LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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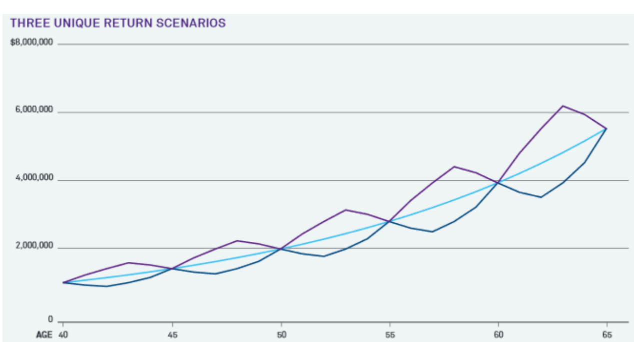
Outlook & Trends

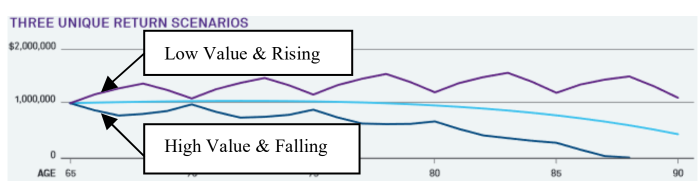
We are abbreviating our usual format in this newsletter to provide enough space to deal with a topic that we believe to be timely and important, but is either generally ignored or poorly understood. Suffice it to say that the economic outlook looks reasonably strong, and the stock market trend has been bumpy this year, but fairly flat overall. Today's subject is volatility and risk. Long-term readers know that we are concerned about risk and the effect that it can have on people's financial plans and lives. After a long bull market, it is natural to not be too concerned about risk and volatility. But this is precisely the time when attention is needed and preparations are necessary.

The conventional wisdom reflected in ubiquitous investment education suggests that following a diversified, buy-and hold approach provides the greatest gains with minimum effort. It is said to be a safe approach over the long-term, because the market will always recover losses. This is largely true for people who have the benefit of the long-term to save and accumulate assets. But there is limited education or strategic information available for people in the income distribution phase of their financial lives, which flips the conventional wisdom on its head. With an ever larger number of people facing retirement, this difference needs to be better understood. This is especially true when market values are as high as they are today. Volatility can be a real problem, as you will see.

Time Sequence of Returns

With a simple investment, it does not make any difference whether gains are experienced early in the holding period or later. However, if market values are high just before or early into retirement, there can be a negative effect that may be felt throughout the retirement years. Blackrock, a leading distributer of Exchange Traded Funds (ETFs), created the following comparison, which you can research at http://acceleratefg.com/wp-content/uploads/2017/05/Blackrock-sequence-of-returns.pdf. The first graph shows hypothetical sequences of investment returns, averaging 7%, with no additions or withdrawals. The results of the differing scenarios were equal 25 years later, regardless of the returns in the beginning period. In the second graph, inflation adjusted withdrawals were added to the *exact same 7% sequence of returns*. Here the results are clearly different.





The person who retires into a falling market has markedly worse results than the person who retires when the market is about to rise. The returns and the withdrawals are the same in each case. Only the timing is different.

If you think about this, it makes sense. The person who loses value early has less principal to generate the earnings to cover the early withdrawals. With less income, withdrawals dig farther into principal than would otherwise be necessary. The lower principal that results then produces even lower subsequent earnings. Unearned withdrawals become an ever larger percentage of principal and continue to reduce portfolio value even further as time passes.

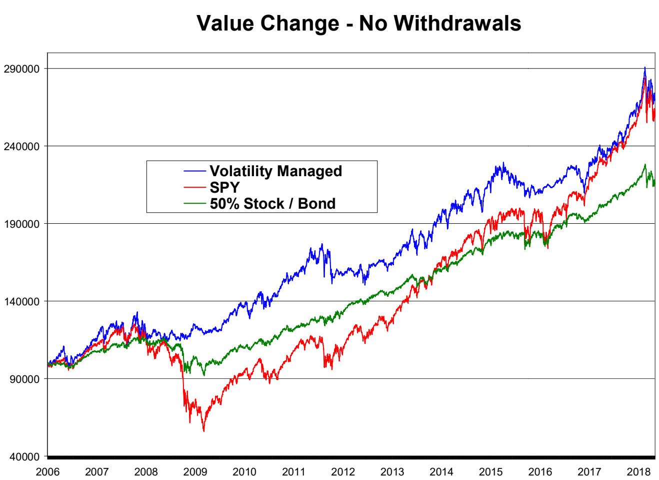
Thinking about this situation another way, suppose your 401(k) is valued at $500,000, and you need this level to make your retirement plan work. What if the investment markets are significantly overvalued though, and the $500,000 is really only intrinsically worth $250,000? Should that be a consideration in your decision to retire? What if, a year after retiring, a stock market decline cuts your $500,000 to the $250,000 level? Your comfortable withdrawal potential would be less than you planned, just like the results in the second graph. A highly valued market at the beginning of retirement may feel good, but an early decline is much more of a problem for maintaining wealth or income than a similar decline at the end. Value, volatility and timing all make a difference.

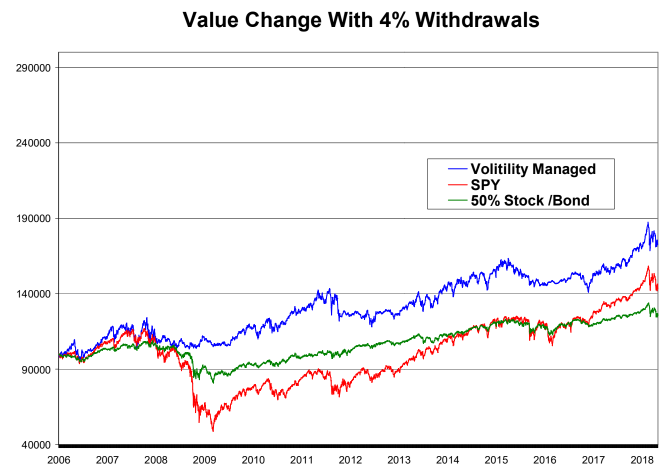
Accumulating and Distributing

The role of volatility is inherently different during the accumulation and distribution phases of your financial life. The conventional wisdom teaches that, while market declines may be disconcerting, in reality they are good for us, because they allow us to practice dollar-cost-averaging. This "magic" effect produces a purchase price that is below average, because more shares can be bought with the same investment dollars when prices are low. Unfortunately, and unmentioned, is that the reverse is also true. Withdrawing money when prices are low requires selling a larger number of shares, producing a lower than average *sales* price. It is dollar-cost-averaging in reverse. Accumulating and distributing are opposites, and appropriate strategies must be considered differently.

Another View

The next set of graphs shows essentially the same effect using historical data rather than hypothetical scenarios. The first graph shows the return of the S&P 500 index (using the SPY ETF with dividends – red line) since 2006. The blue line shows an asset allocation methodology which seeks to manage and reduce volatility*.





The overall gains of the red and blue lines in the first graph with no withdrawals are similar; they wind up in the same place, although the volatility of the S&P 500 is noticeably greater, producing a 60% drop in 2008. The second graph includes withdrawals of 4% annually, increased by 3% inflation as a retiree might follow using "the 4% rule". As mentioned before, because withdrawals have a much greater effect when market values are down, the overall ending principal value of the red SPY line, using the conventionally favored by-and-hold approach is significantly lower than the blue line. Reducing volatility by mixing stocks and bonds (green line) helps to mitigate this problem a bit, but the lower intrinsic returns of bonds contributes to a return less than stocks alone in both cases.

If you would like help preparing for your financial future, managing your investments considering risk and volatility, or planning your income distributions, please call or e-mail.

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*The risk managed methodology, developed by LFM&P, shows results using historical data (back-testing) for the purpose of this illustration. It is not meant to suggest that future results will be similar.

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