Brain Dump of a Financial Advisor, November 16, 2008, Paul S Baumbach

As I prepare for double knee replacement surgery tomorrow, I feel compelled to get philosophical. I will be unlikely to send out a broad update/market review for several weeks. The past few months have shown that significant economic news doesn't wait weeks—it can hit day after painful day. It is in this vein that I have penned this 'brain dump,' explaining what is and has been on my mind looking backward and forward.

I apologize for this being long-winded. Again, I am frustrated that I will likely need to be silent on upcoming news (bankruptcy of one or more US automakers?). I am hopeful that many readers have appreciated the information that I have shared in past writings, and that my silence can cause stress in the coming weeks. I therefore hope that these readers will find some comfort in this write-up, enough comfort to carry them until next month. **There is nothing earth-shattering here, however I think that it has much worthwhile information and opinions, so take your time to read through it.**

This rambles from topic to topic, and for that I apologize. The past few months have forced me to consider information from a very wide range of sources, and in a very wide range of topics. I hope that it makes sense to you, and that you find it helpful.

Regrets—There were advisors, market analysts, and economists who saw this coming. I was not one of those advisors, and the analysts and economists that I studied were not amongst those who predicted the market meltdown. It is important to note that there are thousands of advisors, analysts, and economists, and very few 'got it right.' Furthermore, several of the analysts who in late 2007 were calling for an economic storm had wrongly called for economic storms many times in the past (even a stopped clock is right twice a day).

If everyone recognized the troubles last year, then stocks would have tanked then. If the Fed recognized the storm clouds on the horizon, they would have acted in 2007, instead of waiting, and acting throughout 2008.

Furthermore, recognize that our reactions have fed into the market turmoil. The irrational dash for the exits, the indiscriminate sale of stocks has increased the stock market losses. This was not driven by (foreseeable) economics, but by emotions. Emotions in recent months have led to snowballing the impact of (potentially foreseeable) economic news.

What I most regret is that I was not clear enough in letting clients and readers understand that I don't play this guessing game. I consider it unwinnable. Market timing is wrong as often as it is right, and making a call on when to exit a market requires that this call be right, and it requires a second call to be right, when to get back in. I feel that market timing stacks the deck against investors. Instead, I embrace a disciplined 'buy low sell high' approach, difficult as it is to follow in times like these, as I feel that this reliably stacks the deck in favor of adherents.

Market Timing—Some other advisors adhere to market timing, using signals to identify when to load up on stocks, and when to sell them all. These signals typically fall under the category of **technical analysis**, coming to conclusions about the future direction of stock markets based on patterns in the recent past of stock market prices. I firmly disagree with this approach.

I feel that the fatal flaw in this approach is the false belief in there being a 'causal' relationship between such market signals and future stock market returns. Let's assume that past stock market declines average 25%, and all but a few bottom out only after falling 40% or so. What do you do when stocks have fallen 10%, how about

30%, how about 45%? If most declines of 20% or more are followed by a short rebound, only to fall back to the earlier low, does this mean that it will the next time? It only means so if there is a causal relationship, and there is no economic reason that such a relationship exists.

When to Act—As I wrote in September, I strongly believe that the best action at this time for nervous investors is no action. Nervous investors should, however, begin planning what changes to make, as the stock markets recover (**not** before). Aggressive investors (including myself) have acted by adding to stocks this fall, hoping to be picking up bargains. Buying stocks in a falling market makes sense to me, as does holding onto stocks. Selling stocks in a falling or fallen market does not.

Needing to Sell Stocks—One of the reasons that so many investors have surrendered, and sold into a falling stock market is that they are concerned about their cash flow, especially retired investors who are living off distributions from their portfolios. You have more time than you think.

In the past five years, studies have recommended that when you start to take withdrawals from your portfolios, you begin at a modest level—generally about 4%, and plan to increase it annually with inflation. I have written and lectured about this in the past, and I have worked with clients on this approach. With a moderate portfolio (with 60% in stocks and 40% in bonds), this withdrawal may be up to 7%, due to the shrinkage of the portfolio this year. Is this cause for panic?

It is not good, but the situation is not dire. With the decline in stocks, the dividend yields have risen to 3.4%. Corporate bonds yield about 5.4% (US treasuries yield less than half that). Thus a (rebalanced) 60/40 portfolio should yield about 4.1% in annual interest and dividends. This means that even if the withdrawal rate is 7%, you only need to dip into principal for 2.9%. With 40% of the portfolio in bonds, this retired investor has over a dozen years before they need to sell a single share of stock/stock fund. Even the most pessimistic economist expects the economy to recover well before that.

Bungie Cords—Stock markets at times resemble bungie cords. They typically bounce moderately up and down (slightly expensive, slightly cheap). At times they reach extremes, as they have this fall. In September I considered the market to be slightly cheap, and I advised that clients maintain their allocation to stocks, to benefit moderately when the markets recovered a bit. Instead, the bungie cord stretched further dramatically, and a cheap market has since become incredibly cheap (as stock losses grew painfully). This does not mean that physics has been repealed, that stocks will not recover. To the contrary, this means that when the markets recover, they are starting from such a low point that their recovery should be similarly dramatic. This is the reason for the depth of my conviction that investors remain at (or well above) their normal target level of stocks. The bungie cord will snap back. When, unfortunately, I don't know.

A Better View of Risk—I have read some very compelling analysis by planner Michael Kitces of investors' risk tolerance, which has traditionally examined each investor's emotional ability to handle the ups and downs that investing brings. Kitces separates this concept into three subcomponents.

The **risk capacity** is non-emotional. It describes the investor's financial situation. If the investor has $10 million, and desires $100,000 of annual income, they have the capacity to withstand incredible losses, and thus have the capacity to build substantial risk into their portfolio, hoping to earn superior returns. If another retired investor has $200,000 and needs $1,000 monthly from their nest egg, then they cannot afford to assume much investment risk.

Risk attitude is the temperament factor. It describes the degree to which an investor can tolerate investment uncertainty (and losses). While this may appear to be an emotional element, as I define the last component, you should appreciate that risk attitude is a long-term comfort level each individual brings to investing, and it is unlikely to change much with the ups and downs of stock markets.

Risk perception is the level of uncertainty that the investor feels that today's market contains. There are many investors who consider themselves long-term investors (who have the capacity to accept a large amount of investment risk), and who have an aggressive risk attitude. However, many of these same investors have sold their stocks and moved to cash and bonds. This is due to their current perception of the risk in the markets, as being too large to justify maintaining the normal (aggressive) level of stocks in their portfolio.

This factor is the most emotional and dynamic, and I thus find it to be the most interesting. Due to its emotional component, risk perception can be examined from the perspective of behavioral finance, the study by psychologists of how investors behave. I have written about the field of behavioral finance in the past—I find it fascinating.

Risk perception is fraught with an abundance of opportunities for our brains to misdirect us. For instance, the human mind is wired to find patterns, whether they exist or not. The identification of constellations is one example. Investors typically conclude that the risk of future loss is greater after a string of recent losses (despite facts that contradict this). If you see a coin come up heads five times in a row, you are very likely to feel that it has greater than 50% chance of coming up heads on the sixth toss.

There is also a 'recency' factor. When you pass a speed trap, you are very likely to be more cautious. Yet passing one speed trap does not increase the likelihood of there being one in the next twenty miles—conversely, there is actually a lower likelihood. Our brains are wired to misjudge risk, making it hard for us to make good investment decisions. This is especially true in stressful times such as these.

At this time most investors believe that the risk (chance of future losses) of investing in stocks is greater now than it has been in the past, say during 2007. While it indeed feels that way, it is not the case. The economic challenges are clearer and more substantial than this time last year. However, this is 'priced into the market'--this has already caused US stock prices to fall 40% this year and foreign stocks to fall almost 50%. The ramifications of the economic troubles on companies, the resulting lower profits, are already incorporated into their stock prices.

Investors felt that the level of risk in stocks in early 2000 was quite small, due to the good economic and business news regularly in the news at that time. The good news, however, was priced into the very expensive stock prices. Investors feel that the level of risk in stocks in late 2008 is quite large, due to the high level of bad economic and business news. This bad news, however, is already fully reflected in the stock prices.

One of my primary responsibilities is to help my clients sort out myth from reality. Almost everyone feels that stocks are a fool’s game, and that you can only lose more money by sticking to stocks. That is a myth, and the large number of people who have accepted that myth have helped to stretch the bungie cord to historic levels. Reality will return, eventually, with a vengeance.

Economics—There are many economic fundamentals that are at play in this year's turmoil, and in our eventual recovery. In this section I will touch on many of the more important economic elements at play.

Investors care about a company's future earnings, not their past and current results. As such, stock markets have fallen well before the US economy has slowed, and stock markets will recover well before the economy is back to normal. Stock markets lead the economy down, and they lead the economy back up.

The world economy always has a tailwind. There are more inhabitants (and consumers) every year, and global wealth grows each year. The US economy typically grows at 3% or so a year, after inflation. While the economy can reverse, and shrink, the longer it does so, the greater is the pressure on its eventual recovery.

There are well founded concerns that, facing employment uncertainty, the evaporation of their home equity (and therefore their ability to pay for current items with home equity loans), and the shrinkage of their retirement savings, US consumers will 'check out' (go AWOL, hibernate, remain on the sidelines) for a few years, spending far less than they have in recent years. As consumers make up 70% of the US economy, the worry is that this will prevent the US economy from recovering for years.

I see two major flaws in this argument. First, while the US consumer makes up 70% of the US economy (goods and services produced/provided in the US), the **discretionary** portion of their spending makes up FAR LESS than 70% of the economy. For most of us, non-discretionary spending (shelter, food, health care, transportation, etc) makes up the majority of our spending, and this can and will not be cut back significantly. Cutting back on our discretionary spending will cause tough times for Tiffany's and Carnival Cruise Lines, but times will not be as bad as feared for companies that provide needed (non-discretionary) goods and services.

The second major flaw is ignoring the other 30% of the US economy. Certainly US consumers will be reducing their spending. Slowed economies abroad should result in slower US exports. The last driver of the US economy, however, is government spending, and governments are about to embark on a spending spree, and this is a VERY GOOD development. And spend they will. Not only should the federal government jumpstart infrastructure projects designed to improve the country while providing jobs, but it should also provide funding to state and local governments, so that they can continue services and also provide jobs. At all levels, there will likely be increased spending on highways, bridges, ports, hospitals, etc. Increased upcoming government spending should speed our recovery.

The US government is not a household. While there are similarities and parallels, there are more differences. Economics demands that our government spend our way out of a recession (especially a deep one), and that it cuts back in good times, reducing the debt built up during past recessions. This is well understood by our leaders. The Fed president, Ben Bernanke, is an authority on the Great Depression. That is not a lesson that we are likely to repeat.

Economics holds that stock prices are driven by two factors—the company's profits, and the price an investor is willing to pay for a dollar of profits. This is sometimes called economics and emotions. Over long periods of time, the economics ultimately drives the prices for stocks, the emotional element rises and falls, but all within a band (think of the bungee cord). Over decades, however, the emotional element is drowned out by the economics—whether the company can reliably earn profits, and grow those profits year after year.

The stock market is a market of stocks. The S&P 500 is a collection of 500 individual companies. In addition to managing clients' mutual funds, I also manage individual stocks for some clients. I am therefore able to regularly examine the prospects of individual companies. Companies today are CHEAP.

AT&T is the fifth largest stock in the Vanguard Index 500 fund. Its stock price has fallen 33% this year. Its earnings are expected to rise (a small amount) in 2008 and are expected to rise in 2009, too. It is paying a 5.8%

dividend, which is less than 60% of its earnings (so even if its earnings were to fall 10 or 20%, it could still afford to pay its dividend). Its stock is trading at less than ten times its projected 2008 or 2009 earnings. Compared with values over the past decade, this is CHEAP. And AT&T is not an exception; it is the rule. US and foreign stocks prices have fallen to levels that raise sharply the likelihood of stock investors earning much more than bond investors, from this point forward. This, again, is the foundation for my strong conviction that investors should maintain, if not increase their stocks at this time.

Investing—There are two basic building blocks to portfolios—stocks and bonds. Bonds are loans to companies (and governments). They offer more safety, and a smaller range of results. One of the top factors to consider with bonds is the interest rate. Generally, you should only count on earning the interest rate from bonds. You only earn more when rates fall (which is unlikely from here) and you earn less when rates rise (which seems more likely from this point). Bonds also carry the risk of default, of the company (or government) being unable to meets its obligations.

Stocks are pieces of ownership in companies. They therefore carry greater risk. Offsetting this risk is (much) higher potential returns. Returns from stocks come in a much wider range. These returns come from two factors—the dividends and the price change. You can think of dividends (which are paid quarterly) as a bribe from the company to 'keep the faith'.

I used to work with advisor Richard May, who tells a story of a call he made to a client the day after the 1987 stock market crash. Richard asked the client how they were handling the turmoil. The client, who held a lot of DuPont stock, asked “Did DuPont cut its dividend?” Richard noted that the dividend had not changed, to which the client explained that they had no problem. The client had no need to sell any shares to live on, for years to come, as the dividends and other investment income were more than meeting their income needs.

One natural balancing factor for stock investors is that when prices fall, dividend yields rise (the dividend per share divided by the price per share). Currently, the S&P 500 collection of stocks yields 3.4% in annual dividends. Compare that with the current 2.3% yield for 5-year US Treasury bonds.

But there's more. Stocks not only provide a dividend yield, but they also provide capital gains and losses. This is another area of a natural balancing factor. Completely at odds with human perception, the risk of future capital losses generally falls as stock prices fall. If you consider stock prices in early 2000, stocks had provided annual returns of 15% or more for a few years. While this made most investors feel that future stock returns would continue to rise, that risk levels were quite low, when in fact stocks at that time had a much higher than average risk of imminent losses.

Conversely, in the past whenever stock have fallen 40% or more (as they have this year), future returns invariably are much greater than at other times. This is the bedrock foundation to contrarian investing—buying stocks when they fall, and selling them when they rise. It is very, very difficult, but it tilts odds in your favor to earn more in the future, which is what every investor needs at this time, in order to earn back what has been lost this year.

Asset Allocation—Based on decades of Nobel-prize winning economic and investment theory, for the past twelve years I have been a staunch advocate of globally-balanced asset allocation. This calls for determining the risk tolerance and the financial goals of each client, using this information to set a stock allocation goal (say 65% in stocks) for that client, and directing the rest to bonds and money markets (cash).

Then, depending on many circumstances, I determine how to spread the stocks (US and foreign, large and small, growth and value) and the bonds (US and foreign, high quality and high yield).

The asset allocation doctrine then calls for regularly monitoring, and periodically rebalancing back to the overall (long-term) allocation target. In stock downturns it calls for adding to stocks, and in rising markets, it calls for trimming back the stocks. I continue to believe that this approach places the highest, most dependable, odds in favor of our clients.

Cash Flow-Driven Asset Allocation—The cash flow needs of each client has traditionally been addressed separately from the asset allocation. This has begun to change, and I am pleased with this direction.

For several clients I already have segregated accounts with investments (typically CDs) that will provide three years worth of withdrawals. I heard about this 'Cash Flow Portfolio (CFP) versus Investment Portfolio (IP)' from financial planner Harold Evensky. The approach calls for shifting dollars from the IP into the CFP during strong stock markets, and letting the CFP draw down during falling stock markets. I am working towards a refinement, which places a higher emphasis on cash flow protection.

I plan to increase the number of clients with segregated CFPs and IPs. Not only would the IP include CDs for three years' income, it would also include the bonds that will be able to provide income in years four to eight. I might also direct dividend and interest income annually from the IP into the CFP.

This frees up the IP to be much more aggressive than the overall portfolio (for eight years of withdrawals are safe outside the IP). Furthermore, I would like to have the stock allocation (the proportion of the portfolio invested in stocks) of the IP to be more dynamic than static.

As an example, based on (the revised) risk tolerance and the financial goals of a client, assume that we determine that the overall portfolio should have 60% allocated to stocks. Eight years of withdrawals may call for 25% of the portfolio to be segregated into the CFP. This enables the IP to have 80% dedicated to stocks, with only 20% in bonds (and cash). However, when stocks are expensive, I would like to be able to cut back stocks within the IP quite a bit, say to 60%. When stocks are cheap (as they appears to be today), I would like to raise the stock level of the IP to close to 100%.

I feel that this will improve the ability of each client's overall portfolio to 1) abide by the client's tolerance for risk, 2) meet the client's financial goals, and 3) earn super risk-adjusted returns. The downside is that a dynamic (moving target) stock allocation will make performance comparisons MUCH more difficult (an overall portfolio may be 60% in stocks in the first half of 2008, but rise to 70% by year-end 2008—what measure can you use to determine whether the actual performance in 2008 is good or bad?).

It's Different This Time—It is always different each time. Mark Twain noted that **History doesn't repeat itself—it rhymes.** This market and economic turmoil is both similar and dissimilar to past ones. One factor that is different this time is that we are more globalized than in the past. One negative feature is that investor fear has been globalized, and panic has spread world-wide. Another is that the irresponsible packaging of US mortgage debt has been exported to the balance sheets of banks around the world. One positive feature is that economic strength anywhere in the world will bring good tidings to the US, through improved US exports. One very positive feature is that all of the leading countries and their central banks are working together to soften this downturn. Their efforts are herculean. **They will yield positive results—we simply don't know when.**