

Many axioms and assumed truths can cause more harm than good. A few hundred years ago, the world was flat, about 100 years ago only birds flew and a couple of decades ago, if Steve Jobs had listened to every executive at major computer companies, we still might not have the personal computer.

Investing money has its own set of “sacred cows” that have been perpetuated by both the financial services industry and the financial media. To be successful when investing your retirement dollars, you must recognize them for what they are: outdated or simply untrue. The fact that you’re reading this book means you’re probably at the age when your money is too important to leave to chance. You’ve probably figured out that no matter who’s giving you advice, you’re the one taking the risks. Many of these axioms are designed to entice and placate you into keeping your money invested in risky assets at a time when it’s not in your best interest to do so.

In this chapter, we’ll discuss several of the sacred cows of investing that you need to be aware of in order to successfully avoid them. Here goes.....

Buy-and-Hold

I just made a killing in the stock market -- I shot my broker.

–Henny Youngman

For years the professional investment community has consistently sold “Buy-and-Hold” as the sure way to *win* in the stock market. All you had to do was pick a quality company stock or mutual fund, buy it and let the stock market and capitalism take its natural course. It didn’t matter if it went down, if you held it long enough, it would come back up and lo and behold, you’ll make money.

EXCERPT

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Many now call it “Buy-and-Pray.”

What those on Wall Street failed to understand was that, in order for this philosophy to work, you needed to actually know a bit about which companies and mutual funds to buy and which ones to steer clear of, not to mention having a good idea of the general direction of the stock market is important. The old saying “*a rising tide raises all boats*” is generally true when it comes to stocks. In an increasing market cycle, approximately 80% of all stocks will rise. Both quality stocks and not so quality stocks (dogs) will all be pulled higher by a bull market. On the other hand, in a bear market both quality companies and weak companies will indiscriminately sell off. So it’s far from being as simple as “buy-and-hold.”

If you’d like just a little bit of proof, look at Figure 4 in Chapter 1. This offers clear evidence that the stock market has definable, long-term cycles. Buy-and-hold would have worked well if you decided to buy sometime in the ’80s and early to mid- ’90s, which just so happens to be the longest bull market in stock market history. It wouldn’t work as well if you decided to buy in the late ’90s.

If you don’t believe me, a *Forbes* article published in July 2010, titled “*Buy-And-Hold Is Dead and Gone*” by author Sy Harding, sums it up very well when he said:

“Proof of the fallacy of buy-and-hold as a strategy is easy enough to find. In the 1929 crash and its aftermath the market lost 86% of its value and did not get back to its 1929 level until 1955, twenty-six years later. That was 26 years of waiting for buy and hold investors (if there still were any) for the market to ‘come back.’

“In 1965, just 11 years later, when the Dow reached 1,000 for the first time, the long 1965-1982 secular bear market began. For the next 17 years the Dow cycled between cyclical bull markets and cyclical bear markets, but did not manage to rise above its level of 1965 until late in 1982 (Figure 5). It was another 17 years in which buy and hold investors (again if there were any left) waited for the market to come back. Seventeen years of whipsawing heartbreak for buy and hold investors, but wonderful opportunities for market-timing.”

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“That made a total of 41 of the 53 years between 1929 and 1982 that buy and hold investors were waiting and hoping for the market to get back to previous levels.”

Figure 5



You might be thinking, “If I pick the right stocks it will all work out.” While that is true, it’s much easier said than done. Let’s look at a couple of examples from well-known and widely held companies.

If you bought Apple computer in February 2002, you’d have paid about \$7.50 per share; 10 years later it was worth around \$450 per share, reaching a high of \$667 in September 2012. If you bought this company 10 years ago, congratulations! You hit one of the biggest home runs in the stock market’s history. But what if, like countless other investors, you were sucked in during Apple’s phenomenal run in 2012? There is a good chance you’d be losing money holding the stock that made Wall Street history.

Let’s look at something a bit more mundane. General Electric is arguably one of the best-run companies in the world. If you’d bought GE in early 2003, you’d paid proximately \$25.50 per share; 10 years later, it was worth approximately \$23. During the mortgage meltdown of 2008-09, GE fell to \$10 per share. I wonder how many investors were scared by

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headlines and subsequently bailed out of the stock thinking it might get worse.

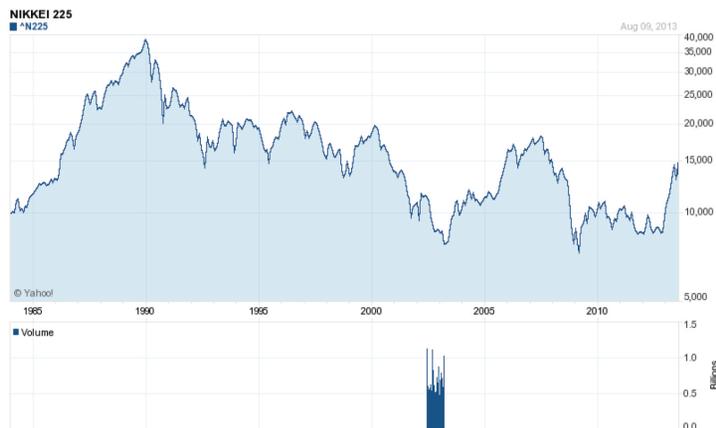
It pays to remember that every investor selling shares of stock is convinced it's not worth holding, while that same stock is being bought by someone who thinks exactly the opposite.

Don't think it could really happen? Ask the average Japanese investor....

Remember back in the 1980s, when Japan's economy and stock market were considered a juggernaut? On December 29, 1989, the Japanese stock market (Nikkei) hit its all-time high of 38,915.87. Today, almost 24 years later, the Nikkei stands at 13,615.19 or 65% below its high (see Nikkei Graph 1985-2013).

The reason I cite the Japanese economy is that in the 1980s, the lack of prudent economic and fiscal policy exerted by the Japanese government allowed their economy and stock markets to create unsustainable price levels, which, as we all know now, failed.

Figure 6: Nikkei Graph 1985-2013



Currently, is the U.S. government engaging in risky economic policy in order to help revitalize our economy after the 2008-2009 market

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correction and great recession? Many economists and market strategists argue that there are striking similarities to what happened in Japan.

Over the long run, I'm sure the Japanese stock market will eventually reach and exceed its 1989 highs. But as the famous English economist John Maynard Keynes once said, "Over the long run, we're all dead."

The important question is: *Can I afford the risk and uncertainty?*

Now, do you think the average Japanese stockholder believes in the buy-and-hold strategy? If you were a Japanese investor relying on the stock market to provide a comfortable retirement, what do you think you're doing now? Who's picking up the slack in their retirement plans caused by the two-decade-long bear market?

Now ask yourself: *If something similar to Japan happens here, can I afford to cross my fingers and hope that the buy-and-hold strategy works?*

4% Income Rule

Since the mortgage meltdown and subsequent stock market decline of 2008-09, the 4% rule has been getting a lot of attention. Devised in the early 1990s by financial planner William Bergen, the 4% rule attempts to quantify the amount of income (inflation adjusted) that can be withdrawn from an investment portfolio of stocks and bonds without running dry over a 30-year period (the assumed length of retirement). Mr. Bergen concluded that an allocation of 60% U.S. stocks and 40% bonds is the optimal mix to produce the highest level of sustainable income.

By using this method of producing retirement income, the odds are relatively low you'll outlive your money, or so the theory goes. In other words, if you retire with \$500,000 in your 401(k), TSP or IRA, how much could you withdraw annually and be reasonably assured you're not going to run out of money?

Generally, analysts and economists attempted to understand how much income a portfolio consisting of different asset classes (mainly stocks and bonds) could generate over an extended period of time without being exhausted. Most academics studying this dilemma concluded that 4% was a safe withdrawal rate. For many years the financial planning community

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used this research as the unquestioned truth of the amount of income to advise their clients to withdraw from their retirement accounts.

You may be thinking to yourself, wait a minute, I've heard for years that the average rate of return of the stock market is somewhere around 9%. So why then, are you telling me that I must only take out 4%?

Herein lies one of the biggest misconceptions within the financial planning community. While it's true the stock market over the last half-century averaged around 9%, this average return has nothing to do with how much money you can safely take out of your portfolio on an annual basis, as discussed in the 4% rule.

You see, there are typically two phases of a retirement account: *accumulation and distribution*. During the accumulation phase, you're adding money to your retirement account and as the market ebbs and flows over time, you're effectively practicing "dollar-cost averaging" or DCA. As the market declines, the contributions you're adding to your retirement plan effectively buy more shares, which amplify the gains during an increasing market.

The distribution phase (retirement) can do just the opposite. When you take distribution in the form of income from your retirement account "reverse dollar-cost averaging" or RDCA is a result. It works like this. Say you take out \$1,000 a month from your retirement account. Each month assets (shares of stocks bonds or mutual funds) must be sold in order to accommodate the monthly distribution. As share prices fall in a declining market, additional shares must be sold in order to provide the same \$1,000 distribution. You may be thinking that it would work just the opposite in an increasing market... That sounds reasonable, but the math doesn't work out that way.

During your retirement years (distribution or income phase), the average rate of return of your retirement account means very little. It's the *sequence of the returns* that is paramount. Figure 7 illustrates this. In this example, we have two retirees, Mr. Smith and Ms. Jones. They're both retiring with \$100,000 and they're distributing \$5,000 annually. The average rate of return of their retirement portfolio over 30 years is exactly the same: 4.5%. So why then does Mr. Smith run out of money in year 17

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and Ms. Jones have money to spare? The only thing that varies in these two examples is the *order* of annual return; remember, both retirement accounts average 4.5%. If you look closer you'll see that the orders of annual returns are exactly the opposite. In Mr. Smith's reality, the market fell the first few years he retired. Ms. Jones, however, had better luck. She happened to retire when the market was increasing.

Figure 7

	Mr. Smith		Ms. Jones	
	Sequence of returns (weak, then strong)	Balance	Sequence of returns (strong then weak)	Balance
Year 1	-5.30%	\$89,700	11.90%	\$106,900
Year 2	-2.10%	\$82,816	8.90%	\$111,414
Year 3	-7.30%	\$71,771	11.50%	\$119,227
Year 4	-11.20%	\$58,732	9.90%	\$126,030
Year 5	9.20%	\$59,136	7.40%	\$130,356
Year 6	2.70%	\$55,732	9.80%	\$138,131
Year 7	-3.60%	\$52,739	11.90%	\$149,569
Year 8	-9.80%	\$42,570	8.90%	\$157,881
Year 9	-2.00%	\$36,719	11.80%	\$171,511
Year 10	10.20%	\$34,464	10.20%	\$184,005
Year 11	6.90%	\$32,911	9.00%	\$195,565
Year 12	-1.50%	\$27,418	11.50%	\$213,055
Year 13	2.10%	\$22,993	9.20%	\$227,656
Year 14	2.40%	\$18,545	6.04%	\$236,406
Year 15	9.20%	\$15,251	-2.50%	\$225,496
Year 16	-2.50%	\$9,870	9.20%	\$241,242
Year 17	5.04%	\$5,466	2.40%	\$242,032
Year 18	9.20%	\$969	2.10%	\$242,114
Year 19	11.50%	\$0	-1.50%	\$233,483
Year 20	9.00%	\$0	6.90%	\$244,593
Year 21	10.20%	\$0	10.20%	\$264,541
Year 22	11.80%	\$0	-2.00%	\$254,251
Year 23	8.90%	\$0	-9.80%	\$224,334
Year 24	11.90%	\$0	3.60%	\$227,410
Year 25	9.80%	\$0	2.70%	\$228,550
Year 26	7.40%	\$0	9.20%	\$244,577
Year 27	9.90%	\$0	-11.20%	\$212,184
Year 28	11.50%	\$0	-7.30%	\$191,695
Year 29	8.90%	\$0	-2.10%	\$182,669
Year 30	11.90%	\$0	-5.30%	\$167,988

You may be scratching your head wondering, "How can I make sure that I retire when the market is going up?" Obviously the answer is.... You

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can't! This is why the rationale underlying the 4% rule is important to understand.

To further explain the effects the sequence of returns has on your retirement account's value, consider the example in Figure 8. In this figure, we have two co-workers, Bob and Bill. Both had \$500,000 in a 401(k) plan and will take income of \$30,000 per year upon retirement. The only difference between these two is the *date* they retire. Bob retired in 1990 and Bill retired in 2000. As you can see, because of the yearly returns (Dow Jones Industrial Average), their account balances at the end of the decade differ drastically.

Successfully preventing your retirement accounts from depleting is not only dependent upon the amount of money you take from your accounts as income, but the variance in the returns achieved on those accounts, over time. Unfortunately, as a retiree you can't either control or predict the future returns your retirement account will receive when your money is invested in asset classes that fluctuate in value.

Figure 8

Bob: retired in 1990				Bill: retired in 2000			
Year	Return	WD	Balance	Year	Return	WD	Balance
1990	-4.34%	\$30,000	\$449,602	2000	-6.18%	\$30,000	\$440,954
1991	20.32%	\$30,000	\$504,865	2001	-7.10%	\$30,000	\$381,776
1992	4.17%	\$30,000	\$494,667	2002	-16.76%	\$30,000	\$292,819
1993	13.72%	\$30,000	\$528,419	2003	25.32%	\$30,000	\$329,364
1994	2.14%	\$30,000	\$09,085	2004	3.15%	\$30,000	\$308,794
1995	33.45%	\$30,000	\$639,340	2005	-0.61%	\$30,000	\$277,094
1996	26.01%	\$30,000	\$767,829	2006	16.29%	\$30,000	\$287,345
1997	22.64%	\$30,000	\$904,873	2007	6.43%	\$30,000	\$273,892
1998	16.10%	\$30,000	\$1,015,728	2008	-33.84%	\$30,000	\$161,359
1999	25.22%	\$30,000	\$1,234,328	2009	18.82%	\$30,000	\$156,081

As Figures 7 and 8 illustrate, relying on assets that change in value as the income source of your retirement account comes with more risk than most retirees realize. It's imperative that retirement accounts generate a predictable and sustainable return so they can produce long-term income in order to maintain your standard of living throughout retirement. We'll discuss strategies and techniques to provide sustainable income in Chapter 3.

So when should you start the transition from the accumulation phase to the distribution phase? The answer to this varies, but I believe the transition should start at least five years prior to retirement. Think back to the market correction of 2000-2002 and the more recent decline of 2008-2009. If you were planning to retire close to those dates and waited until you actually retired to transition or reallocate your retirement accounts into areas that would be less prone to market volatility..... you might still be working!

The 4% rule has come under increasing scrutiny. Low interest rates coupled with a volatile stock market caused many researchers to decrease the percentage withdrawal they believe safe. In the February 8, 2013, *MarketWatch* article "Retirements 4% Rule Gets Downsized," the author discussed the paradox of income, longevity and market risk as presented by the 4% rule. The author summed it up well stating, "In today's markets, retirees who want a 90% probability of achieving their retirement income goal with a 30 year time horizon and 40% equity portfolio, should withdraw just 2.8%."

If her conclusion is correct, current and future retirees have much to think about. Do you reduce your lifestyle to meet your income or plan on working a bit longer in order to save more?

Let me be clear on something: *I don't hate the stock market*. If I did, it would be hypocritical because I own stocks and mutual funds within my retirement accounts. The point I'm trying to get across is that both history and research indicated assets that tend to fluctuate in value such as stocks, bonds and mutual funds are poor investment choices when solely being used to provide long-term, stable income.

Bonds Are a Safe Port in the Storm

As investors, we've been told bonds in our portfolios are a diversification tool that controls risk. While it's true that bonds are much less volatile than stocks, many investors are unaware that bonds also come with their own risks. Bonds have two basic levels of risk: credit risk and interest rate risk.

At their core, bonds are income instruments. When you're buying a bond, you're acting like a banker in that your lending money to a public company, state government or the federal government (the issuer). The issuer, in turn, promises to pay you a fixed interest rate for a set period of years, at which time your principal will be returned.

The credit risk of a bond is defined as the ability of the issuer to pay the ongoing interest payments as well as return the principal upon maturity. Credit risk is important to gauge when buying a bond from the public company or perhaps a state government or one of the entities within a state government. The federal government is assumed to be risk-free, therefore it carries no credit risk. I understand that because of recent federal budget deficits and the escalating national debt, many believe U.S. government bonds are not as risk-free as they used to be. But, for the purposes of this discussion I will assume that the U.S. government will not default on their obligations. They can always print more money, right?!

My goal in this section is to discuss interest rate risk and how it affects the market value of the bonds you may be holding.

As most know, interest rates and bond prices have an inverse relationship. As interest rates in the economy fall, bond prices push higher, and vice versa, when interest rates increase bond prices decline.

Here's a basic example. I purchase a \$1,000 bond yielding 6% and maturing in 10 years. The issuer of this bond will pay me \$60 a year for 10 years and then return my \$1,000 investment. Now let's assume that sometime after my purchase, interest rates increase to 8%.

In this case, I own a bond that is only paying 6% when other similar bonds may be purchased at the new, higher interest rate. The market price of my bond will decline to a level at which the \$60 annual interest yield

will equal the current market interest rate (8%). The current value of my bond will be \$750.

$$\$60/.08 = \$750.$$

Of course, the opposite is true when interest rates decline. Let's say interest rates fall to 4%, my bond becomes more valuable because the \$60 annual yield is greater than the amount a similar bond will currently provide. My bond will increase from its purchase price of \$1,000 to approximately \$1500.

$$\$60/.04 = \$1500$$

It's not that simple, of course, because when it comes to the market nothing ever is! The bond's credit rating, maturity and duration also play into its market value.

The concept I'm trying to help you understand is that interest rate movements can have profound effects on the value of the bonds you hold. For those of you who'd like a detailed understanding of how bonds are priced, here you go.

$$\text{Bond Price} = \frac{C}{(1+i)} + \frac{C}{(1+i)^2} + \dots + \frac{C}{(1+i)^n} + \frac{M}{(1+i)^n}$$

Why is this important to understand now?

Currently, interest rates are at a level that most of us just a few years ago would not have imagined. Because of the housing and mortgage fiasco of 2007 and the subsequent stock market and economic decline that shortly followed, the U.S. Federal Reserve has adopted a low interest rate policy. By working hand in glove with the U.S. Treasury, the Federal Reserve injected trillions of dollars into our economy. This is being done in an effort to revitalize the economy and help it dig its way out of the deep recession that resulted from the unwinding of the housing and mortgage bubble.

Is there a new bubble forming?

Is the low interest rate environment we're in currently creating a bubble in the price of bonds? As the stock market plummeted in 2008-

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2009, large sums of money were pulled from the stock market and subsequently placed in bonds. This is a classic “flight to safety” trade. Historically, in times of stock market decline investors will naturally move assets into safer areas such as bonds and money market accounts. While this makes sense, the astute investor must examine the probable outcomes of this strategy.

As the demand for safer asset classes such as bonds increases, the prices will naturally rise causing their effective yields to decline.

This phenomenon is highlighted in the October 18, 2012, *Business Week* article “Bond Fund Investors Beware.”

Authors Saumya Vaishampayan and Margaret Collins discussed that from January through August 2008, U.S. investors poured \$982 billion into bond funds while pulling \$439 billion from stock funds. This trend continued and only recently is showing signs of stabilizing.

As a result of this mass exodus from stocks to bonds, the risk-averse investor has relied heavily on the stability of bonds. Over the past few years, they have been rewarded for their caution. The investors who were frightened out of stocks and fled to bonds in 2008 and 2009 were rewarded as interest rates declined and bond prices increased. From 2010 through 2012, interest rates consistently stayed at a remarkably low level, and in early 2013 the 10-year Treasury bill traded at approximately 1.9%. This recent stability may satisfy investors, but dangers lurk just around the corner.

The current generational low level of interest rates will not last forever. Invariably, rates will rise, causing bond prices to fall.

If you think about it, the “real return” of the 10-year Treasury bill is approximately 0%. Currently, inflation is averaging around 2% annually. If T-bills pay 1.9%, after inflation is considered your buying power hasn’t increased a bit. The “real return” is the interest rate adjusted for the rate of inflation, which tells if you gained or lost ground.

And we haven’t even considered taxes...

Rising interest rates are caused by any number of sources. The Federal Reserve’s increase in the money supply may cause inflation as discussed in Chapter 1, or the U.S. economy may finally turned the corner and start to

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grow at a more rapid pace. In either case interest rates will likely increase from the current levels.

You may think, “If interest rates start to rise, I’ll have time to simply move my money out of bonds and avoid the decline.” While this is certainly possible, it is the same mindset many investors had before the 2008 and 2009 stock market decline. It’s much easier said than done.

At the current low level of interest rates, as little as a 1% increase in the market rate of interest could cause bond prices to drop 15% or more in value, depending on their maturity date and duration. How fast could interest rates increase by 1%, you ask? History is riddled with instances where interest rates either increased or decreased by 1% or more in a matter of weeks. As an investor, it’s difficult to discern what an abrupt change in market direction means. Does this constitute a short-term anomaly within the current trend or does it constitute a new and different trend that may indicate a true decline in value? For anyone who’s currently holding bonds or considering investing more money in bonds, here’s something to think about first:

Bond rates are “at a historic high, 96.1% above the predicted trends. Last time bonds were this high was “in 1940, 86% above the trend. That was the tail end of the Great Depression when investors ran from stocks and piled into bonds. Today bond prices are already above that point.”

MarketWatch.com, October 2011

Additionally, Bill Gross, probably the most respected authority on bonds, appears to agree with MarketWatch:

“Unless 100 Years of financial history are meaningless, bonds must go down - and yields and interest rates, up.”

What both of these sources are blatantly telling us is bond prices are at historical highs and are ripe for a decline.

When exactly will interest rates start to increase in earnest and drive the price of bonds down? The truthful answer is, I don’t know and neither does any financial advisor or market analyst. But unless human history and economic laws cease to exist, it will undoubtedly happen.