. If we choose to accept the rough ride in return for a better standard of living there are some things we can do to smooth out some of the bumps as well as give ourselves a leg up on the old market.

Of course, there is still the valid question as to why we should believe that the stock market will provide a good return into the future. The popular argument is that stocks have had a long-term average annual performance of about 10% per year for a couple of hundred years. Unfortunately, the same argument is often applied toward investing in bonds and in the paragraphs above I stated that just because bonds have done well over the past several decades is no evidence they will do well in the next several. In fact, the better bonds have done over the past 30 years or so, the *worse* they likely will do over the next couple of decades.

The Danger in High Interest Rates

Stocks are a very different thing than bonds. Bonds constitute *loans* to some corporate entity. With a loan there are relatively few variables and some very real certainties. Bonds can be evaluated based on two simple numbers, *yield to maturity*, and *credit worthiness*. In essence, an FDIC insured certificate of deposit is a "bond." While we normally think of them as what we get when we actually deposit money in a bank, we can buy them on the secondary market, just as those "7.5% annuities" are available on a secondary market. If you were to find a \$100,000 7.5% CD (or annuity or Treasury bond) on the secondary market that would pay out its principal in five years, given today's interest rates, the price to purchase that instrument would probably be around \$125,000. In other words, you would pay \$125,000, receive \$7,500 per year for five years (and likely pay taxes on that amount) and then get back \$100,000 at maturity. The "yield to maturity" on that instrument is 2.17%, before we figure in the extra taxes. While you were receiving about three times the income per year that you could get from a new bond you probably would be quite happy. When you only got back \$100,000 from your \$125,000 investment you might not be quite as pleased.

Bonds, Cds, annuities, and anything else with a fixed payout and a maturity date can be calculated with precision. Unfortunately, those same instruments can be advertised in such a way that they seem to be something they are not. The standard against which all interest bearing financial instruments are measured is the U.S. Treasury obligation. As of today the ten year Treasury note (the

benchmark of benchmarks) is yielding **2.05% per year**. Anything, and I mean *anything* that has the potential to provide a higher average rate of return than that carries *risk*. Risk is manageable in most cases, but when a salesperson or advertisement suggests that a higher interest rate is available without risk, then you can be absolutely certain that "false and/or misleading" information is being presented.

It is important to recognize that the higher the "guaranteed" rate offered above that of a U.S. Treasury obligation, the higher and greater is the risk to your investment. Bernie Madoff was producing an average annual rate of return of about 10% to 12% with the perception of little or no volatility in the value of the original investment. Here is possibly the most interesting thing about that; those same investors could have achieved about the same return in a legitimate investment portfolio had they been willing to tolerate some rather severe short term declines in market value. Rather than accepting the short term and often quite scary, market plunges and spurts, they opted for a "safe" solution and in many cases lost everything. There is a fundamental truth there.

Stocks

So, now we are back to stocks. Frankly, that is the only option if you want to have a return higher than about 2% to 3% per year. I know that commodities are out there, and more particularly, gold. Suffice to say that gold will have to rise to about \$2,300 per ounce to merely break even (before taxes) with where it was 30 years ago. Considering that most of us do have to pay taxes, it will need to get closer to \$2,750 per ounce just to return the net buying power of the amount of money it took to buy an ounce of gold in 1981. Any investment that is still in a loss position after 30 years is not one I can suggest is going to be much help for a long-term retirement program.

Stocks, as individual issues, are risky. Stocks as an asset class over a long period of time are as safe as anything you can own. If you were to have bought the 30 individual stocks in the Dow Jones Industrial Average 30 years ago and hidden the certificates away in a safe deposit box, today your losses would be staggering. There are only a very few of those companies that have survived those three decades. On the other hand, had you somehow been able to invest in the Index itself (you really had no way of doing that back then) you would today have an investment that was worth about 12 times what you paid for it. That works out to an average annual rate of return of about 9%. Over that same time period we had just under 4% average annual inflation, so you would have netted about 5.2% per year in terms of a real return. To do that you would have had to reinvest all the dividends you earned as well as retaining all the capital gains from stocks as they were eliminated from the Index. Over that same period the real (after inflation) return on bonds was about 3.43% per year.

So, why am I claiming that stocks will tend to do better than bonds (or anything else) into the future? The reason is actually fairly simple. Stocks, as an asset class, represent companies that are focused on making a profit. Their executives generally have their future well-being defined by how profitable the company is. Successful people (like corporate executives) tend to behave in a manner that will make them better off in the future if they are given the chance to do so. Sometimes they get greedy, as we saw as Enron, Lehman Brothers, AIG, and Bear Stearns (among others) collapsed into ruin. In other cases they get lazy and far more concerned about their take than the company's profits. We saw that as Montgomery Ward, Dell, Kodak, and other sank with a whimper rather than a bang. Still, as an *asset class*, investing in stocks tends to produce better returns over the long-term than any other asset class.

At this particular moment in time, investing in that asset class is particularly attractive. Why? Simply put, because stocks have done relatively poorly over the last ten years. Historically when they have done that, they tend to make up the difference in the next ten. That by itself is not a sufficient reason, but it is an indicator. It is when we look at the numbers that we can see the real, "Why." The S&P 500 Stock Index today is priced at about ten times next year's earnings, or profits (P/E ratio of 10). That means that stocks are effectively yielding about 10% per year. The key issue here though is that independent analysts pretty much all agree that that "yield" will not remain steady, but will *rise* by about 10% per year over the next five years. That means that in about 7.2 years the earnings of the S&P 500 Stock Index will very likely *double*.

Even if we stay as pessimistic about the future as we are today, meaning that the P/E ratio stays at about 10, then it would be reasonable to expect to see the Dow at about 24,000 at the beginning of 2018. History indicates that it will be a lot higher than that because we tend to swing from pessimism, where we are today, to outsized optimism. If we do that we will likely push the price of stocks up to something closer to 30,000 on the Dow. That number, by the way, would put that stock index right in the middle of the historical price to earnings relationship we have seen over the past century or so.

There then is the question of whether to believe the analysts or not. I have been watching those analysts for quite a while now. They are still very much aware that overestimating future earnings not only will cost them their jobs, but in some cases will result in prosecution. As a result, earnings analysts tend to rather severely underestimate future earnings since about 2000. More,

corporations are sitting on absolutely record quantities of cash. That cash is earning nothing. When they do finally regain some confidence in the direction that regulation and the economy is going those corporations will very likely suddenly start spending that money in an effort to stay ahead of their competition. That will be a bigger stimulus than anything the government could do.

Where We are, Where We are Going

We have been here before. We, both as a government and as individuals, are carrying more debt than we are comfortable with. We are in the process of figuring out how and actually doing the job of paying that debt down to a more comfortable level. My best guess is that in about two or three years we will be there. Between now and then we are likely to see growth come in fits and spurts. As we get the debt down (and we are) we will see the economy and the market recover. It is now, at the point of maximum uncertainty when things are the lowest, that the opportunity is the greatest. I am very comfortable in saying that five years from now we will look back and wonder what it was that was so scary.

Meanwhile, there are other equity asset classes that have a better and more stable long-term return than that of the S&P 500 Stock Index, and that stability gets better if we mix the right ones together in the most appropriate way. We can't offer guarantees and we can be sure that the ride will have some bumps and grinds that are anything but pleasant, but we can be sure that we are on the track that history and science tells us is the most likely to provide what we need.

As is always the case, a good asset allocation plan is the best policy.

If you have questions or thoughts on any of this, don't hesitate to email or write.

Sincerely yours,

Jeff McClure