

Lowly Analyst Free Newsletter

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In this Issue

The Markets

Retirement Investment Risks

The Market

Markets are highly volatile. Currently stocks are inexpensive. Despite this, for the month stocks went down and continue in a down trend while long term bonds soared.

Consumer spending tumbled 3.7%, the sharpest fall since '80. Durable goods' orders dived 6.2%. Four-week average unemployment benefits are 518,000 - a 26 yr. high. Unemployment is expected to hit 9% by year end. In October new homes sales fell at a 5.3% annual rate.

Inflation rates for Nov. '07 were 4.3%; for '08 they were as follows: Jul. 5.6%, Aug. 5.4%, Sep. 4.9%, Oct. 3.7%. At the moment there is no sign of inflation. While the amount of money has increased by 10%, the velocity of money has decreased by 12% therefore avoiding inflation and raising the possibility of deflation. Since the velocity of money equals the GDP divided by the amount of money, a decrease in GDP and an increase in the amount of money can lead to deflation.

Asset Classes: For the past month: Large Value down 8%, Large Growth -8%, Mid Value -10%, Mid Growth -15%, Small Value -11%, Small Growth -12%, Micro -13%.

Sector ETF's: For the past month: Gold up 13%, Silver 7%, Intrntl Telecom 6%, RAFI Utilities 2%, Euro 0%, Natural Resources -2%, Energy -2%, Consmr Goods --4%, Agric Commodities -4%, Intrntl Real Estate --5%, Natural Gas -7%, Industrials -7%, Covered Calls -8%, RAFI Health Care -8%, Global Mtrls -8%, Biotech -8%, Technology -9%, Consmr Srvs -9%, Transportation -10%, Semiconductors -10%, Aerospace -10%.

Foreign Investing: For the past month: Italy up 10%, China 6%, So Africa 2%, Hong Kong -1%, Malaysia -2%, Singapore -3%, Spain -3%, Japan -4%, Mexico -5%, Emrg Mrkts -6%, France -6%, Forgn Lrg Div -6%, Sweden -6%, United Kingdom -6%, World - US -6%, Brazil -7%, Europe 350 -7%, Pac-J -7%, Latin Am -8%, US -8%, BRIC -8%, Australia -9%, Canada -11%, Taiwan -12%, Cindia -12%, India -14%, So Korea -16%, Russia -23%.

Bonds: Extended Duration Treas up 23%, 20+ yr Treas 17%, Long Term Treas 10%, Insured Ca Munis 10%, USD Emerging Mrkt Bnds 8%, Munis 6%, Intermed Gvmts 6%, 3-7 Yr Treas 5%, Total Bnds Market 4%, High Yield Bnds 4%, Emerging Mrkts Sovereign Debt 4%. AMT Free Lng Munis 3%, Intermed Credit Bnds 3%.

Retirement Income Risks

1. Introduction

In today's newsletter we define risk and discuss the risk that you may not reach your financial goals for your retirement and your estate.

2. Definition of Retirement Investment Risk

Before we can discuss risks intelligently we have to define the concept. There are many definitions of risks. My definition of retirement investment risk is the probability distribution of the percentage that you will not achieve your inflation-adjusted retirement and estate goals. For example., if your goal is to have cash purchasing power of \$100,000 annually after income tax and a \$0 estate but no debt, then the risk is the probability distribution of not achieving this goal, e.g., the probability of achieving \$10,000 income, \$20,000 income etc.

In an earlier newsletter I estimated the investment risk you should take to have the maximum sustainable withdrawal rate. This risk is the risk of the average US stock market. At that level of risk, you have the highest probability of not outliving your assets.

3. Types of Risks

- a. The risk that you cannot accumulate the required savings.
- b. The risk of changes in your cash flow needs because of inflation in your living expenses.
- c. The risk of tax changes.
- d. The risk of living longer than expected.
- e. The risk of having unexpected expenses (e.g. health).
- f. The risk of having lower than expected returns particularly in the accumulation and early retirement phases.
- g. The risk that you cannot sell your assets, liquidity risk, e.g., real estate.

The point is there are many risks other than total investment returns.

All risks are probability distributions. Keep in mind that averages are irrelevant. They indicate that 50% of the time the risk is below or above the average. You generally do not want to take the average risk. Ideally you want to take only a small risk e.g., a 10% risk that you have an adverse outcome. You don't want to have an average, i.e. 50%, chance of running out of money.

4. Insurable Risks

You can partially insure yourself against some risks. Full insurance is never possible.

All insurance has a cost. The cost may be more than you are willing to pay, e.g., long term care insurance.

You cannot insure yourself against all risks.

You can partially insure yourself against inflation and investment return risk by buying an inflation adjusted annuity. You retain the risk that the insurance company will be unable to pay. Typically the inflation adjustment is made according to an index. A retired person's living expenses usually increase faster than the index because of health costs and the need for assistance with tasks that he did himself e.g., mowing the lawn or housework.

In general, I do not recommend annuities. Annuities are generally expensive; the insurance company wants to make a profit and its investments have high management fees. Also the largest US insurance company, The Hartford, is currently in financial difficulties. Insurance obligations are generally somewhat protected by the state, but the insurance contract governs, not what the salesman said.

5. Investment Return Risk

Generally higher returns have higher risks. If you are Bill Gates, you can leave your money in a money market fund. You need not take any risk with your investments. Most of us have to choose between eating well and sleeping well. We have to take some risk.

6. Mitigating Investment Risk

You can mitigate investment risk by holding a well diversified portfolio. A well diversified portfolio is in asset classes that have a low long-term correlation with each other. That means you want to hold assets that go up when some assets go down. Long term and short-term correlation differ. You are interested in long-term correlation.

Unfortunately, bull and bear market correlations differ also. Typically in a bear market all asset classes are correlated.

7. Life Expectancy

As you know, you can do much to influence your life expectancy. Contrary to what most people think life expectancy is primarily a function of your life style, not of your genes. Even senior citizens can still influence life expectancy. While most of us cannot be perfect, we each should do what we can do.

Recent research indicates, for instance, that the number of nerve cells is not fixed. The body can generate new nerve cells even in old age.

More amazing we can even develop new nerve pathways. We can exercise our brains just as we can exercise our body and benefit from it.

The keys to long life are weight control, good nutrition, and exercise. Weight control is the most important factor. Try to eat foods that have a low glycemic load. Glycemic load is the amount of simple and highly soluble sugars.

8. Current Investment Strategy

Know your risk tolerance. Do not take more risk than you can tolerate. If you do, you will sell out eventually when the market is down. The market could fall another 40%.

Until the market clearly indicates its direction, do not load up on equities. A few days of market advances do not indicate that the market is going to go up.

You should have a low volatility portfolio such as a large amount of short term, high grade fixed income securities in a diversified fixed income portfolio. You should not acquire long term bonds, since they are very volatile and you do not get adequately rewarded for the risk. You should hold some gold funds (not gold mines) and some stocks. Remember, markets are unpredictable. This is a good time to seek professional advice.

Stock markets are complex systems. No one can predict them. Eventually the stock market will go up again. In the '80s and '90s we had unusually high returns. Such returns are unlikely to come back soon. Individuals, businesses, and governments have such heavy debts that as we pay these back, our living standard and investment returns are likely to fall.

You have to live in the world as it is, not in the world you would like it to be. Make your plans on realistic assumptions.

9. Bottom Line

- Financial markets are complex systems, hence unpredictable.
- Returns from financial markets do not follow a normal distribution. Markets have many more extreme events.
- The world has changed since 1929. The response of Government has been better. The US still has the strongest economy of the world.
- Monitor the risk of your portfolio and do not exceed a level that you can tolerate.