Five Dangerous Threats to Retirement

There is a retirement crisis in America.

The Center for Retirement Research at Boston College estimates that more than half of working-age households face the risk of not having enough income for retirement.

The National Institute on Retirement Security reports that at least 65 percent of workers are saving less than they will need for retirement.

The New America Foundation asserts that less than 50 percent of middle-income retirees have any type of pension income, and barely more than half have any form of asset income.

From the Harvard Business School, Vanguard's John Bogle, Forbes, Employee Benefit Research Institute to the Senate Committee on Health, Education, Labor, and Pensions, there has been a clarion call to address this crisis.

Entire books have been written on the causes of this crisis, from the fact that people are living longer to the shift from defined benefit plans (i.e. pensions) to defined contribution plans (i.e. 401-k plans). From a big picture, it comes down to a. insufficient savings and b. less than optimal investment management.

It is the purpose of this whitepaper to discuss the latter by highlighting FIVE major risks that could effect your retirement portfolio. Keep in mind that this is a general discussion and every individual's situation is different. We recommend you discuss any specifics with a professional.

1. ***A POSSIBLE BOND MARKET BUBBLE*** *There is opinion and there is fact, and in the world of investments it is often hard to distinguish between the two. This is a fact. There is an inverse relationship between interest rates and bond prices. This is very important. Allow yourself a picture of a see saw. I know; some high finance here. On one end is your bond mutual fund. On the other are 'interest rates'. Rates go down, bond prices go up; interest rates go up, bond prices go down. We have been in a cycle of declining interest rates since 1984.*

Date	10 Year Treasury Rate
Aug 26, 2014	2.39%
Jan 1, 2014	2.86%
Jan 1, 2013	1.91%
Jan 1, 2012	1.97%
Jan 1, 2011	3.39%
Jan 1, 2010	3.73%
Jan 1, 2009	2.52%
Jan 1, 2008	3.74%
Jan 1, 2007	4.76%
Jan 1, 2006	4.42%
Jan 1, 2005	4.22%
Jan 1, 2004	4.15%
Jan 1, 2003	4.05%
Jan 1, 2002	5.04%
Jan 1, 2001	5.16%
Jan 1, 2000	6.66%
Jan 1, 1999	4.72%
Jan 1, 1998	5.54%
Jan 1, 1997	6.58%
Jan 1, 1996	5.65%
Jan 1, 1995	7.78%
Jan 1, 1994	5.75%
Jan 1, 1993	6.60%
Jan 1, 1992	7.03%
Jan 1, 1991	8.09%
Jan 1, 1990	8.21%
Jan 1, 1989	9.09%
Jan 1, 1988	8.67%
Jan 1, 1987	7.08%
Jan 1, 1986	9.19%
Jan 1, 1985	11.38%
Jan 1, 1984	11.67%
Jan 1, 1983	10.46%
Jan 1, 1982	14.59%
Jan 1, 1981	12.57%

If you look at historical interest rates, would you guess which way rates are going here? Will interest rates fall to zero or rise to a normal rate of 4% to 5%? Particularly when you consider that a majority of economists say that rates are artificially low due to the massive intervention of the Federal Reserve through quantitative easing. Now that we are all clear on the inverse relationship of bond prices to interest rates, it is time to introduce a new fact: DURATION

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Definition of 'Duration'

$$ModD(y) = -\frac{1}{V} * \frac{\partial V}{\partial y} = -\frac{\partial \ln (V)}{\partial y}$$

"A measure of the sensitivity of the price (the value of principal) of a fixed-income investment (BOND) to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices."

Okay, thought I would show off after the see saw example. Duration is a bit complicated to calculate but easy, and important to understand. It measures how much your bond (or bond portfolio) will change in value when interest rates change. Here is a good rule of thumb. For a 10 year bond, a 1 % change in interest rates means the bond will change 10% in value. You have a $100,000 10 year bond (or a $100,000 in a bond mutual fund with a duration of 10 years) and the Federal Reserve slows quantitative easing and interest rates go from 2.38% to 3.38%. What happens to the market value of your bond holding? You stand to lose approximately $10,000! That is why duration is important. If you hold fixed income investments, you should know and understand the duration of your portfolio.

Why is this important and what does this have to do with a possible bond market bubble.

Here is a real world test. Look at the table above and look at what interest rates did in 2013. I will make it easy. Interest rates backed up from 1.91 to 2.81%. Yawn, what is the big deal. The return of the bond market in 2013 was -9.10%. That is a big deal if your stocks or real estate drops that much. That is the bond market when rates go from 1.91% to 2.81%. There are $39,800,000,000 in the United States bond market. 39.8 Trillion. According to Morningstar, at the end of 2013 there was 5.7 trillion dollars in fixed income mutual funds alone.

It's now more than 5 years after the Financial Crisis. Real Estate never goes down, but it did. The stock market declined more than 40%. Seeking safety, millions of American investors poured their hard-earned money into various forms of fixed income investments such as bond mutual funds. And they did well. But now we understand duration and interest rates and we must ask the question: if interest rates go back to historical normal levels, what will happen to the value of trillions of dollars invested in bonds and bond funds? In the past decade we have had a dot.com bubble and real estate bubble and a bank bubble and a stock market bubble; is it possible that we could find ourselves facing the same thing in the bond market?

What to do, what to do? While there are broad strategies such as bond laddering, underweighting asset classes, buying inflation protected bonds or owning only short term

bonds, the answer points to analysis of every individual's risk tolerance, time horizon, objectives and overall portfolio construction. To not consider the risk of rising interest rates to a retirement portfolio might not be the wisest of choices.

2. ***Longevity Risk or The Risk of Outliving Your Money***

   Here's the good news. All the statistics say we are going to live a long life. Here's the bad news: those same statistics show you are at a greater risk of outliving your money. For a 65 year old couple today there is a 50% chance that one of them will reach the age of 88, and those numbers are extending every year that passes. The Society of Actuaries is due to release new mortality tables and reports indicate that someone who is 65 will live an additional 22.7 years. In fact, for some they will be retired for longer than they worked. It now falls to today's families to create income from their investment accounts that allows them to move to the next phase of life with a degree of certainty that they will have the income they need for as long as they need it.

Why has Longevity Risk moved to the forefront of concerns for investors? Consider these facts. Twenty years ago a family worked until they were 65. Statistically they lived 9.2 years after retirement. Most had pensions paid for by their employers that lasted for the rest of their lives which was supplemented by Social Security and personal savings. Also, while still a cost, health care costs were moderate.

Today, the same 65 year old retiree will live 22.7 years longer. Interest rates on CD's and deposits are less than 1%, there probably is no pension or it is a modest one; replaced by the accumulated assets in a self-directed IRA, 401-k or 403-b plan. And health care costs have spiraled to become one of the major family expenditures.

What can be done? While there is no way ALL the things that can be done to mitigate this risk can be covered in this whitepaper, we will touch on a few that deserve attention. As always, address your personal situation with your needs and objectives-preferably with a credentialed professional.

One important step to not outliving your money is to utilize one of the new probability-based financial planning programs that will give you a good statistical probability of not outliving your money. Using sophisticated Monte Carlo analysis, the program runs multiple simulations under every conceivable economic and market condition to give you the probability, on a percentage basis, of not running out of money at various spending levels. We at Founders Wealth Management and Planning feel strongly that this is an invaluable tool in analyzing and minimizing longevity risk. We also feel strongly that clients should choose probability based financial planning that incorporates Monte Carlo statistical analysis and NOT the more plain

vanilla financial planning programs that use linear returns. Let's be honest, exactly how useful is a financial planning program that says inflation is going to be 3.5% every year, and the stock market is going to return 8.5% every year and that interest rates are always 5.5%. For that is exactly what these simple financial planning programs do. Your financial future is important so settle for nothing less.

Another tried and true tool in avoiding longevity risk is the use of Immediate Annuities. While this is a rather boring and old school solution, it remains one of the best. One of this author's more famous professors in Finance at the Wharton School of Business stressed the use of these types of annuities to all his students. An immediate annuity guarantees an income stream to the owner and/or their spouse for life, effectively shifting the risk from the investor to the insurance company. Do not confuse the immediate annuity with other types of annuities such as index or variable annuities. The immediate annuity is the tool here.

3. ***Inflation Risk, or the Risk of Purchasing Power***

You know the old saying that 'nothing is guaranteed in life save death and taxes'? You can add inflation to that statement in the financial world. It is 1980 again. My jeans still fit and not only can I touch my toes but I can even see them. A loaf of bread cost .51 cents. Our new 3br 2.5 bath home cost $60,400 and I mailed the mortgage check in a stamp that costs .15 cents. College tuition cost $3,400 and a movie ticket (okay, to see a young Harrison Ford) cost $3.30. Let us transition here. You are a recent retiree in 1980 living on your investments and social security. If you did not factor in inflation in the management of assets to provide an inflation hedge and increasing income and dividends, could you afford the cost of goods today?

Put another way, what is the income you would want to retire with today? Let's use a number of $100,000 so you can easily scale that to your need. With just a historical inflation rate, your spending power will have dropped to $45,900 in 2034!
Again, one of the very few things in the investment world that we can guarantee is the corrosive effects of inflation. As we have already discussed, many investors under estimate how much money they will need for retirement. Similarly investors significantly underestimate how the purchasing power of their income will hold up over the years of their retirement.
Perhaps no area of investment management and portfolio management requires more complexity than managing a portfolio for inflation risk. Allow me to provide you with some investment terms. Nominal Returns are the raw investment return. Real Returns are Nominal returns –inflation. It is critical to manage portfolios with the real return in

mind, not just nominal returns. When managing portfolios for real return, attention to asset allocation is critical. While historically certain asset classes such as dividend paying equities, commodities, and alternative investments, have been better inflation hedges than others, it is the specific weightings, non-correlation factors and fixed income structures and durations that are important.

4. ***The Three P's- Insufficient Planning, Process and Procedures- The Investment Policy Statement***

The big money is with the institutions, be they Pension Plans, Insurance Companies or Investment Pools. Estimates are that these big institutions control over 76% of the daily volume of the stock exchanges. CALPERS controls over $293 BILLION in assets. NYS controls $176 BILLION, while the Harvard Endowment controls over $30 BILLION! Every investment decision made by these institutions is controlled by an IPS, or Investment Policy Statement. What is it that these institutions know that most investors do not? Exactly what is an IPS?

An investment policy statement is a client-specific document designed to address the objectives, constraints, risk tolerances , and overall procedures and policies that govern investment portfolio and the family or client's financial life. The document should set forth clear rules and procedures such as asset allocation, asset classes, rebalancing, concentration levels, social restrictions, restricted asset classes and buy and sell disciplines. The long-term strategic asset allocation of the portfolio should be detailed, to help ensure that the portfolio is invested in accordance with the investor's long-term goals. The IPS should also clearly define the roles and responsibilities of investment advisors, professional managers and custodians. This should include fees, performance reporting and applicable benchmarks, statements, monitoring, reviewing and reporting.

In short, it is a road map and a report card that minimizes surprises, oversights and miscommunication that can negatively affect your investment portfolio and your retirement.

We provide Investment Policy Statements for clients. Please feel free to contact us for any questions.

5. ***Mistakes in Investment Management***

- ***Timing***

Independent research by Dr. Wade Pfau, Professor of Retirement Planning at The American College shows that 80% of the risk of financial failure during retirement is determined by the investment returns in the first 10 years. Along the same lines, the

first 10 to 15 years of returns is the primary factor in determining the income levels that can be spent from investment portfolios every year without exhausting savings.

It is therefore CRITICAL to have a specific plan and asset allocation strategy for the immediate period BEFORE and AFTER retirement to address this issue. As a case in point, imagine being the unlucky investor who retired six months before the 2008 Financial Crisis. Plan in place, you have the assets to provide you a comfortable retirement with some to spare. A year later, you have 25%-40% less after the financial and real estate collapse. Again, it is critical to have an Investment Policy Statement and Tactical Investment Strategy in place that takes into consideration this specific risk.

- ***Underperformance of Mutual Funds***

According the ICI (Investment Company Institute), there is $15.7 TRILLION dollars invested in mutual funds as of the end of 2013. Much of that is through retirement funds such as 401-K plans. Yet statistics show that mutual funds consistently underperform their benchmarks and indexes. Investors pay dearly for this underperformance both in fees and the loss of compounded growth in their investment portfolios. SPIVA, or the Standard & Poor's Indices versus Active Funds Report show that, over 3 years and 5 years, 78.9% and 72.14% of all actively managed funds FAILED to beat the index. Even more alarming is the fact that 92% and 87.9% large cap growth funds failed to beat their index.

Once again, these are general comments and not meant to be recommendations. All investors must carefully consider their specific situation, objectives and risk considerations. We always recommend consulting a advisor.
Should you want additional information or have questions please feel free to contact us
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