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Adjusting Our Expectations

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In this letter I want to look at the big picture, at the exceptional and unusual economic and investment challenges that we currently face, and at an overall system of strategies for success.

I agree with Mohamed El-Erian of PIMCO that our most likely immediate future will have "too little growth, too much debt, high joblessness (particularly among the young and long-term unemployed), excessive political polarization and growing calls for greater social justice."[1]

John C. Bogle, the founder of the Vanguard Group, now the second largest mutual fund company in the world, says that "the (current) market sea is the roughest he's ever faced."[2] Bogle has more than 60 years in the investment business and single-handedly changed the investment world in 1975 by creating the first investment option that simulated an index. For decades he has been an exponent of "buy and hold" for the long-term and diversifying. "But diversify into what?" he laments. "What's so frightening now is that the alternatives are so poor."[3]

Bill Gross, arguably the greatest living bond expert, claims that "the cult of equities is dying."[4] What he means by the "cult of equities" is the ***rigid belief*** that stocks can always be counted on to return at least a 10% average over any 10 year period of time. Now in 2012, any investor can easily compare the return of stocks "for the past 10, 20 and 30 years and see that long-term Treasury bonds have been the higher returning and obviously 'safer' investment than a diversified portfolio of equities."[5] Going forward, Gross argues that neither stocks nor bonds will likely have returns that meet the expectations of most retirement plans. His opinion is that stocks should not be counted on for long-term average gains greater than 4%, nor bonds for gains greater than 2%.

(Note: As of June 30, 2012 the S&P 500 index has made virtually nothing for 12.5 years.)[6]

To gain insight on our own probable future, following the crash of 2008, a recent academic study looked at three historical examples where massive debt disequilibrium created stock market panics.[7] They are the years following the panics in the U.S. of 1873 and 1929, and the Japanese stock market crash of 1989. "Amazingly, ***twenty years after each of these panic years***, long-term yields were still very depressed, with the average yield of just 2.5%. . . . Therefore, history suggests that over-indebtedness and its resultant slowing of economic activity supports the proposition that a prolonged move to very depressed levels of long-term government yields is probable."[8] (Emphasis added.)

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I could go on, but here is my point: we are living in a very different investment environment than we had in the 1980s and 1990s. To protect your nest egg and still get adequate yields for you to live a comfortable retirement, we need to do two things. First, we must continue following the principles of investing that I will outline below. Second, within the boundaries of these principles, we need to be alert to productive opportunities in asset classes that may be different from those that worked best in prior years.

Investment Principles

Early this year I sat down and wrote out the investment principles that I follow when investing. I printed them up for myself to keep them always upper most in my mind. In the same spirit, I would like to share these with you as a point of discussion about any investment that you currently have or that I might recommend to you in the future. I consider the first four requirements, and the last two desirable additions when possible.

1. Is it **Diversified?** Never take default risk with an individual stock or bond no matter how attractive. Think about how Enron was written up for several years in a row as the top performing company… until they went broke. In other words, we only invest in diversified pools of stocks and bonds.

2. Is it **Transparent?** Can I independently check and see what I own? This requires an independent custodian for any money manager we might want to employ. We only invest in portfolios with investment companies that are required to report all their holdings every quarter.

3. Do I have a **Sell Discipline?** Do I have objective criteria, written down, that tell me when to sell if I am wrong, and when to sell and protect profits if I am right? This is my answer to the "buy and hold strategy" which has not worked for the past 12 years.

4. Is it **Liquid?** Can I change allocations; can I go to cash, on a daily basis? This does not mean that we are active traders; it simply means we must at all times retain the option to employ our protective sell disciplines.

Desirable Additions

5. Can I add **Insurance?** Can I add any additional protections? Since 1998, when it first became possible to have an insurance company guarantee* our retirement income, this has been a core strategy for most of my retirement clients including my family's accounts and my own.

6. Is it **Tax Efficient?** Can I set this up in a way that minimizes taxes? Of course this has meant that we take maximum advantage of tax laws that favor tax-sheltered compounding like IRAs, TSAs, SEP IRAs, Roth IRAs, Defined Benefit Plans, and non-qualified annuities. When tax efficiency is not possible for certain investment goals, we resolve to be content to pay taxes on our profits.

(Note: In my investment career, the biggest losses I have seen came to investors who overlooked the dangers in investments which promised enormous tax benefits. I have seen significant losses

in oil drilling, cattle feeding, movie making, and affordable housing to name a few. And, yes, I too have been hypnotized by this Siren in the past. Strap me to the mast and plug up my ears…)

Investment Strategies

Within the parameters of our 6 principles, we cultivate a nimble outlook, seeking opportunities that have a higher probability of success. We strive to avoid investment options that seem overpriced now, where we cannot assess a future advantage, where we cannot find a diversified and transparent way to participate, or where we cannot determine a sell discipline criterion. For the past several years, we have often rotated our investments among various bond sectors based on the premise that there will continue to be a desire for higher yields in a low interest rate environment (with a sell discipline, of course). We are currently studying the real estate and the emerging market bonds sectors, but have not yet found opportunities that meet all of our criteria. We continually review our current investments for possible improvements, and the investment environment for additional opportunities, but we also believe in "letting our profits run" (except when our sell disciplines are triggered). Past performance, of course, does not guarantee future results.

Please feel free to discuss the above principles with me in reference to any of your current accounts. Call me anytime for a review or if I can help you or your friends and family with any financial or investing concern.

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The views expressed are those of the author as of the date noted, and are subject to change based on market & other various conditions. They may not reflect the views of United Planners Financial Services of America.

*Guarantees are based on the claims paying ability of the insurer.

Certain risks exist with any type of investment & should be considered carefully before making any investment decisions. Keep in mind that current & historical facts may not necessarily be indicative of future results.

[1] www.PIMCO.com, "Secular Outlook 2012, Policy Confusions & Inflection Points," 5/15/2012
[2] LA Times, "A Mutual Fund Master, Too Worried to Rest", August 12, 2012,
[3] **Ibid.**
[4] PIMCO, "Investment Outlook", August 2012
[5] **Ibid.**
[6] The S&P 500 averaged only 0.1% annually from Jan 1, 2000 to June 30, 2012 according to Morningstar
[7] ***Debt Overhangs: Past and Present***, by Carmen & Vincent Reinhart, and Kenneth Rogoff, National Bureau of Economic Research, Working Paper 18015, April 2012.
[8] **Ibid.**