

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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How Does This Market Drop Impact My Future?

Information travels faster than ever now which tends to amplify panics and crises. The natural herd tendency to sell or buy is fanned by the rapid flow of news, often in its raw state. Globally linked computerized exchanges make buying and selling more efficient and faster than ever. What is crystal clear in this time of crisis and uncertainty is that we have no control of the markets (short of shutting them down). They are bigger and more powerful than any government and they will find their equilibriums in all circumstances. Predicting or timing them is all but impossible, especially over full cycles.

The information age heaps data upon us in such vast quantities that we find ourselves shoveling much faster just to keep our heads above it. But with all our effort, there remains little time to think or to process it. In our exhaustion we rely on newspaper columnists, television commentators, and financial experts to do it for us. We in essence allow total strangers who know nothing about us, about our needs, our goals, or our dreams to exert huge influence over our decisions, decisions that might have major consequences on our lives and on our fortunes.

What's the alternative? You recognize that stocks and bonds are a necessary part of your financial future because they offer proven long-term solid returns, yet you understand they have risks in the short term, occasionally huge risks. As you look forward, you recognize that you cannot predict what market returns will be over your lifetime, but you still try to achieve the very best returns possible hoping they will provide enough funding to meet your life's goals. But hope is not a strategy and returns alone may not get you where you need to be. What you need is a plan that addresses the volatility of the markets.

The most significant risk we all face in our investment programs is timing risk. Specifically it is the impact a sequence of market returns will have on our investments over the course of our lifetime. Depending upon our stage in life we are either accumulating or spending our assets. The stock market is going to do what it will in the coming years, regardless of our saving or spending plans. We have to recognize that. You might be fascinated to learn that you can actually achieve a lower rate of return, yet meet your goals in spades. It all depends upon how your cash flows line up with market returns along the way.

Here's an example: Meet Harry, age 54. He has an \$800,000 portfolio, is saving 16,000 a year and wants to retire at age 64 on \$100,000 a year. He follows his advisor's recommendations and invests his portfolio with 60% stocks and 40% bonds.

Now suspend your sense of temporal reality a little. Let's assume that our story takes place in 1940 and that Harry's advisor can look into the future. He can provide his client with the exact average return he will achieve over any 38-year period and further that Harry can choose that period to live his life. Harry is told that he can have a **9.8%** return if he is willing to time travel to 1960 compared to a **7.5%** return if he simply chooses to stay put and live his life from 1940. Which would you choose, suspending all other life quality issues that might impact your decision?

We are taught by Wall Street and simple logic to seek higher returns. Yet is that the best approach for us? You will recall that Harry had specific savings and spending goals. The timing of his cash

flows as you will see is dramatically impacted by the actual market events that occur. Perhaps if his advisor could have known the actual annual market returns rather than only a simple average, he might have been able to help Harry with his decision. He would know that Harry would be broke at age 90 if he jumped into the future and followed his saving and spending plan from 1960 to 1998. However, if Harry simply stayed in his place and time, he would have enjoyed the reality of passing a \$2.5 million estate to his heirs. He would not have worried in his later years about his money running out. Of course he would have missed Prince's *Party Like It's 1999* top hit – that is if he could have afforded the CD.

Our example graphically illustrates how merely chasing returns can be dangerous. It also demonstrates that market swings have a dramatic impact on outcomes depending upon whether one is saving or spending. So how do we address the risk of timing? We plan for it.

Many of our clients have taken advantage of our Wealthcare® planning approach. Wealthcare® incorporates Monte Carlo analysis to address the volatility of markets and how they are likely to impact the unique savings and spending goals you have. The analysis forces a wide range of possible percentage changes in each asset class you own and an even wider range of possible portfolio values over your lifetime. Using thousands of scenarios the Monte Carlo simulation charts the relative likelihood of your portfolio values providing us and you with a probability estimate of reaching your goals. Our process is ongoing and changes with market realities as well as with your life changes.

On a quarterly basis we run the analysis to determine if your plan is over, under, or properly funded based on changes in asset values. If you wish to make changes we do so and make the same determination. By overfunded we mean that the model suggests that you are virtually assured of reaching your goals. In other words you would be making undue sacrifices in your lifestyle in order to pass along more money than you planned to leave in your estate. You might choose to reduce your risk by choosing a portfolio with a lower allocation to stocks. You might choose to retire sooner or to save less. The point is we offer you the options plainly and simply when your adjustments can make a significant difference in your long-term plan. Wall Street on the other hand invests as much money as you will give them and with as much risk as you say you can tolerate regardless of whether it is appropriate or required to meet your goals.

As you might well imagine, some of our clients are in an under-funded position now, given the market's significant drop. You would be correct. We have no special crystal ball to avoid the short term pains of market investing. What we do have is a disciplined approach in Wealthcare® (as well as six model portfolios beyond the scope of this Brief) that provides reinforcement of what we know to be time-tested advice. If the model for our under-funded clients suggests lower probabilities of success then we take steps to improve those probabilities. We tailor our recommendations according to each client's needs because we understand as part of the process his or her priorities. Some may be willing to increase savings, others to retire later, and still others to take a more significant exposure to the stock market.

Do you notice that the advice is to ADD exposure to stocks when stocks are cheap and to reduce exposure to stocks when they are expensive? Importantly, all our advice is focused within the confines of each client's unique life plan. We are not predicting or timing the market, simply recognizing where each client is relative to his plan along with remedies to get back on track.

This is a time to be planning not to be running in panic as we see all around us. Yes significant damage has been done to the economy and it will take years to wring out the excesses that built up. But these are macro problems that will work themselves out regardless of what we do. But there are changes and adjustments you can make TODAY to dramatically improve our possibilities for success in meeting our life goals. We believe very strongly that we can help through both our Wealthcare® approach and our low cost risk adjusted model portfolios.