Why Americans Need Active Portfolio Management to Retire Comfortably

By Bob Deitrick, ChFC, CEO
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Happy Father's Day to All of our PFP Dads!

Traditional Age-Adjusted Portfolios Simply Don't Work

Traditional asset allocation models maintains that as individual's age and approach retirement, their investment portfolios need to reduce exposure to high-risk assets and focus on capital preservation through investments such as conservative bonds. A typical portfolio recommendation for an investor over the age of 55 might look like this:

TYPICAL PORTFOLIO ALLOCATION FOR INVESTORS OVER 55

Source: FCA Inc.

Based on the Barclays U.S. Aggregate Bond Index, this pegs the majority of one's portfolio at a ~ 2.1% annual yield, just below recent inflation estimates for the CPI at 2.2%. If you add in taxes, and the equity and real estate portions of one's portfolio using this model have to over-perform on a substantial basis to offset the loss in buying power of a bond-heavy portfolio and to provide real returns. This old strategy is archaic, in our view.

Bond Risk is Greatly Underestimated - Moreso Than You Think

There can be no guarantee that a high bond allocation will preserve the value of your portfolio. Bonds face many of the same risks as equities, including the financial health of the issuer as well as default risk and market risk. But they are particularly vulnerable to interest-rate and inflation risks. Since bonds typically offer a fixed interest rate (TIPs and floating rate bonds are the exceptions), increases in market interest rates can lower the value of the bond, while increased inflation will whittle away the purchasing power of a bond.

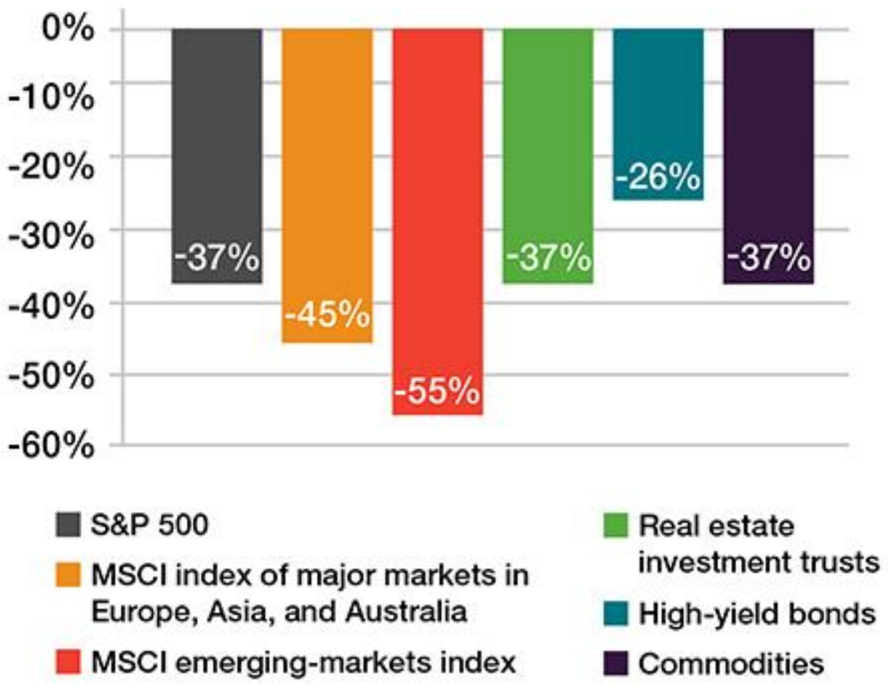
Age-adjusted Portfolios Lack Inflation Sensitivity

Inflation has been remarkably low in recent years, but there is no guarantee this trend will continue at or below 2%. The U.S. money supply, as measured by M1, has increased since the credit crisis, generally outpacing domestic GDP. Through the increased money supply, the Fed has deliberately sought increased inflation. At some point their wish will come true and will be fully granted.

Correlations Can Break Down With Severe Market Declines

Traditional market theory maintains that bond values and stock prices are uncorrelated – meaning that they move in opposing directions. When stocks decline, bonds should increase in value, maintaining the overall value of a diversified portfolio. Recent studies have shown that in times of market uncertainty, these relationships tend to break down with higher-risk (B to BBB) bonds most vulnerable to losses. In the market decline of the Great Recession asset classes became more correlated moving down together.

ASSET CLASS MOVEMENT (2007–2008)



Source: FCA Inc.

Retirees Need Equities to Produce Higher Returns to Their Portfolios

Buy-and-hold investment approaches rely on the market's long-term upward bias to recover from a bear market. But recoveries are neither guaranteed nor predictable. It took close to five years for most major market indexes to recover from the 2000–2002 market decline and over three years to recover from 2008–2009's worst levels. History shows, on average, bear markets begins every 5.5 to

8 years, with an average duration of 18.1 months. Omitting the distortion of the 1929 crash, the average time lost making up bear markets is 3 to 4 years***.*** That calculation measures the time spent for indexes to return to breakeven from the lowest point in a bear market—recapturing past market highs can often take even longer.

Active Portfolio Management offers More Effective Risk Management than a Bond-Centric Approach

The difficulty with using bonds for risk management is that investors forego the opportunity to participate in equity-market gains while remaining vulnerable to bond-market losses. 2013 was a good example of bond-market risk. The average core bond fund (at least 85% of assets in investment-grade bonds) fell 2% or more in 2013, including reinvested interest. The S&P 500 Index gained 31.9%, including reinvested dividends. The challenge is to capture equity performance for a retiree's portfolio as we at PFP did in 2013, but without the potential for losses such as the 37% loss that the S&P 500 experienced in 2008. Active management also has the potential to reduce the risk of bond investments, with the ability to utilize long/short bond funds and other strategies as well.

Active Management Isn't Perfect but It Does Work…

The common criticism of active management is the statement that no one has ever been able to perfectly predict the market. But active management isn't based on predictions and it doesn't have to be perfect to work. The reason is the mathematics of gains and losses are incongruent. It doesn't take a 37% gain to recover from a 37% loss. It takes a 59% gain to recover from a 37% loss. If the market drops 50% or more as it did in 2008/2009, it takes 100%+ to get back to even… Reduce the loss and an investor increases the leverage on the upside.

There's More Than One Way to Actively Manage Your Portfolio

Active management encompasses a wide spectrum of investment strategies. As the availability of data, computing capability, investment alternatives, and market sagacity expands, so, too, do active management capabilities. ***<u>The right approach is the one that makes sense for you - our client.</u>*** That means a diverse blend of strategies all of which can benefit under an active management umbrella.

Active Management Style Accommodates Behavioral Finance Bias

Faced with market volatility, investors tend to approach investing in predictable, although not necessarily logical, ways. These reactions tend to be counterproductive to long-term portfolio growth, and it is well-documented how individual investors have historically underperformed broad market indexes when left to their own emotion-driven decisions. Active management adds discipline, through professional money management, to the equation, resulting in the increased peace of mind so important to our clients who are on the verge of retirement. ***This can potentially benefit our retired clients.***

Market Bubbles are Inevitable

Exploiting their opportunity and limiting the damage of bubbles requires active management. When it comes to pursuing exceptional portfolio gains, there's nothing better than a good market bubble. But what goes up inevitably comes down. One of the best quotes on that topic comes from market analyst John Mauldin, credited to one of his mentors: "Mr. Market is a vicious sadist. He will do whatever it takes to create the greatest amount of pain for the largest number of investors." ***This is one of the benefits we perform for our clientele.***

Our Summary on the Topic of Active Management…

It's hard to calculate how long we will have the pleasure of living on this planet and in this great country, but the one thing you want to ensure is that your money does NOT run out before you do. Answering in the affirmative requires the notion of combining capital preservation with the opportunity for capital appreciation. While no investor or investment management style can predict the future with 100% certainty, everyone requires the flexibility to respond to opportunity.

Active management can potentially create solid opportunity.

We highly encourage you to sit down with us this summer or early in the fall to have your retirement plan calculated or re-calculated to see where you are in relation to this very important objective. Please reach out soon to set up a time to review this important topic with us.

Have a great weekend and again Happy Father's Day to ALL of our PFP Dads!

Most sincerely yours,

Bob Deitrick and Steven Morgan