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Asset Management • Retirement, Tax and Estate Planning • Fee Only • No Commissions • Independent Advisor

April 4, 2019

Here is our newsletter for the 2nd Quarter of 2019

The Markets Update

The 1st quarter was almost as good as the previous quarter was bad. Every asset class had positive returns, many double-digit with the biggest gains in the assets which lost the most the previous quarter. Even U.S. bonds did well with the AGG index returning 2.9% as the rise in interest rates last year was pretty much reversed in the 1st quarter.

For the last year U.S stocks and real estate performed best, but foreign and emerging market stocks and bonds, along with natural resource stocks and commodities still show negative returns.

Asset Class Returns- Ending 3/31/19

Asset Class	1st Qtr 2019	One Year
US Large Cap Stock	13.7	9.5
US Small Cap Stock	14.6	2.0
Foreign -Developed Mkts Stock	10.0	-3.6
Emerging Mkts Stock	11.4	-6.8
US Intermediate-Term Bond	2.9	4.5
Emerging Markets Local Bond	2.6	-9.6
High Yield Bond	8.0	6.1
Inflation-Protected Bond (TIPS)	3.2	2.6
Cash	0.6	2.2
US Real Estate	17.3	20.1
Natural Resource Stocks	15.7	-6.4
Commodities	10.2	-4.9

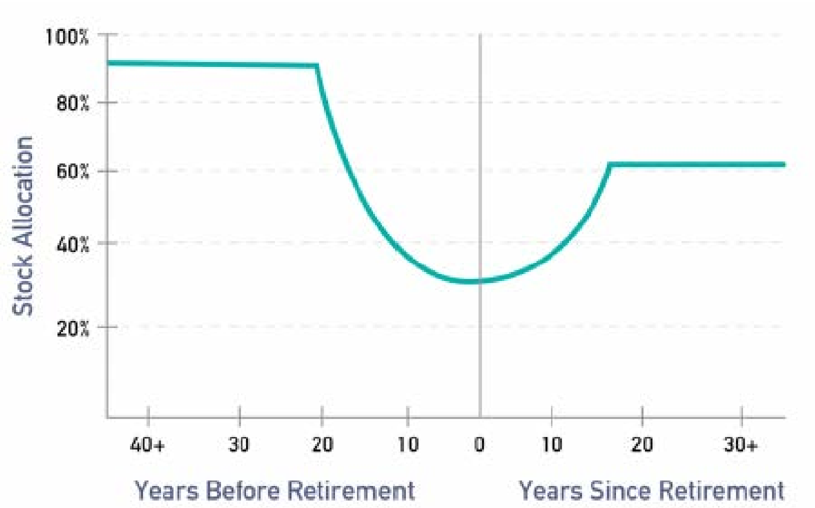
The biggest news during the quarter was the “about face” from the Federal Reserve on the outlook for interest rate hikes. At the beginning of the year the Fed was expected to raise rates 0.25% two more times this year. Last year 3 more hikes were anticipated. Recently the Fed signaled there would likely be no more interest rate hikes this year and the reduction in the Fed balance sheet would be more measured. The markets liked the new message in the short term, but most believe it reflects the realization of slower economic growth going forward than the almost 3.0% the U.S. got in 2018.

The Problem with Target Date Funds and Other Asset Allocation Strategies in Retirement

A lot of people are easily bored with academic research, but the financial planning profession has generated research which is being ignored my most, but not me. Wade Phau who is a professor of retirement income at the American College has been writing about the big problem with the asset allocation recommendations commonly used for retirees. His paper appeared in the Journal of Financial Planning in September of 2013, co-authored with Michael Kitces, another retirement researcher at Pinnacle Advisory Group. The paper, “Reducing Retirement Risk with a Rising Equity Glide Path” shows how retirees should start retirement with a lower allocation to equities and increasing that allocation throughout retirement.

This is exactly the opposite of the recommendations made by most. For example, the two most popular 2020 target funds from Vanguard and Fidelity, which are suggested for someone retiring next year, have a stock allocation of 53 to 55%. Starting at 2020 the stock allocation is slowly reduced over the next 10 years to around 30%. These funds seem to use the old "age in bonds" rule of thumb where you subtract your age from 100 and that becomes your equity allocation. Note the target date funds and other portfolios managed by others I have seen, are using more like 120 minus your age, and simply recommending a 65 year old retiree invest 120-65 or 55% in equities. For my clients, their age is not the only thing that defines them and their goals.

Their research compared using an alternative glide path to investing in a traditional balanced 60/40% equity/fixed income portfolio and reducing equities to 30% over time. He looked at different time horizons but 30 years was the base case. He also looked at various average return scenarios. Here are the conclusions.



- Results show, surprisingly, that rising equity glide paths in retirement—where the portfolio starts out conservative and becomes more aggressive through the retirement time horizon—have the potential to actually reduce both the probability of failure and the magnitude of failure for client portfolios.
- Overall, the results show that rising equity glide paths from conservative starting points can achieve superior results, even with lower average lifetime equity exposure. For instance, a portfolio that starts at 30 percent in equities and finishes at 60 percent performs better than a portfolio that starts and finishes at 60 percent equities. A steady or rising glide path provides superior results compared to starting at 60 percent equities and declining to 30 percent over time.

In short, for most retirees the common practice is wrong. It makes sense to me that the most risk a retiree faces is at the beginning of retirement when their nest egg is the largest and the length of time it has to last is the longest. A big loss near the start of retirement is the biggest risk. We will explore this point further below.

But a Mostly Equity Allocation Has Worked for Me in the Past. So Why Change?
There is a big difference while you are building your nest egg (the accumulator) and when you have to start using it in retirement. Here is a simple illustration to show how the math works for simple time-weighted returns. Note: assumes no cash flows in or out of the investor A and B below.

Consider that A and B have $1 at the start. For the next 5 years A's return profile is as follows:

1. +10%   2. +30%   3. -50%   4. +40%   5. +5%

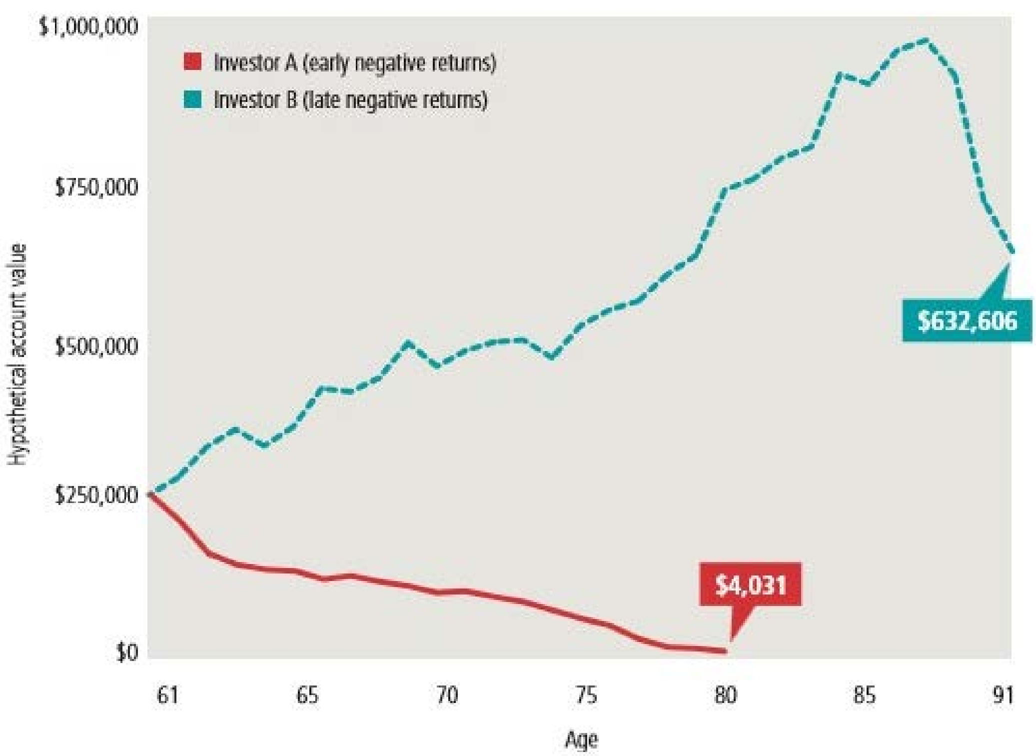
B's return profile is as follows:

1. -50%   2. +10%   3. +5%   4. +30%   5. +40%

A's $1 at the end of the 5 years is: $1 x 1.1 x 1.3 x 0.5 x 1.4 x 1.05 = $1.051
B's $1 at the end of the 5 years is: $1 x 0.5 x 1.1 x 1.05 x 1.3 x 1.4 = $1.051

Different sequence of returns but they end up at the same place. Even though B suffered a big loss in the first year, it did not matter with no cash flows out of the account. Also, note the process of dollar cost averaging while working will smooth the ups and downs of a portfolio. For example, after B's 50% loss in the first year they could now buy twice the number of equity shares than before the loss. Also note we are simplifying by ignoring the fact that sequence can make a difference because the accumulator will have more dollars invested later than earlier. This is why it is wise to reduce your equity allocation as your approach retirement.

However, in retirement when you start taking from, instead of adding to your next egg there is a whole different story. The chart below shows two 30 year hypothetical periods where two investors entering retirement invested in the same portfolio. The portfolio started with $250,000 and both investors took $12,500 per year (5%) inflated by 3% per year for inflation. Both investors had a 6.6% <u>average</u> annual rate of return (reasonable for a balanced portfolio) on the underlying investment for the 30-year period.



The only difference in the two plans is the sequence of returns. Investor A started with three years of negative returns while investor B started off with positive returns and suffered negative returns late in retirement. Note we have had two periods of 50% losses in the equity markets over the last 20 years.

Reverse Mortgage

In our newsletter of July of 2015 I discussed the options for providing more income in retirement by using a reverse mortgage. These are hard to understand and are not for everyone. However, if you are settled into what you think will be your home during most of a long retirement, you should consider these. I have a retired couple client just starting one. They will use the reverse mortgage to pay off a small loan they took out for a solar system and will get monthly tax free income for as long at both or one of them stays in the house. So the immediate impact is instead of paying into the home (paying off the existing loan) their home pays them. All they are doing is giving up some of their home equity in the future when they or their kids sell the home. The equity in your home does not have to be "dead equity". For more information give me a call.

Thanks for reading and give us a call to discuss your challenges and opportunities.

Sincerely,

Stan Johnson
Comprehensive Financial Planning, LLC
Registered Investment Advisor
NAPFA Registered Financial Advisor