

Lowly Analyst Newsletter

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The Economy and the Market

Foreign stocks are increasing at a faster rate than domestic ones. Stock prices are closely related to expected future earnings. They are also one of the best predictors of future economic health. US economic leadership is being challenged on many fronts.

US markets performed relatively poorly compared to the rest of the world. US equities are expensive than international ones. Valuations are adapting to international standards. Interest rates are rising and the yield curve is flattening. Emerging markets are becoming more investor friendly (e.g. India). Compared to the rest of the world US shares are more expensive relative to bonds. US Inflation has risen to 4%. This is a good time to increase your holdings of foreign developed and emerging markets.

In client portfolios, I continue to hold a core portfolio of institutional asset class funds in each of a dozen different classes with a heavy dose of foreign investments. This core is supplemented by sector funds in natural resources and housing.

Asset Classes: US stock market went up in the last 6 month. mid-map growth performed best; large-cap growth worst. Growth outperformed value except large cap. All classes were up at least 4% for the 6 months.

Sectors: For the last 6 months transportation, networking, basic materials, financials, biotechnology, and semiconductors were up over 10%. Most sectors had positive returns; consumer service, consumer goods, and telecom. Utilities were exception.

Foreign Investing: For the last six months emerging markets performed best - Brazil, Russia, S. Korea, Eastern Europe, and India all up over 30%; China up 16%; foreign developed markets up 14%; Canada up 24%; outperforming US, up 6%.

Sustainable Withdrawal Rates II Last Month's Discussion

This is a continuation of last month's discussion. We defined sustainable withdrawal; illustrated inflation adjusted withdrawal; discussed our method; defined our concept of risks; showed historical risk, return, and inflation for the last 200 years; showed the relation between risk and return for the post-war period; and illustrated how volatility can decrease asset growth; gave life expectancies; and showed sustainable withdrawal rate as function of annual return at various ages.

For the sake of new readers we will repeat some of last month's discussions.

Abstract

- a. Definition of sustainable withdrawal
- b. Our concept of risks
- c. How volatility decreases asset growth
- b. Sensitivity of withdrawal to return and age
- c. Sensitivity of withdrawal to volatility and age

1. Sustainable Withdrawal

Sustainable withdrawal is the inflation adjusted rate of withdrawal that results in the desired residual value at the deaths of the owner and the significant other. It is the amount of purchasing power you can withdraw without running out of money.

2. Our Concept of Risks

The key risk for retirees is the risk of not achieving their objective, of outliving their assets. The major risk is not the volatility of the portfolio. Inflation and changing real returns are far greater risks. A money market fund can be very risky if it does not provide enough purchasing power.

3. Post War Volatility- Return Relation

Over long periods of time higher risk has lead to higher returns but not for short periods.

Volatility/Year	Return/Year
0%	0.5%
5%	2.3%
10%	4.0%
15%	5.8%
20%	7.6%
25%	9.3%
30%	11.1%

4. How Volatility Decreases Asset Growth

	Portfolio 1	Portfolio 2		
	Return	Assets	Return	Assets
Start		100		100
Yr. 1	10%	110	70%	170
Yr. 2	10%	121	-50%	85
Average	10%		10%	

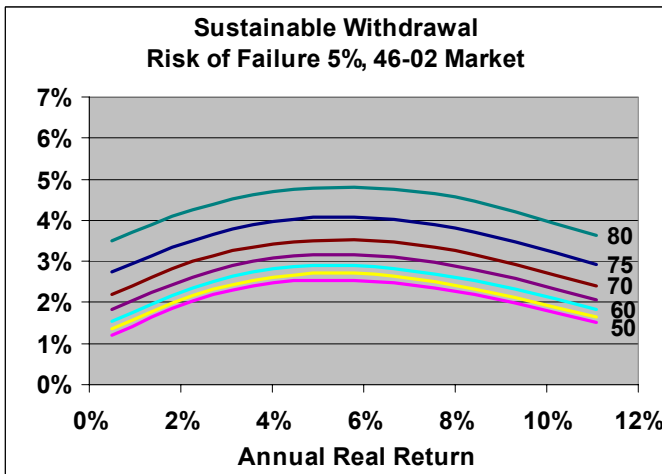
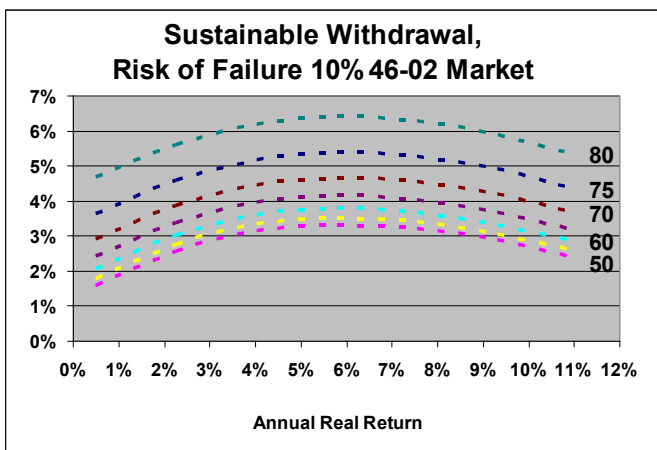
The Table shows that high volatility decreases asset growth.

5. Life Expectancy

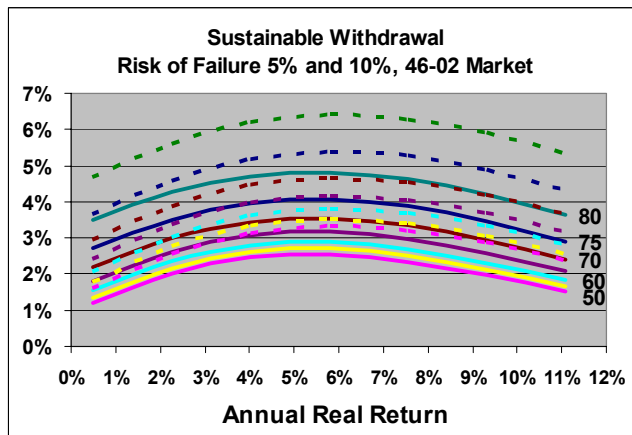
Age	Life Expectancy
50	30.3
55	26.1
60	22.0
65	18.2
70	14.7
75	11.5
80	8.8

Source: US Life Tables 2002.

6. Withdrawal Rate as Function of Return



The next figure shows withdrawal rate increases about 1% as the chance of running out of money decreases from 10% to 5%.



7. Minimum Required Distribution

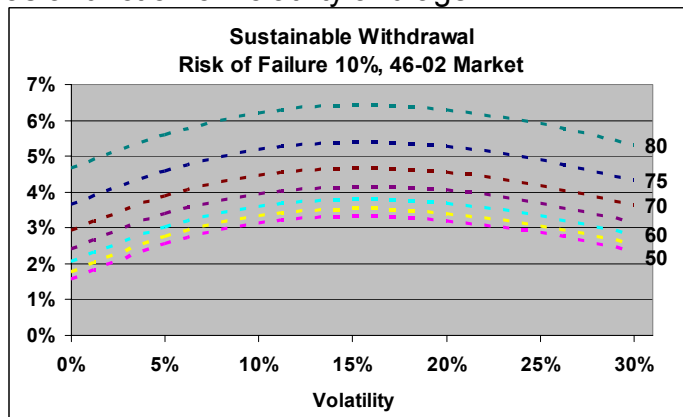
The sustainable spending rate is about equal to the minimum required distribution.

Sustainable Spending

Age	Failure Risk		Minimum Required Distribution
	5%	10%	
50	2.5%	3.3%	2.5%
55	2.7%	3.5%	2.8%
60	2.9%	3.8%	3.2%
65	3.2%	4.1%	3.8%
70	3.5%	4.6%	3.6%
75	4.1%	5.4%	4.4%
80	4.8%	6.4%	5.3%

8. Withdrawal Rate as Function of Volatility

The next Figure shows the withdrawal rate as a function of volatility and age.



The Figures show volatility and return are related. Withdrawal rate increases up to a point. Volatility increases returns but can have a negative effect on compound returns and withdrawal rate. Initially, return increases reaching a maximum at about the volatility of the total US stock market, at higher volatility returns and withdrawal decrease. Therefore your volatility should be that of the market but no higher if you need a large cash flow.