HM Payson PLANNING NOTES

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Is Market Volatility the Greatest Risk to Your Retirement?

"Not only is the traditional model for retirement planning outdated, but the traditional structure of the retirement landscape has changed."

By John S. Beliveau, CFA, CFP®

Recent stock market volatility has returned to levels unseen in many years. As of mid-January, the stock market has experienced its second correction in the past six months (a correction being a decline of 10% or more) after going four years between previous corrections. In 16 out of the 25 trading days thus far in 2016, the S&P 500 index traded up or down more than 1%. Given the uncertainty of Social Security and Medicare, the move away from pensions, low interest rates, etc., it should come as no surprise that anxiety has been increasing among those investors in or nearing retirement; the current state of the financial markets only adds to their distress. (Hearts and Wallets, 2015)

Current Challenges in Retirement Planning

The traditional approach to retirement planning involves moving the vast majority of one's portfolio to "safe" investments (e.g. cash, Treasury bills), but with a 10-year Treasury bond now yielding 1.95%, (compared to 7.5% in 1995) this model is no longer useful. Given the current market, investors are feeling even greater pressure to move toward assets that can provide short term safety, while in turn accepting historically low yields on their money. This creates a unique challenge for retirees. Making a move to safe investments comes with real opportunity costs including 1) producing very little current income, 2) offering no prospect for capital growth and 3) allowing inflation to erode purchasing power over time.

Meanwhile, stocks are trading modestly above their long term average valuation, indicating that future stock returns (over the next five years, anyway) are likely to be less than their historical average. Investors need to take into account stock market valuations at the time of their retirement and whether they should reasonably expect to earn a lower or higher rate of return during the early years of retirement before the market returns to more normal valuations.

Not only is the traditional model for retirement planning outdated, but the traditional structure of the retirement landscape has changed. Fewer companies offer traditional pension plans whereby the employer sets aside and invests funds for the future benefit of its employees. These pension plans are being replaced with defined contribution plans (e.g. 401(k), 403(b)), which place the saving and investing responsibilities on the employees. Furthermore, Medicare and Social Security are underfunded. For these programs to stay solvent, some combination of a reduced benefit level, older eligibility age, higher plan premiums, and increased payroll taxes will likely be required.

Hierarchy of Risks Revisited

With financial media obsessing over market declines, investors mistakenly deem volatility their only financial risk. However, as we've often said, volatility in stock and bond prices is rarely the most significant financial risk facing clients. We stand by this largely due to the short term nature of market declines.

In contrast, we put forth the following set of financial risks that pose a greater threat to those in or planning for retirement. (For an extended discussion, please refer to our Hierarchy of Risks Planning Note from 2013)

1. Spending Risk – Excessive spending from a portfolio is the most significant long term risk facing clients. We are comfortable using the 4% rule over a 25-year retirement period as a sustainable spending model (i.e. spend 4% of one's portfolio value at retirement, adjusted annually for inflation). Those who have large fixed, non-discretionary expenses that force them to spend at a meaningfully higher rate (e.g. 6% or more) are far more vulnerable to exhausting their assets. High spending

rates require high rates of return, causing investors to lose control over their long term financial position and to depend on the market to produce above average rates of return.

For this reason, we advise clients to make sure they understand the composition and amount of their expenses, as well as incoming sources of cash. When spending risk is too high, it becomes important to set financial priorities to see where adjustments can be made.

2. Inflation – Modest inflation rates can adversely affect the purchasing power of an investor's assets. A 3% inflation rate over ten years will reduce the purchasing power of a dollar by over one-third, and inflation for retirees is generally higher than 3% due to rising healthcare costs. Furthermore, given that Social Security benefits will (at the most) match inflation, bonds tend to pay a fixed level of income, and pensions generally do not have a cost of living adjustment, we advise clients to incorporate a hedge against inflation into their portfolios.

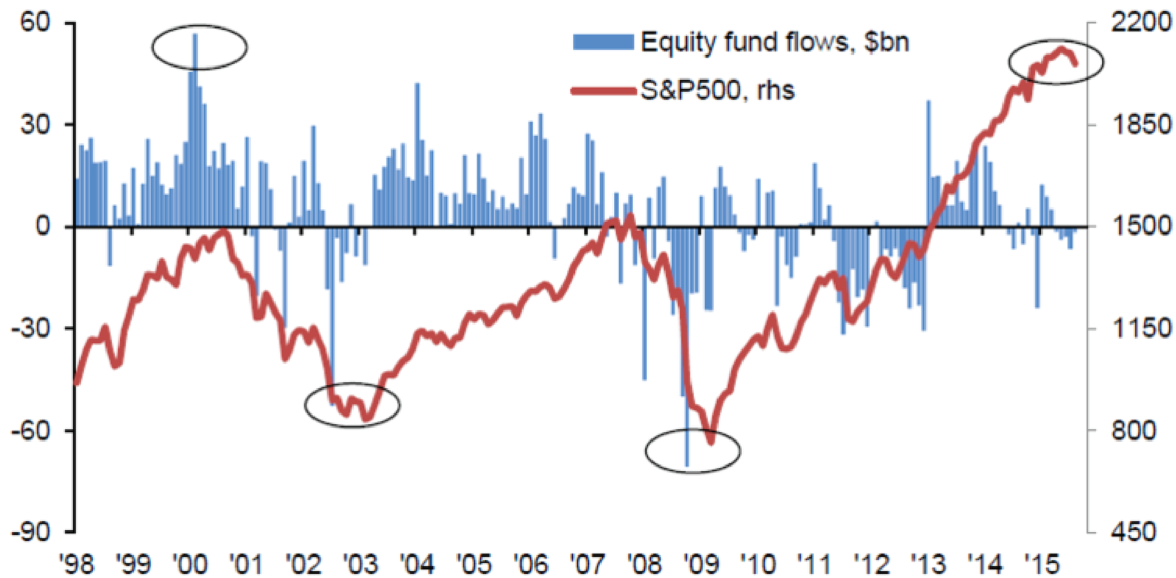
HM Payson views dividend growing stocks as a means to hedging inflation risk. Companies that have the ability and willingness to grow their dividends over time, at rates faster than inflation, allow investors to withstand inflation's erosive effects. Consider Johnson & Johnson (JNJ), a high quality healthcare company that has been committed to increasing its dividend. In 1996, JNJ paid $0.375 per share in dividends, and, with its annual increases over the past twenty years, the company now pays $3.00 per share, an eight fold increase. WalMart, ExxonMobil, United Technologies and even many technology companies (Apple, Intel, and Microsoft) fit a similar profile of high quality, dividend growing stocks. While dividends tend to be consistent and reliable, the trade off to hedging long term inflation is near term stock price volatility.

3. Behavioral Risks – Few things damage a portfolio as much as buying due to greed and selling out of fear. We are wired to flee from perceived danger and pain, so it is not surprising that investors react by selling in the face of market losses, then waiting until they feel better to return. Sadly, this causes investors to execute redemptions and subsequent purchases at inopportune times. History is replete with examples of poor timing, the most recent being late 2008 and early 2009 when investors sold out of stock based mutual funds en masse. In hindsight, this was a very high price to pay for liquidity as the market has more than doubled over the

past six years.

Exhibit 11: Equity Mutual Fund Flows versus Stock Performance

Equity mutual fund inflows ($bn) vs. S&P 500 index

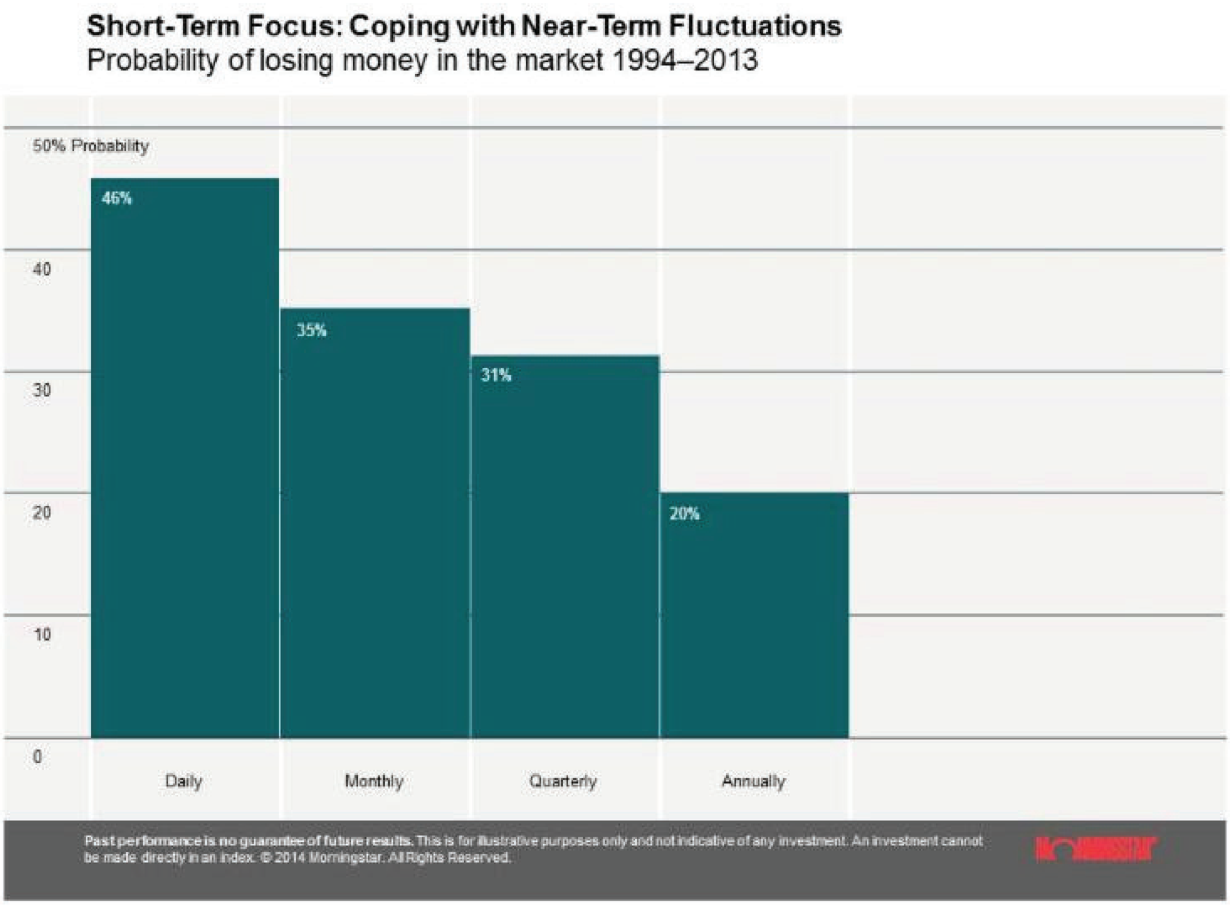


Source: Investment Company Institute, Haver Analytics®, Credit Suisse *August average through 8/25/15

Establishing a thoughtful Investment Policy Statement (IPS) based on a client's short and long term needs allows us and the client to stay committed to the investment strategy and reduce behavioral risk. An IPS is a dynamic document that can, and should, be revised when there is a change in client circumstances rather than changing due to the short term direction of the market.

Interesting Observations about Volatility

For all of the attention volatility risk receives, we believe it warrants a long-term risk management perspective. Time and diversification go a long way in reducing volatility's long-term impact. The probability of making money in the stock market increases significantly with time. For example, over the past twenty years, there was a 46% chance of losing money in the stock market on any given day, but the probability of loss declined to 35% over a one-month time frame, further lowering to 20% over a full year.



Looking back further from 1926 through 2013, the odds of losing money over a five-year period were 14%, and there has not been a 15-year period of time in which the stock market has lost money. Note that the five-year periods showing negative returns are clustered around the post-1929 crash and the tech bubble burst in 2000, while the five-year period from 2008-2012, which includes the great recession, shows a positive return.

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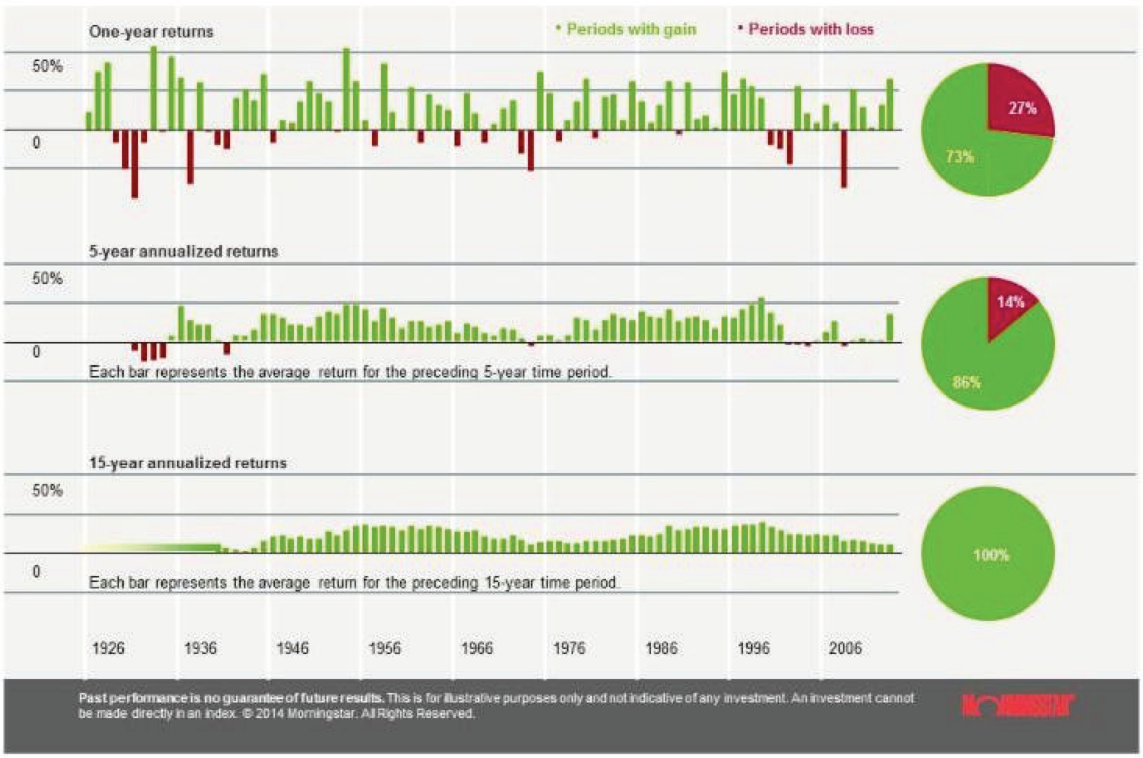
Risk of Stock Market Loss Over Time
1926–2013

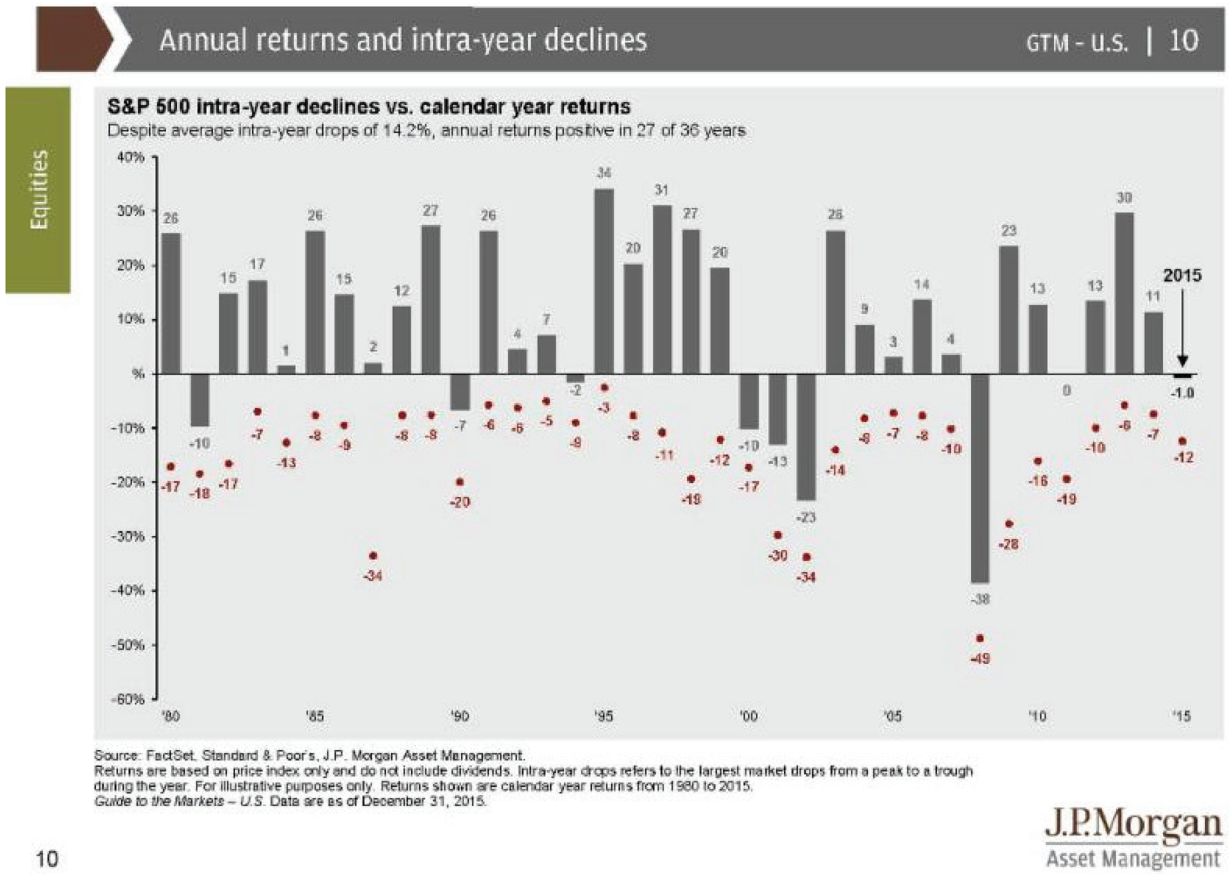


Obviously, we cannot offer guarantees when investing in the stock market but the odds decidedly increase in one's favor the longer the investment time frame.

Managing Volatility

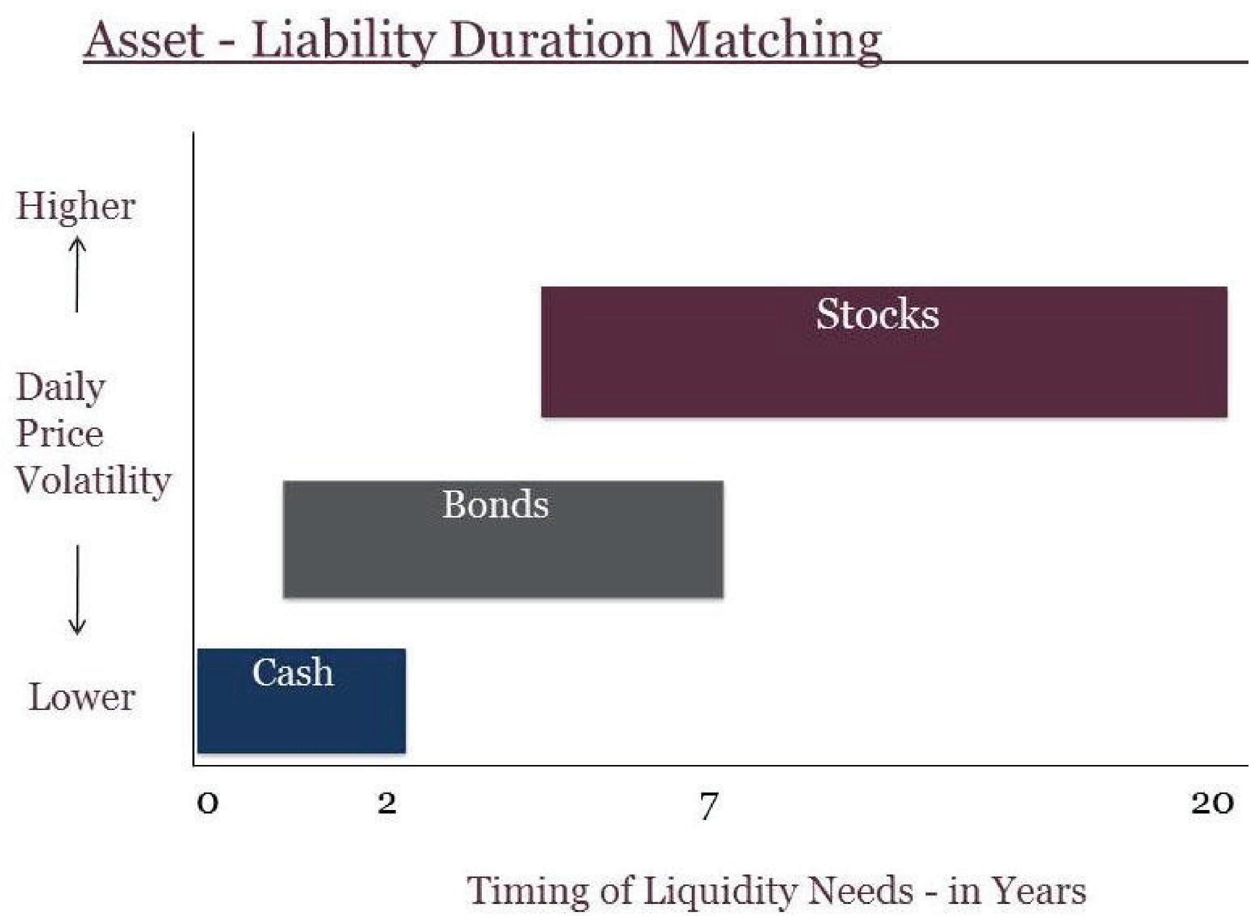
Due to the recent corrections in the stock market and the renewed volatility, we are often asked, "are you selling stocks and raising cash?" or "what are your plans for my portfolio?" We are most reluctant to make significant changes to a client's investment strategy due to market turmoil. Rather, we are more likely to buy stocks in down markets when investing in a quality business becomes more attractive.

We understand markets will experience a correction once every 18 to 24 months, or so. Even during years in which the market performed well, it generally experienced at least one correction or near-correction.



Accepting that likelihood is necessary to being a successful long term investor. More severe declines, such as a bear market (20% decline or greater), tend to occur during or before an economic recession. We view each of these as temporary conditions which will recover with time, but how much time it will take is impossible to answer. Consequently, we need to construct client portfolios to weather both corrections and bear markets while still participating in the subsequent bull markets.

We accomplish this by taking an “asset-liability matching” approach to building client portfolios.

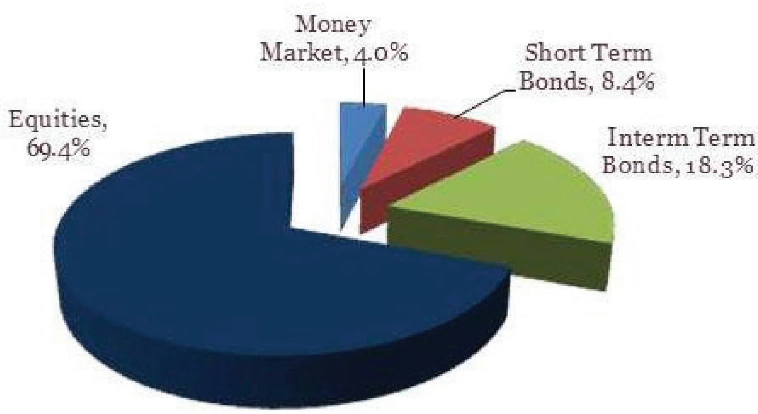


Simply put, we use short term assets, such as cash and short term bonds, to fund short term portfolio distributions (those occurring between 0 and 2 years) for which we do not want to assume any volatility risk; medium term assets, such as intermediate term bonds, to fund cash needs during years 3 through 7; and long term assets, such as US and international stocks, to fund longer term needs where inflation becomes a more important risk to manage than volatility.

Building Block Approach

Portfolio Size $1,000,000

Year	1	2	3	4	5	6	7	Totals	
Spending Needs / Liabilities	$40,000	$41,200	$42,436	$43,709	$45,020	$46,371	$47,762		
Asset Type: Money Market	$40,000							$40,000	4.0%
Short Term Bonds		$41,200	$42,436					$83,636	8.4%
Interm Term Bonds				$43,709	$45,020	$46,371	$47,762	$182,862	18.3%
Equities								$693,502	69.4%



This approach does not eliminate the risk of volatility, but manages it from becoming a significant risk to a client's long term financial well being. In contrast, owning solely cash and high credit quality, short term bonds eliminates volatility risk but does not protect against inflation and offers minimal income production. It is important to note that long term bonds are not capital preservation assets as their values are quite vulnerable to rising interest rates.

Black Swans

Clients often ask "what is the likelihood of another 2008 recession?" These so called "black swan" events refer to economic or financial conditions that we have never seen before and therefore are unpredictable in terms of both time and impact.

In essence, most black swan events tend to be short lived and thus more dangerous for leveraged hedge fund managers than for retirees who withdraw only modestly from their portfolio each year. This presumes that the retired investor has sufficient liquidity and resources in low volatility assets to fund multiple years' worth of spending. The asset-liability matching process described above is designed to provide for that needed time cushion.

We found Michael Kitces' (author of financial planning blog, 'Nerd's Eye View') recent video discussion on the risk of black swan events on retirement to be interesting and worthwhile. Kitces does claim that the asset-liability model is challenged if a black swan event lasts for an extended period of time. So, again, there are no guarantees, but we deem our approach to be a prudent way to manage and balance the multiple risks that clients face in the modern financial landscape.

Conclusion

We recognize that market disruptions can be stressful to investors as the future is always uncertain. For this reason, we believe it is critical to develop a thoughtful, long term investment plan with the understanding that inevitable disruptions occur. Our role as an advisor goes well beyond choosing which individual stocks or bonds we purchase on our clients' behalf. Constructing well designed portfolios, establishing prudent investment policies, managing financial risk, and providing counsel during times of market stress are how we best serve our clients.

Source: "American Confidence in Financial Situations Drops in 2015". Hearts and Wallets. Hearts and Wallets. n.d. Web, February 11, 2016.