ADDING VALUE

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Behavior influences on portfolio decisions have as much impact as asset allocation. There is never a free lunch. Market timing, no matter how seductive or persuasive, does not work on a consistent basis. Therefore, one must always be aware of the law of unintended consequences on portfolio decisions made in extremely negative market conditions.

SURVIVAL OF THE CALMEST

Historical statistics from 1909 are as follows:

- Average life expectancy was 47 years.
- Only 14% of homes had a bathtub and only 8% had a phone.
- There were only 8,000 cars and 144 miles of paved roads.
- The tallest structure in the world was the Eiffel Tower.
- 90% of all doctors had no college degree.
- The population of Las Vegas was 30.
- Crossword puzzles, canned beer, and iced tea did not exist.
- Two out of every 10 adults couldn't read and write and only 6% had graduated from college.
- There were only 230 reported murders in the entire country.

The United States has come a long way in one hundred years and although my mother-in-law recently died at 103 years of age she was still very cogent, so I know *first hand* that **no one** in 1909 predicted any of the dramatic changes in these statistics by the year 2009.

This seems like a rather unusual way to begin the Third Quarter 2009 newsletter but given the "universality of Catastrophic Markets" (a phrase turned by Marty Whitman) that characterized 2008, it has some validity. In the statistics books, two thousand and eight will go down in the annals of investing as a historic year. Based on history, single-year market declines on the order of 40% have a mathematical likelihood of occurring *just once a century*. In the wake of this 100-year traumatic event, many are re-thinking their financial plans. Their questions include:

- Should I go to cash?
- Should I move to a more conservative allocation?
- Do I need to cut spending?
- Will I recover from this, and when?

The objective of this newsletter is to answer these questions, to examine some alternative viewpoints of portfolio management after the stock market decline, and to provide some options for future portfolio construction. A secondary objective is to remind everyone that we do not live in a stagnating world, it is growing, pulsing with energy, and changing daily. Understanding that change is the standard could help us to avoid making long-term decisions from short-term results.

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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GOING TO CASH

Going to cash or shifting to a more conservative allocation reduces portfolio volatility but *it also protracts the time required to recover from the downturn*, and in some cases, could even preempt recovery altogether. All investment plans should be developed to last a lifetime and be built conservatively enough to endure extreme market swings. We try to build investment portfolios based on the idea of "core" capital. Core capital is defined as the amount of money an investor will need at any point in the future to cover personal spending for as long as both spouses may live. Since investors must meet their core needs even in dismal markets, it is important to stress test the portfolio against a particularly difficult market.

A useful measure is that each $1 million of core capital supports about $40,000 of before-tax annual spending. Therefore, each $2 million supports $80,000, and so on.

Because each family unit spends and budgets cash flow differently, this benchmark provides some helpfulness in knowing how much should be saved to replace job income in retirement.

PORTFOLIO ALLOCATIONS

Investors today all feel as though their long-term plans are at risk. However, it is not unusual for actual and projected wealth to vary considerably at any point in time. <u>In fact, the path of actual wealth will always fluctuate around a core line.</u> Sometimes you will be comfortable, at other times uncomfortable. There are two variables that determine where you stand relative to the original plan. These variables are: the start date of the need to withdraw cash from the investment portfolio and the withdrawal rate required to support spending needs. Each investor faces a different situation based on these two factors.

Those individuals who still are several years from retirement should be somewhat indifferent to the market moves. Indeed, during the current downturn they had a substantial opportunity to dollar cost average at very attractive prices into retirement plans or taxable portfolios with any excess cash or to continue funding portfolios as before the crash. They were afforded a chance of a lifetime to purchase securities at extremely reduced prices, sadly few did.

The Yacktman Focused Fund provides an extraordinary example of this. It has appreciated more than 70% from the lows reached on March 9th through June 30, compared to a more anemic recovery for the S&P 500. Indeed, most of the managers in your portfolio have handily beat any of the comparable indices of the asset class in the period since the March lows. In most of our recent reviews, most investors are unaware of this remarkable period of exceptional returns, choosing instead to focus on the continued worrisome economic news.

In the most extreme case, someone who retired at the end of 2007 or start of 2008 faces a difficult set of circumstances. These individuals have experienced a significant negative fluctuation from the core portfolio and do not have history as a guide to restore confidence. Further, they are a little uncertain about their early retirement spending requirements. Their employer lifeline has been cut (earned income) and they must rely on their own savings to withstand the downturn.

On the other hand, an investor five years into retirement is quite close to the original plan and may feel secure enough to wait until a full market cycle has evolved before taking action. Finally, someone who retired in 1994 or earlier is today dramatically ahead of his "core" number, thanks to the 1990's bull markets, and sees no need to panic.

At our firm, almost all the investor "panic" occurred with those nearing or just entering retirement.

THE ROLE OF SPENDING

Unquestionably, spending is the one variable that is in our control and that has a guaranteed impact on the pace of the portfolio recovery. Everyone has reassessed expenses and spending in this environment. It only makes sense that being more frugal during periods of portfolio stress will both prevent the investor from making draconian portfolio changes and will provide a margin of safety to the portfolio. Taking control of spending also provides an investor with an efficacious outlet to "do something" without disrupting a portfolio process.

Bernstein, an independent investment firm, recently updated their quantitative model to value an investor's core portfolio of $1 million, 20 years into the future under two different spending scenarios: maintaining spending at 5% per year or reducing the annual spending ratio to 4%. (The core portfolio is represented by a diversified portfolio of 60% global stocks and 40% bonds.) The basic premise of their assumptions in updating their models is that poor markets may continue over the next 20 years. This is highly unlikely, but could represent a worst case scenario. As a result of their analysis, the worst case scenario is that a one million dollar core portfolio with a continuation of 5% spending (inflation-adjusted annually) under poor market conditions would have $300,000 remaining at the end of 20 years, while a reduction to a 4% spending rate would have a minimum of $800,000 remaining. Both scenarios were modeled at a 90% confidence level. In either situation, the investor has successfully maintained his spending in each of the next 20 years with money left over.

Whether what remains is "enough", of course, depends on whether the investor's life span falls within the 20-year period and perhaps what his legacy and other goals are.

During the last tumultuous year, every client had enough cash to support their original spending levels without the need to monetize any of the losses. Those that voluntarily reduced spending (rather than asset allocation) in light of the market volatility greatly expanded their margin of safety of meeting their spending needs in the future.

RECOVERY

It goes without saying that determining an asset allocation with a risk level one can tolerate is arguably the most important investment decision one can make. This has always been an important decision, but strong markets have sometimes made investors complacent enough to allow a drift to a higher equity allocation, while similarly a bad market has a strong gravitational pull toward total risk intolerance. Being aware of these understandable but powerful behavioral tendencies will without a doubt make a difference in having enough spending potential from the core portfolio throughout one's lifetime.

In short, no matter what rationalization one uses to reduce asset allocation and therefore portfolio volatility, downshifting to a lower-risk portfolio lessens the volatility, *but it also locks in today's losses and limits the investor's ability to recover to his estimated core amount. There is an important trade-off between feeling comfortable with volatility and the risk of running out of money or unnecessarily crimping a future budget.*

Using the same assumptions from Bernstein's model shown in the previous section at a 5% spending rate, but reducing the equity allocation to 20% equities, would leave only a portfolio of $100,000 in year 20. This unintended outcome may be totally unacceptable to most investors now in their early 60's, raising the

head of the ugliest monster of all: that the investor will live longer than his portfolio does.

We advise all investors to view their portfolios in layers, not in aggregate. During periods of extreme market fluctuation, it is much more effective to set aside two or three years of ready cash in a separate portfolio for these emergency market conditions than to change the overall portfolio allocation. This strategy allows the portfolio to grow with the recovery over the next 20-year period modeled in the Bernstein scenario and results in a portfolio value of $300,000, the same result as a reduction in spending rate.

SUMMARY

The world changes over time. Over 100 year periods, it changes more than most people can forecast but never as much as most people adapt. Who would have foretold that the baby boomers would have started their careers in 1973 and 1974 during a severe recession and inflationary time and would be at the cusp of retirement with a repeat economic performance? The devastation in portfolio values was equally destructive at both periods of time. The investing winners during both periods were or will be those that understand the importance of core capital and the lifelong portfolio. No matter how painful, gut-wrenching, or sheer-terror inducing certain market gyrations will be, a steady, calm objective stance will enable most of us to win the battle in the long-term with money to spare.

Respectfully yours,

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