May 2006 Volume 11.2

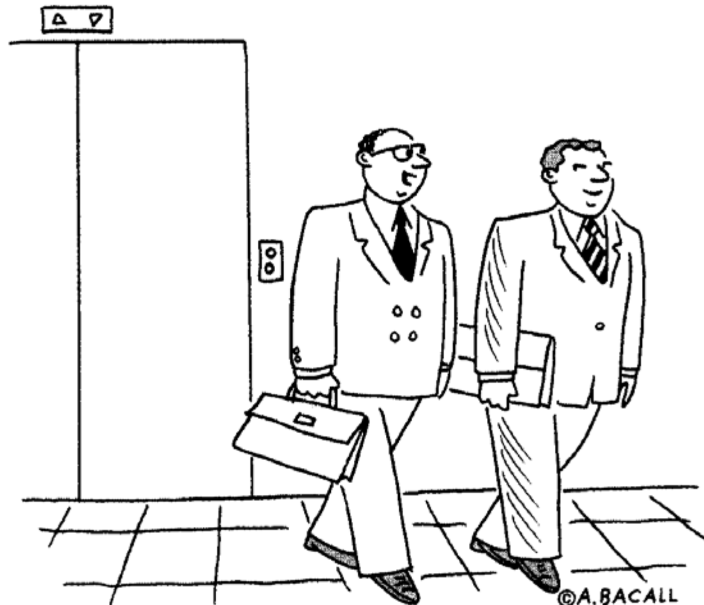
BFAS Money Line

Worried About the Wrong Things

From what I see in the media, people are very worried about the direction of the country. Without getting into the politics, **people seem to think the country is in trouble economically even though the country is experiencing economic conditions seldom seen in the last fifty years.**

On the other hand, I see many reports that **we, as individuals, continue to spend more than our income; and don't seem to be concerned about it**. In 2005 and prior years, a significant portion of consumer spending was due to money being pulled from their homes through refinancing.

We have **an economy with unemployment below 5% (historically it is 6%), inflation at about 2.5% (historically at 3.5 – 4%), and corporate earnings at historic highs**. We are running a government deficit that, while high in absolute terms, is not high as a percentage of our economy and it is coming down.



"The company is doing much better since we outsourced our ethics division to tribal warlords."

Our ability to bounce back from the economic shocks of 9-11, a diffuse war against extremists determined to violently reorder the world into their medieval image, and the impact of high oil prices is amazing. **Of all the world's economies, our economy is in far better shape than most; especially those in Europe**.

While the national economy is doing very well, **consumer savings rates are the lowest on record**. We are spending all of our income and some of the dollars pulled from our houses. (Of course, this doesn't apply to my clients who routinely save 10% - 15% of their income annually)! Report after report shows **Baby-Boomers are ill prepared for their impending retirement**. A recent Fidelity Retirement Index report shows that the average American is on track to replace just 57% of their current income during retirement. Most people are going to need at least 80% of current income during retirement.

If we do increase our savings rate, there will be a reduction in the country's gross domestic product (GDP)

since consumer spending makes up 70% of GDP. An increase in savings would reduce imports and thus also reduce our current account deficit with the rest of the world (we buy more of their stuff than they buy of ours).

Recently, we have seen **the yield curve (relative rates of short term versus long term interest rates) resume a more normal curve upward**. You may recall, my last newsletter discussed the possibility of recession due to an inverted yield curve. The curve only remained inverted a relatively short time and was barely inverted. **Thus, according to recent studies, the probability of recession is fairly low**. Even so, most economists predict a relative cooling off of our economy later this year.

In my opinion, people who should be worried about their spending and poor preparation for retirement, are instead worried about an economy that is performing much better than they give it credit for!

The numbers in the chart below represent one-year returns:

Asset Class	1 Yr Rtn (04/30/06)
S & P 500	+15.41%
NASDAQ	+20.86%
Lg Cap Gwth	+18.82%
Lg Cap Val	+16.89%
Mid Cap Gwth	+29.99%
Mid Cap Val	+21.96%
Sml Cap Gwth	+33.75%
Sml Cap Val	+27.63%
Foreign	+35.31%
Interm Corp Bds	+ 1.45%
Foreign Bds	- 0.57%

Savings

As I said earlier, most of us don't save enough for our retirement. Our culture so promotes the **spend now, worry later** mindset that many don't even start thinking about saving for retirement until they are in their 40's or 50's. I have had people come to me at age 50 who earned $100,000 annually, had $50,000 in savings and wanted to retire in 5 years! Realistically, their choices are to work forever or dramatically reduce their lifestyle now with a hope of retiring sometime on a reduced income.

Most of this problem could be resolved with better financial education of children and young adults. Einstein supposedly said that the, "greatest discovery of mankind is the concept of compounding." This not only applies to investment return, but also to the opportunity cost of spending.

Opportunity cost means there is a huge difference in what you pay for something and what it actually costs you. At my age, spending $10 on an item is likely to cost me about $20 in future retirement assets. However, my two year old grandchild would be giving up almost $1,300 in future retirement assets.

Many people want to have a fine home as an "investment", and homes have appreciated nicely over time. However, the money you spend on furniture has an opportunity cost. The $20,000 you spend getting the best furniture rather than just suitable furniture has an opportunity cost of $200,000 for a 35-year old couple.

Finance professor Dr. Timothy Johnson tells his college students that **all they need to be wealthy is to save $1 a day from age 20 to age 70** – a daily sacrifice of a cup of coffee or a candy bar. If they invest this **$365 a year** in the broader market, they **will have invested $18,250 over 50 years**. He asks them what it will be worth when they retire and they usually guess small amounts. The reality is they lost **a $2 million plus nest egg** by frittering away $1 a day. That's a good lesson for students and clients alike."

Real Estate Bubble?

While there is a lot of talk of a real estate bubble, most of you seem to be ignoring it. Local real estate agents I speak with will acknowledge that home sales are much slower this year, but are relentlessly optimistic about the future. About the most negative comment I get is that local home prices might level off for awhile.

I have probably **analyzed a dozen investment real estate deals in the last year and not one had a positive cash flow**. In many cases, you will also not get a tax deduction for your real estate investment loss since they start phasing out at $100,000 income and are eliminated at $150,000.

Most of these real estate investment deals rely upon property appreciation to

make money. Generally, the deals I evaluated required appreciation of 1% - 6% to break even.

Since local real estate values jumped about 45% over the last two years, appreciation of real estate is assured, right? It is a common human trait to expect observed trends to continue, however that's the same thinking that got people in trouble with Internet stocks, Enron and Worldcom.

The over-used Adjustable Rate Mortgage (ARM) is most likely to torpedo further real estate appreciation in many areas. The large increase in interest rates will cause ARM mortgages to dramatically increase payments. Many, who depended upon the low ARM mortgage payment to purchase more house than they could otherwise afford, will not be able afford the new payments. Already, **foreclosures are up over 100% year-over-year in almost a dozen cities**.

At the same time that higher mortgage payments are forcing people to sell their homes, these higher payments will limit buyers. Prices in some areas will go flat, some will fall.

I recently spoke to a friend in New York who bought a house for $100,000 and sold it 15 years later for $75,000. I personally observed many homes for sale in San Antonio in 1988 with sale prices $10,000 - $15,000 below purchase price. I watched many homes, even those owned by Air Force officers, go into foreclosure. Although Texas at the time was feeling the pinch of a downturn in oil at the time, San Antonio was not an oil town. You would think that a town like San Antonio with a heavy military population would be immune to real estate price declines. It was not immune, and neither is Hampton Roads.

My former financial advisor got me into Technology, somewhere around the top, ...So I got him into Real Estate, somewhere in New Jersey

Another clue to a real estate bubble is the proliferation of real estate seminars and books. One local commercial promises 53% returns. If I (or even a broker) made such a claim for investment returns, I would be fined, if not barred from financial planning!

Yes, real estate is good for diversification of your assets rather than having all your money in stocks and bonds. In most cases, I **recommend no more than 1/3 of your net worth being in real estate due to its illiquidity**.

Most people have more than 1/3 of their net worth tied up in real estate with just their home. If they have built up sufficient assets to diversify their assets outside the home, real estate is a great choice when priced right.

I am a fan of buying on sale, not at the price peak. Depending upon price appreciation to make you whole in an investment might be a long-term proposition if you buy high. On the other hand, **buying real estate in a distressed market can be a fantastic investment**. Time will tell whether we are really in a real estate bubble! Speaking ill of real estate these days is akin to bad-mouthing Internet stocks in 1999. Everyone was getting rich, nobody listened.

Retirement

I just returned from a national conference in Dallas which I attended for continuing education. It seems like the tsunami of Baby-Boomers is generating more and more study of how to withdraw money in retirement.

In the go-go 90's many brokers were telling their clients they could

withdraw 10% of their retirement assets annually since the market would keep going up 15% yearly. In 1994, an exhaustive study by fellow financial planner William Bengen, CFP® showed that withdrawal rates of 4.1% of a stock/bond portfolio (adjusted for inflation annually) had a 100% success rate if stocks made up 50% - 65% of the portfolio. In 1998, a study by three professors at Trinity University (Cooley, Hubbard, and Walz) showed how inflation adjusted withdrawal rates above 4%, even 5%, were sustainable, but at reduced probabilities of success.

As I track these studies, I see **that the introduction of small cap stocks and international stocks to the studies increases the withdrawal rate**. A recent study in the Journal of Financial Planning by Jonathan Guyton, CFP® and William Klinger tested a number of portfolio decision rules (such as no portfolio withdrawal increases for inflation in a down market). By using twelve rules, withdrawal rates could increase to 5.2% - 5.6% at 99 percent confidence rate for portfolios with at least 65% stocks.

The overall sense I get from all the studies is that **a properly diversified portfolio should allow a 5% inflation adjusted withdrawal rate with a high probability of success**.

Bear in mind that this portfolio is not generating 5% interest and dividends. That would require investing wholly in bonds and the income would be fixed, not inflation adjusted. No, the 5% inflation adjusted withdrawal is part dividends and interest and part selling of some stock gains.

One of the advantages of this system is that taxes on stock dividends and capital gains are lower for most people than bond interest. Thus, you get inflation protection with high probability of success and lower taxes.

Yes, this violates the “live on interest, never touch principal” adage that everyone has heard. However, that adage was born when inflation was unknown. Today’s inflation will cause your expenses to double in 24 years. Trying to live on a fixed income in today’s environment is a recipe for disaster as expenses keep climbing with no increase in income.

On a slightly different tack, **age and financial assets have long determined when to retire.** Today, people take more cues from their internal compass rather than relying on what others expect of us.

With increased longevity, people are reassessing what they want to accomplish in each stage of their lives. Some feel that their work not only provides financial rewards, but also mental, emotional and psychological satisfaction.

Dr. Richard Johnson in his book *The New Retirement* identifies five benefits derived from work:

1. Financial compensation
2. Time management
3. Sense of purpose
4. Status
5. Socialization

Finding ways to replace each of these benefits in retirement is key to a satisfying and happy retirement.

To gauge your readiness for retirement, ask yourself these questions:

1. What is your personal definition of a successful retirement?
2. What are some words or phrases that would describe your life when you retire?
3. What will you be retiring from? Relationships? Activities? Responsibilities? Social Networks?
4. What will you be retiring to? Hobbies? Volunteering? Relationships? New Job? Further Education?

Retirement is too important to simply rely on money and age factors; psychological and emotional readiness needs to be factored into the decision.

HAVE A GREAT SUMMER!!

Edited and Published by:

Ronald S. Pearson, CFP®

Beach Financial Advisory Service

6204 Ocean Front Ave.

Virginia Beach, VA 23451

(757) 428-6634

E-mail: ron@beachfas.com

www.beachfas.com