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"Why Shouldn't I?"

A Story of Perspective, Planning & Behavior

Matthew S. Clement, CFP®, July 2010

SUMMARY: Enclosed with this three-page correspondence is an article from Nick Murray[1], which I offer for your reference. The reason I frequently share his articles is because of how artfully Murray is able to connect items from current events—in this case the electronic trading glitch of May 6th—with foundational and fundamental principles—in this case the almost-always negative impact of responding to news. This particular article brought me back to those days in late 2008 and early 2009 when "panic" was at a peak, and from which this correspondence is derived.

Shortly after the second wave of capitulation (i.e. abandonment of reason) which brought the S&P 500 Index below 700 during the first week of March 2009, our office received a number of phone calls and emails from clients expressing concern. Clients are always encouraged to reach out to me, whenever they wish, for whatever the reason, and this series of inquiries was certainly no exception. Many felt alarmed, and reasonably so, given that they had not seen equity prices at those levels since September 1996 and, more to the point, given that they surely didn't *consciously* recall *ever* seeing such prices. Panic is, as Murray's article articulates, one of primary phenomena that I'm trained to help people manage, and so I was ready to assist then, as I am today.

In response to what has become a prolonged period of insecurity and skepticism, I am going to share one such client communication, from Tuesday March 10th of last year, in the hope that you might see yourself in this situation and hence learn from what ensued.

The email was from a man in his early fifties whom I had been working with for just six months.[2] His statement and question was, ***"I don't believe the market will recover from this decline for at least a decade, and since I need to retire in less than ten years, I don't have the luxury of losing any more money. Should I move into bonds, either permanently or at least until the end of the recession?"***

Never wishing to answer an *unasked* question, I responded with what was technically a complete answer: ***"No."***

But I've got smart clients, and this man is no exception. Realizing the incomplete phrasing of his question, he wrote back with a clarifying and open-ended add-on: ***"Why shouldn't I?"*** I responded that day, and repeat now, the following:

> Because it will not help you and does not match your plans. Specifically, given your current and expected resources; having discussed, in great detail, the goals you and your wife have for yourselves, your children, and the rest of your family; and having thereafter created your

written retirement plan, I'm pleased to report that your plan **still works as written**. As I hope you will recall, your plan requires that you:
(1) Continue to save 12% of your gross household wages, and for at least eight more years;
(2) Spend no more than $65,000/year thereafter, adjusted for inflation, which is the amount we've determined will allow you to fully fund all of your lifestyle and legacy goals; and
(3) Earn an average real return on your investments of 5%, net of fees, between now and the end of your plan, whenever that may be.

With regard to item #3, it is specifically your *continued* use of a globally diversified equity portfolio, the same portfolio you owned six months ago and that you own today, which will allow you the greatest possibility of reaching this target over the span of your joint retirement. The use of a *fixed income* portfolio, or 'bonds' as you describe it, will simply not allow for the accomplishment of these goals. Because of the inevitable loss of purchasing power from taxes and inflation, the longer you were to use a fixed income strategy, the greater would be the risk that your plan would not work (that you would run out of money), *nearing certainty* over the course of an average two-person retirement.[3] Contrary as it may seem *in this moment*, and likely at other such moments in the future, your safest course of action is to continue to follow your written plan. I'm hopeful you know this to be true, but please let me know if you remain in doubt.

My client gave me the courtesy of the following response: ***"Matthew, thank you. Yes, it makes sense that I have to continue to do what I planned to do. What I'm still having trouble with is how you can be so confident that I will get the results that you say I will get. What if I don't?"*** Here is my final response in this discussion:

My confidence is absolute, not relative. You see, I do not know *when* equity prices will return to previous levels, only that they *will*. I also do not know whether prices will trend lower or higher in the near-term, only that whichever direction they move, your continued saving and investing will bolster you, not harm you.[4]

The success of your *plan* will depend primarily on the success of your *planning*. Said differently, that which is in your direct control—your own behavior through time—will be the largest contributor to your financial success and security. This includes your willingness to be thrifty, prudent, objective, disciplined, and patient, and on your ability to maintain faith in the future of global economic progress. I can bring your awareness to these qualities, and to their importance, but I cannot cause them to exist in you. That's up to you.

To the extent that there are variables *outside* your direct control, we have done, and will continue to do, our very best to anticipate all likely events, gauge the probability of all of life's many scenarios, plan accordingly, and respond as necessary to address such issues as they arise. Amid all of this, and for as long as you are open to my guidance and advice, my commitment to you is that you will always have a plan that works.

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As for the 'globally diversified equity' to which I so purposefully refer, the willingness to *own* such a portfolio is certainly behavior-driven, as is the willingness to consistently *maintain* it. But what of the *price movement* of such a portfolio—isn't that outside our control? Well, as a matter of fact it is; which makes it all the more baffling that so many people try so very hard to control it, to time it, and to avoid it. In light of this, let me spend the rest of my response on the nature of relative price movement, and its implications.

The characteristics of price and value operate on a time spectrum, but for our purposes, I'll isolate just two categories—short-term (1 to 10 years) and long-term (over 10 years). In the short-term, returns from equity ownership are: (a) highly volatile, (b) unpredictable, and (c) based primarily on speculation, not intrinsic value. In the long-term, however, returns from equity ownership are: (a) much less volatile, (b) much more predictable, and (c) based far more on fundamental criteria, such as companies' capital values, their ability to earn revenue, and their ability to pay dividends. In this way, the *longer* one is prepared to engage in ownership of equity, the more such a portfolio may be properly categorized as a known and predictable *behavior* and less as an unknown and unpredictable *outside variable*.

For an historical context [and it's the only context we have, despite what CNBC would have you believe], during any extended period of U.S. history, there exists a positive (+) gap between the total returns available through ownership (equity) and the total returns available through fixed income (bonds). Since 1945, this gap, known as the 'equity premium' and expressed as a 30-year rolling average, has ranged from as low as 2.5% to as high as 10.5%,[5] with an overall average of 4% (representative of approximately 7% real return for equity and 3% real return for bonds). As such, there exists no long-term *financial* benefit from doing what you've alluded to, which is to abandon an asset class which will have a real return of roughly 4% more than the asset class which would replace it. The only benefit would be of the *psychological* variety, and this where my real work begins. Ultimately, it is my responsibility to keep you focused on your long-term financial security while concurrently keeping your own psychology from distracting you from good behavior. [Note: There are several things we shall do to help mitigate the cash flow *impact* of short- and intermediate-term volatility and economic cycles, which during retirement is expressed as 'sequence of returns risk.' However, these tools are for those already retired… and you're not done buying yet!]

Your *financial self* tells you that equity prices represent all available information as to the actual past results, as well as the anticipated near-term results, and that valuations therefore stand today having already accounted for what has recently happened *and* what market makers believe is *about* to happen. Your financial self therefore instructs you to ignore the 'doom and gloom' with the knowledge that equity prices, as a leading-indicator, will begin again their forward march toward new highs *well in advance* of anyone acknowledging that the economy is improving; and, therefore, it instructs you to act in accordance with a long-term investment philosophy rather than a near-term economic outlook.

Your *psychological self*, however, tells you a different story. That's the part of you which feels (rather than thinks) that because prices have moved lower recently they will *continue* to move lower, and that because there is always a 'bottom' to every cycle, it may somehow be possible to determine where it will be, and therefore, to effectively time your involvement in and out of equity ownership. While it is true that there is a 'bottom' to every cycle, it is also true that it can be known (a) only in retrospect, and (b) only because it failed to stay there—neither of which helps us in advance. Sadly, it is axiomatic that the American public's collective attempt to "time the market" is responsible for the average owner of equity mutual funds sacrificing over three-quarters of the real returns that would have otherwise been available to him, had he simply stayed consistent with his long-term investment philosophy.[6] My clients, including you, are shielded from this perpetually failing attempt simply by continuing to follow the plans they have created, and now maintain, with my assistance. If you'll continue to focus on your planning, you will more successfully ignore your impulse to react to bad news. And during those disconcerting moments when you're just not sure—I'll stand ready to remind you.

Or… Stated a bit less verbosely in the final line of Murray's article, "I don't think it'll have much to do with you, either. **Unless you panic**."

1. Murray, Nick. The Great Crash That Wasn't and the Propensity to Panic, June 2010. Reprinted and distributed with permission.
2. Questions and responses are used with client's permission. Client's name is omitted for privacy and confidentiality.
3. The actuarial average for a two-person retirement, expressed as a non-smoking couple aged 62, is currently thirty years, meaning that half of couples may require planning beyond thirty years.
4. Reference is being made to systematic monthly investing at relative prices. Relative price movement is inversely correlated with future values. Intrinsic values correlate with prices only over extended periods.
5. Seigel, Jeremy. Stocks for the Long Run, 2nd ed, 1998, Equity Risk Premium (30-Year Compound Annual Moving Average) 1831-1997, pp 16-18.
6. Comparison of Average Annual Returns 1990-2009; data as of year-end 2009. Lipper, Inc. data shows inflation-adjusted returns of average equity fund at 5.1%. DALBAR, Inc. data shows inflation-adjusted returns of average equity fund investor at 0.4%.