ADDING VALUE

Volume 5: Edition 1 | First Quarter 2006

First Quarter Investment Review and Outlook

SUMMARY:

All individuals are unique and have life circumstances that dictate their savings programs. However, there are some basic rules that when followed have application for all wealth generation. They are:

1. Start saving early in life.
2. Save some money annually and never spend it.
3. Don't commit to obligations that prevent success of your savings program.
4. Don't be too conservative in your asset allocation strategy.
5. Beware of inflation.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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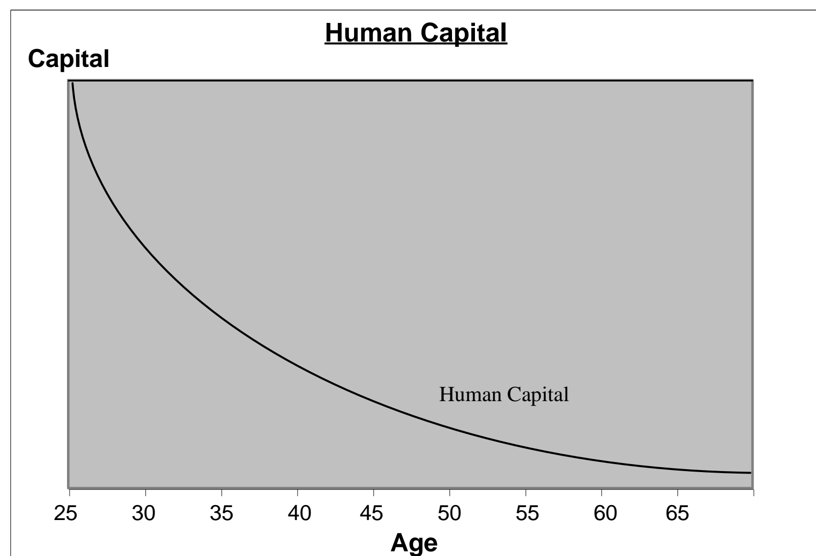
Life-Cycle Investing

This newsletter is devoted to Life-Cycle investing. We wanted to address the questions of: Should investors have different portfolios when they are young, in middle age, or old? Should asset allocation be dependent on how wealthy one is? How important is it to start an early savings plan? If we disregard the platitudes and textbook recommendations, i.e. "the equity allocation percentage should be 100 minus the investor's age", we can come up with several extremely interesting observations that are lessons for ourselves as well as our children.

What is Human Capital?

We start our working lives at age 21 with a great deal more energy and potential, than money. Armed with a quality college education, we can expect to accomplish good things with our career. In fact, the minute we start our first job, we are at the maximum life cycle peak of human capital, where human capital is defined as the total value of an individual's future earning power. We feel on top of the world and to some extent we are; nothing seems too hard or too ambitious, everything is possible. As a society, we exploit these characteristics with college graduates taking education loans to go to graduate school or a young couple financing a home purchase with a mortgage. In both cases, lenders use human capital as collateral for their lending decisions. Human capital is often the largest "asset" for a young investor.

Graphically, this situation can be shown as follows:



Source: Ibbotson Associates. Inc. 2006

The critical decision at this first crossroads of adulthood is for these young adults to start and continue a savings program that mitigates against the inevitable decline of the human capital. (We know how hard it is to tell this to a "20-something"). However, from the moment of acceptance of that first job, there is a slow, inexorable, but inevitable decline in human capital. Therefore, it is important from the very start of a working career to establish a life-long saving habit and to build a financial capital base. These steps would include:

1. Participate in an employer's savings program, if any, to maximize the employer contribution. In most cases, this means if the participant saves 6% of their salary before tax, than the employer will match dollar for dollar 50% of the participant's savings.
2. Contribute to a ROTH IRA to the extent allowed by law.
3. Start an after-tax savings plan even if there is no tax-advantage.

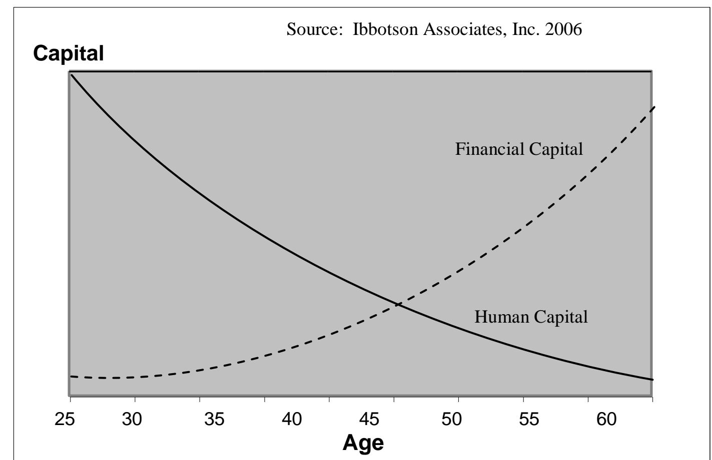
There is no need to get fancy with investment options and asset allocation at this point in savings cycle, in fact, just keep it simple, stupid (KISS), is a great motto. Look for the cheapest investment that doesn't require expensive research (an S&P 500 Index) works well, disregard the temptation of fiddling with the monthly statements or complicated investment options, and spend quality time maximizing your human capital and continuing education.

Watching Paint Dry

Waiting for a portfolio to grow is like watching paint dry or a pot to boil or a tree to reach a 6" diameter. Time seems to be suspended. The amounts of money accumulated seem to be insignificant and mundane for the effort and the seductive attractions in our consumer-driven economy. For years and years and years, nothing seems to happen and then suddenly 20 years have gone by, your career is at the 20-year mark, and if you have continued your original savings plan, no matter how great the temptation to spend, there it is –you have $120,000. Basically underwhelming!

Illustratively, this is the goal:

Expected Financial Capital and Human Capital over the Working-Life Cycle



Let's just think about what happens to the asset allocation models during this first 20 years of working life if we include labor income. Some implications that are apparent are:

1. Young investors will and should invest more in stocks than older investors because of human capital;
2. Investors with safe labor income (i.e. safe human capital) will and should invest more of their financial portfolio in stocks;
3. Investors with labor income highly correlated with stock markets will and should invest their financial assets in less risky assets (i.e. minimize company stock holdings as evidenced by the Enron catastrophe); and
4. Investor's ability to adjust his or her labor supply (i.e. higher geographic flexibility or higher demand of the investor's professional services) also increases the investor's allocation to stocks.

As with most investment portfolios, the amount and risk/return characteristics depend on age, health, education, occupation and experience. But in most cases educated, healthy young adults should invest in equities. Another unique aspect of this time in our lives is mortality risk—that is the family's loss of human capital in the event of a wage earner's death. Life insurance is the perfect hedge for human capital in the event of early death, because term life insurance and human capital have a negative 100 percent correlation with each other. If life insurance pays off at the end of the year, human capital does not, and vice versa. It makes sense to have a life insurance policy during this time (ideally equal to the re-

maining present value of wages that would have been earned until retirement) while we wait for the build-up of our financial assets.

It is important to remember that the basic tenet for most of us for the first 20 years of our working lives is *saving money*, diligently, annually, inexpensively, aggressively, and methodically in good times and in bad times. Saving prudently, also means gradually increasing the savings rate as salary and bonuses increase.

The First-Half of a Working Career

Somewhere between age 40 and 45, if you have been able to adhere to an early savings plan, life gets a little more interesting. The decline in your human capital now needs to be taken into consideration, something that is seldom done. Anecdotally, this is a very vulnerable time in the working life cycle. For the most part, careers have had a successful start, money has accumulated, and everyone is still relatively healthy. Our outlook is positive both financially and career-wise, but with all this positive reinforcement, we start to make decisions that may be suboptimal to the critical second 20 years of the working life cycle. We are susceptible to letting down our "savings" guard. We need to protect the assets that we have accumulated to date. As insignificant as they seem, they are the base from which compound interest will now accrue at a rapid rate. It is not surprising that for the first time you may need both a medical and a financial checkup. The situations to guard against at this stage are: don't make financial commitments that take away from annual savings, and don't make financial commitments that require exorbitant future maintenance (as Lee Eisenberg in The Number puts it: "The giant sucking sound we heard from our newly laid stone patio was a $25,000 property tax bill. Gross that up and you're talking $50,000 in retirement income just to cover it!")

Because large and sudden shocks to consumption are painful, arriving at a given increment of discretionary wealth by saving small amounts over long periods is much easier than arriving by saving large amounts over a short period.

From Middle Age to Early Retirement

Although investment advisors may have their personal, subjective opinions, they do not have a professional basis for telling clients how they should trade off current spending against future wealth. In most "normal" situations, here is what happens to the paths of employment capital, retirement liabilities, and more conventional investment assets from age 45 to age 55.

First, your capitalized saving stream from future employment continues to rise until about age 55. From that point until retirement at age 66, the value of human capital begins to fall. In addition, in this period of age discrimination, corporate accounting fraud and corporate bankruptcy you may find yourself downsized, your health may deteriorate, your employer may go out of business etc., so that you may not be able to realize the full 10 years until "normal" retirement. In other words, up until age 56, if possible, you are using the power of human capital to create a retirement portfolio. If we are lucky, we are given another 10 years to fine-tune the mistakes or the good fortune of the first 30 years of employment.

Second, because of prudent savings in earlier years, aided by moderate investment performance, financial assets can be expected to rise steadily and rapidly. As slowly as it took to accumulate the assets, now they seem to have a life of their own during the period from 55 to 66 years, and by normal retirement, are larger than implied human capital. In fact, due to the miracle of compounding, continuing with the same amount of annual savings $2,400 for another 25 years compounding at 8% per year in the second half of your career, you accumulate $900,000 for a grand total at retirement of $1 million. All it takes is $2,400/year for 45 years, compounded at a rate of 8% per annum. Financial assets continue to grow but with much greater fluctuation than previously-for two reasons. First, growth of financial assets is now dominated by investment returns rather than new savings. Second, the increased discretionary wealth permits all of the financial wealth to be invested in an equity portfolio rather than in less-volatile investments.

Third, during this period, it will also become a little easier to calculate if there is any reality between what you have saved and what you need to live comfortably (i.e. whether the use of your human capital has allowed the crossover in retirement to the use of financial capital.) Remember, a million dollars conservatively invested yields $40,000 a year in income, which is hardly what it takes to feel like a million bucks.

The best advice for this period of your life is: Don't lose what you have saved! If it is difficult to do this yourself because of time, inclination, or professional demands, find an investment advisor that you can trust. Always remember the bursting of the global stock market bubble in 2000. Although there may be some reasons to fine-tune your risk tolerance, most of the time you can have an aggressive allocation to equity provided the account is diversified and the equity portfolio has a high margin of safety.

Retirement

Numerous prior "Value-Added" newsletters have addressed the topic of retirement. The simple message is that you can safely withdraw about $40,000 for every $1 million of capital. To assume that you'll die before you're really, really old is risky financial business. To assume that you can plan to die when you run out of money is not feasible. In addition, many financial services firms now estimate that you need to set aside $200,000/person just for health care expenses. Another pitfall in retirement is inflation: It gets you coming and going: The value of your holdings diminishes while at the same time prices go up. We really don't know how high inflation will soar through the boomers' retirement years, but given the longevity risk, the health care cost risk, and the inflation risk one will have to be very careful about being too cautious about how they invest.

Retirement will be a challenge to the baby boom generation. As Lee Eisenberg says: "A long life, comfort, and security lie in one direction. Everything you'd rather not think about lies in the other." Asset allocation is vitally important now; too conservative, and your risk is to be trounced by inflation, too aggressive, and your risk is permanent loss of capital.

As life insurance was available to young investors to hedge against mortality risk, there is also a financial instrument available during retirement to hedge against longevity risk. The instrument is an immediate annuity and it may be a lifesaver for some people. Simply, it guarantees that you will not run out of money before you die.

Summary

- Save like mad until you are 45.
- Don't incur horrendous future expenses at age 45 to reward yourself for your success in the first 20 years of your working life.
- Instead, let your portfolio experience the "miracle" of compounding from age 45 to age 65.
- Hope that you will not have to face physical infirmities, job loss, or anything that impacts the human capital part of the equation until at least 55 years of age.
- Spend on average no more than 4-5% of your investment portfolio in the early years of retirement, knowing that there are many big unknowns still lurking on the horizon-health, date of death, and inflation.
- Resign yourself to the fact that it is impossible to know with any assurance when you will die, but that it is better to have some left over than to die with a $0 portfolio; we still need a margin of safety.

A good investment policy will change over an investor's life cycle. In our company, each individual client has a unique situation and deserves a unique portfolio. In general, flexibility favors the young investor, because it allows him or her to be more aggressive in allocation to stocks and other risky assets and allows for more time to correct mistakes, if any. A responsible young adult who develops a life-long savings habit and suffers no large medical, occupation or familial shocks usually reaches retirement fully in charge of his or her destiny. We know this, because these young adults have grown up to become our clients!

Sincerely,

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