

Lowly Analyst Newsletter

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The Economy and the Market

What happens to countries with huge debts financed by foreigners? Iceland financed its trade deficit (16% of GDP) from foreigners. Its high interest rate attracted foreign funds; that and easy mortgages led to an economic boom. GDP grew 8.2%/yr, stock index surged five fold from the end of 2002 to February 2006. Foreigners became concerned. Fitch reduced its government debt rating. The Krona declined 18% against the dollar since January. Iceland's stock market fell 20% in Krona.

The US situation is different. The US dollar is a reserve currency; foreigners still fund our debt. Deficit spending might unwind gradually, but Iceland should serve as a warning.

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: For the 6 months, micro-cap up 19%, small-cap 19%, mid-cap 13%, and large-cap 9%.

Sectors: For the 6 months gold up 40%, basic materials 22%, natural resources 21%, networking 19% transportation 21%, semiconductors 21%, global financials 18%, real estate 18%, industrials 17%, global energy 17%.

Foreign Investing: For the last 6 months Russia up 117% in \$, Pakistan 73%, Venezuela 72%, Brazil 62%, Columbia 53%, Indonesia 52%, France 51%, Turkey 46%, Poland 46%, India 45%, Peru 39%, China 33%, Canada 33%, Saudi Arabia 32%, S. Korea 30%, Mexico 30%, Austria 30%, S. Africa 28%, Taiwan 23%, Egypt 22%, Philippines 22%, Singapore 21%, Germany 20%, Sweden 18%, Thailand 18%, Netherlands 18%, Japan 17%, Czech Rep. 17%, Australia

16%, Hong Kong 16%, Belgium 16%, Argentina 14%, Chile 13%, Italy 12%, Israel 11% Denmark 11%, Spain 11%, Malaysia 9%, Switzerland 8%, Britain 8%, and Hungary 8%, Emerging Market 37%, Euro Area 23%, World 16%, Europe 13%, US 10%.

Controlling Risk

1. Introduction

We are going to examine the relationship between withdrawal rate, percentage of stocks and US Treasury bonds, portfolio drawdown and terminal wealth.

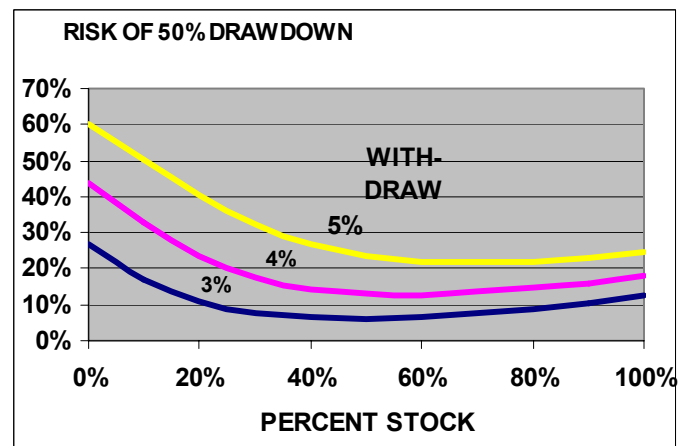
2. Method

Gary Smith and Donald P Gould, Pomona College, discuss withdrawal rate in a recent paper. They based their simulation on the US market from 1925-2004. Unfortunately they did not use a well diversified portfolio and used no foreign stocks and bonds. Nevertheless the paper provides some insights.

Smith and Gould used a 65 years old couple that withdrew at an inflation adjusted rate. When one spouse died withdrawal rate decreased by 25%. (In the last three news letter we showed that for a couple of that age the best withdrawal rate is about 3.4%).

3. Drawdown Risk vs. Percent US Stocks

The figure below shows the risk of having a drawdown of 50% in inflation adjusted wealth as a function of the percentage of the portfolio in US stocks at various withdrawal rates. The rest is in US Treasury bonds.

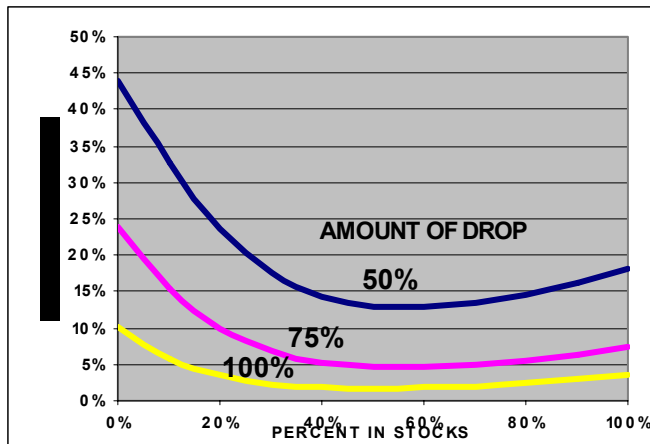


Initially the risk decreases due to increased return, then it starts very slightly to increase.

4. Percent in Stock vs. Amount of Drawdown

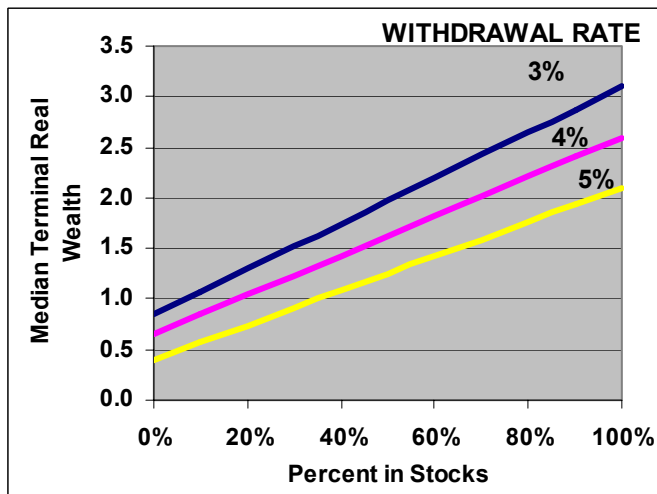
The following figure also shows the risk of asset draw down, but this time for various amount of drawdown in inflation adjusted assets for a 4% withdrawal rate. Again the risk initially decreases and then slightly increases.

Note that an all bond portfolio has a 44% risk of a 50% drawdown.



5. Percent of Assets in Stock vs. Estate

The next figure indicates that for a 4% withdrawal the median terminal wealth increases by about a factor of 4 as percentage in stock increases from 0 to 100%. Here the portfolio starts out at 1. This shows that a high bond percentage decreases the amount of the estate.

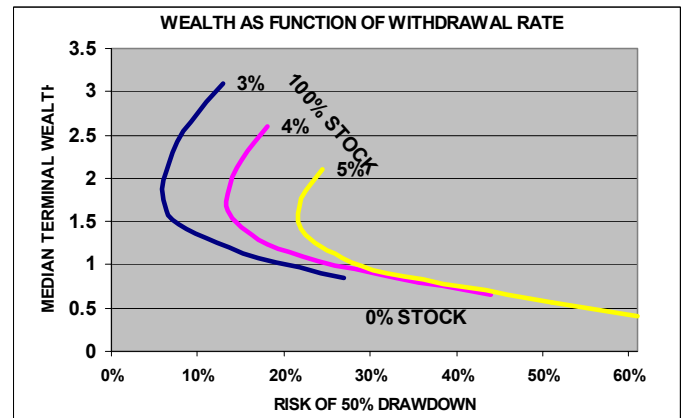


6. Terminal Wealth vs. Drawdown Risk

The next figure displays terminal wealth as a function of the risk of a 50% drawdown at various withdrawal rates for various percentages of stock in the portfolio. For example, the figure shows that at a 4% withdrawal rate and 100% of the portfolio in stocks there was an 18% probability of having a

drawdown of 50% of the inflation adjusted portfolio value. On the other hand, an all bond portfolio had a 44% chance of the same drawdown. The high risk of drawdown is the effect of inflation.

To make the all bond portfolio even worse the median terminal wealth is 2.6 times the initial value while the terminal wealth for the all bond portfolio has shrunk to 60% due to the effect of inflation.



7. Effect of Inflation

In 1980 we had inflation rates of 13.5%. Such inflation rates were devastating for a bond portfolio. Not only does the interest have little purchasing power but in addition the principal decreases. This was the reason for high drawdown of bond portfolios.

Because of our large debt and large deficits and dependence on foreign money, high inflation is again a possibility.

8. Better Dead than in Bonds

Bonds do not provide a secure retirement income. Bonds have large drawdowns (except inflation protected) and low terminal wealth.

9. Takeaways

- An all bond portfolio has about 2-3.5 times the probability of large draw downs than an all stock portfolio depending on withdrawal rate.
- An all bond portfolio has a median terminal wealth of about 40-80% of the initial value; an all Stock portfolio has a median terminal value of about 2-3 times the initial value.
- The lower the withdrawal rate, the lower the probability of large draw downs.
- Once the stock percentage reaches 50%, the risk of drawdown does not change much.
- It is very important that you understand these relations. Call me if you have questions.