Registered Investment Advisor Firm

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HAPPY NEW YEAR!

Happy New Year…now lets get down to business!

Some long time readers may recall that in October 2011, I wrote the following regarding the "4% Rule" vis-à-vis being the percentage of withdrawal for your retirment portfolio to sustain you while in retirement:

"As a rule, your portfolio will produce a higher withdrawal rate when the market has a low price to earnings (P/E) ratio … a tool that can be used to estimate the future long-term returns (15+ year cycles) of the stock market (it doesn't work very well in predicting short term market returns).

If you're a retiree, it can be used in establishing a good starting withdrawal rate; an amount that could safely be withdrawn each year, with the ability for subsequent year's withdrawals to increase with inflation.

I too was familiar with the 4% drawdown mantra, but I wanted to research this further.

As a result I found a very interesting study presented in the Journal of Financial Planning in October of 1994 by Bill Bengen CFP® (he is widely referenced in multiple studies for his work on this topic), in which he made some observations which remain valid today when calculating withdrawal rates in the context of rolling 30 year timeframes, a timeframe which could be considered reasonable for a retiree at or near 62. Among his observations were:

- When the price to earnings ratio of the stock market (S&P 500) is below 12, safe withdrawal rates range from 5.7% to 10.6%.
- When the stock market's price to earnings ratio is in the range of 12 - 20, safe withdrawal rates range from 4.8% to 8.3%.
- When the price to earnings ratio of the stock market is above 20, safe withdrawal

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rates range from 4.4% to 6.1%."

Fast forward to 2012 and Bill Bengen has again made news by proclaiming now he isn't convinced the rule still applies, given the current economic environment. When Bengen, first recommended the 4% drawdown in the 1994 *Journal of Financial Planning* article, it was based on a "worst case" scenario of an investor who retired in 1969.

This is critical to the assumptions and advice some (financial professionals and do-it-yourselfers) relied on for decades. These assumptions were built on the concept of a balanced portfolio where it was typically allocated between roughly 60% equities and 40% fixed income to a 50/50 portfolio.

Much of the problem associated with his thesis was limitations of reconstructing historical retiree's portfolios from 1926 forward trying to capture asset class returns and inflation to model safe withdrawal rate projections.

Bengen completed his work in 1993 when there were 38 complete 30-year retirement periods available to study (1926-1963). Today there are 57 from 1926 to 1982. His updated studies concluded that the retiree that retired on January 1, 1969 was the "big loser."

The conclusion determined the sequence of investment returns is crucial for portfolio longevity, something I alluded to in my 2011 article.

Over the past few years, the availability and use of financial calculators have proliferated on the Internet. The unfortunate part of most of these calculators is that they either force you to make unrealistic assumptions or in some cases assign those assumptions for you by default. These calculators can be helpful for transition points to help you understand and make those transitions, but lets' explore more closely why you should be very careful when relying on these outputs.

If you're looking for that magic number that says "you've made it, go out and play," it doesn't exist. Consider the variables of input and you'll understand what I'm talking about.

Start with the inflation rate and how it affects your investment returns. The amount of money you make off your assets is only what your nominal return is minus the inflation rate. In addition it also affects your expenses over time so it works against you on both sides of the equation.

- Did you know in 2012 it took $6.47 to buy what $1 in 1969 would buy?

You must therefore be able to identify your **personal inflation rate** which is driven by your lifestyle. The official rate of inflation is really a political issue and it taxes savers and those with assets. It's essentially a mechanism used by the government for redistributing money that they thought you saved. Therefore trying to predict the future inflation rate is like trying to predict the political future. Therefore we have a problem

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with the first variable of trying to assess future values and needs. There are PhDs who spend their entire careers trying to predict inflation rates one year into the future, but you're expected to predict it 25 to 40 or more years in the future? If you get just the one assumption wrong by a couple of percentage points (which is very easy to do), you could have twice as much need for retirement assets than you forecasted or you could have half as much.

A good way to think about this is to envision driving from the east coast to the west and trying to predict the exact minute of arrival. Along the way you'll need additional data and instruments, like a gas gauge, a map or GPS to make sure you're even headed in the right direction.

Next we need to look at investment returns. Typically many rely on the "average" market returns and that number is typically based on the past 70 years of market data to calculate growth going forward. There are at least two problems with making that assumption.

The first one is the assumption we're in the midpoint of that market cycle so we can expect the same average going forward for the second half, when in fact the market may well be overvalued and can't possibly sustain that rate of return going forward. The second is failing to account for market volatility and sequence of returns (the magnitude of returns over any extended period of time).

Valuation is statistically relevant to your expected return over a 10 to 15 year time horizon. That time frame is very relevant to retirement planning. So when you look to valuation, you should try to determine where you are on the market cycle as markets tend to move to from overvalued, to undervalued and back to overvalued, over extended periods of time. These calculations affect the mathematical expectancy of your portfolio.

Market cycles alone do not account for volatility which can have a profound effect on your portfolio's valuation, especially if you've begun the drawdown phase where you're taking money out for living expenses. As you drawdown your portfolio, you dramatically affect the ability to produce that "average return" in order to predict long-term retirement cash flow needs.

Risk management is a key tenant to retirement portfolio management. If you were a retiree who retired in 2000 and lived through the roughly 50% decline of the market and were counting on the 4% withdrawal rate to meet long-term expenses, you would have knocked out 60-70% of your assets without even adjusting for volatility, just off spending alone.

The probability of ruin in retirement is highly correlated to the sequence of returns in the first 10-15 years.

The next vital piece of data in order to predict whether your portfolio will sustain you through your retirement is your life expectancy. Go ahead, try and nail that one in advance.

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Even if you are confident in picking a number, are you going to plan to go broke on your 95th birthday? What if you die at 75 and there's this huge portfolio you were never able to take advantage of? With the advances of healthcare there may be every reason to believe if you're reasonably healthy now, you could live into your 100's. There is no statistical reality for any single lifespan.

What if you work an extra 10 years in a job that you hate? Is that a guaranteed loss as you've lost 10 years of life doing something you really didn't want to do in the first place?

Planning for retirement is not an easy process and it requires flexibility, the ability to adapt to life's choices and economic realities. If you're inclined to use simple online calculators, remember to carefully calculate the effect of your input data and change the data both up and down to see how it affects your long term prospects. The only real data input that you can control is your lifestyle choices. You may have limited control over the length of time you elect to work, especially if self-employed, but the savings rate and rate of expenditures are the most malleable under your control.

As you can see there are many variables to consider when planning for your retirement and even after you enter your retirement years. The process is not one of "set and forget," but one that you should regularly revisit, especially if you have a significant life changing event.

A great time to address many of these issues are during your annual review with your DIG financial adviser or investment professional. You need to be proactive, after all it's your financial future.

If you're not already a DIG client, and feel you could use professional assistance, or maybe you just want a second opinion, there may be no better time than the start of a new year to make sure your tank is full and your GPS is working for your retirement journey. Contact either Bob Davis or myself through the DIG website (www.davisinvestmentgroup.biz) and we'll be happy to assist you on your road to a rewarding retirement.

Davis Investment Group

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If have questions or would like further information on this month's topics, please contact me directly at (925) 360-6819 or through email at: Bud@DavisInvestmentGroup.biz

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