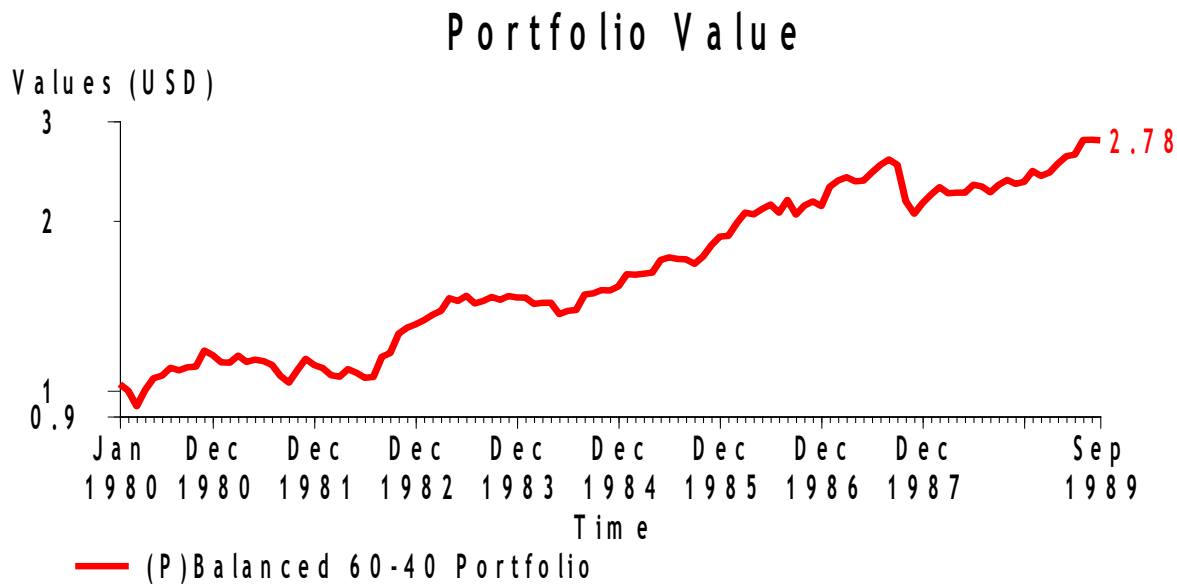




The Retirement Lottery

On January 1, 1980, Jim and Jane Smith sold their business and retired on \$1,000,000. Peter Jones, their financial advisor, determined that they needed \$48,000 a year - increasing annually with inflation - to fund their lifestyle. Balancing growth with protection, the couple invested in his recommended portfolio of 60% large cap U.S. stocks and 40% intermediate-term Treasury Bonds. Peter then rebalanced the portfolio every year to this target mix.

Nine years and nine months later, Jim and Jane discussed with Peter how delighted they were with his strategy. Not only had their income kept pace with inflation, increasing to \$75,000 in 1989, but their portfolio had skyrocketed in value. As illustrated in the following Exhibit, every \$1.00 they had invested in 1980 was worth \$2.78 by 1989. Jim and Jane were worth \$2,780,000 despite nearly a decade of growing withdrawals. Even the October 1987 market crash was just a bump on the road to success.

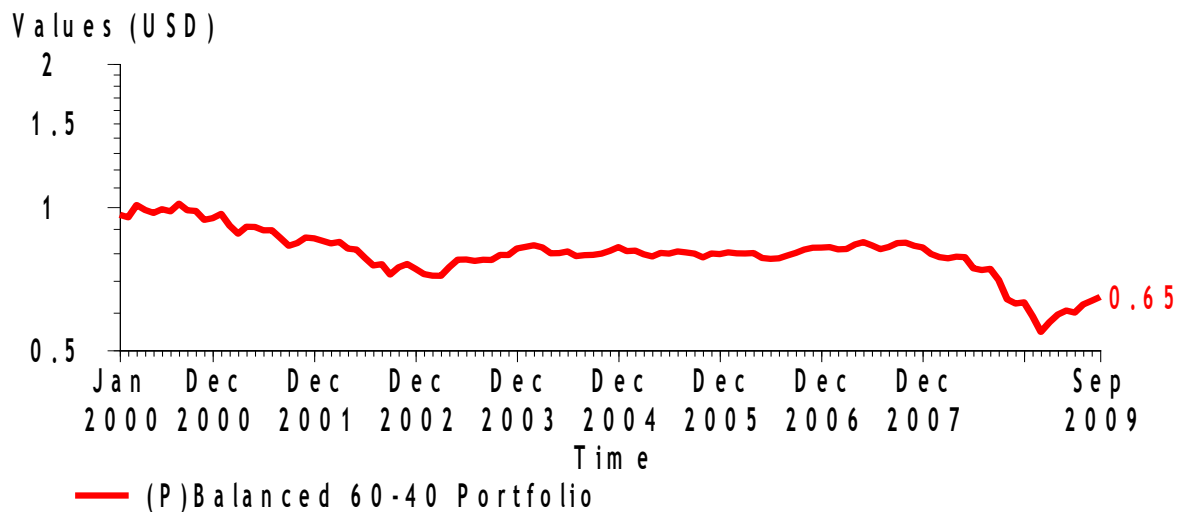


Fast forward to January 1, 2000, and Jim and Jane's nephew, Bill Smith, also retired with \$1 million. Having listened for years about the success of Peter's winning investment strategy, Bill invested in the identical asset mix. He also withdrew \$48,000 in the first year and increased his withdrawals annually by inflation. Given his uncle's and aunt's experience, he was confident he had a winning plan.



Nine years and nine months later on September 30, 2009, Bill sits down with Peter and complains bitterly as he contemplates the vestiges of his \$1 million. As illustrated in the following Exhibit, every \$1.00 he invested in 2000 is now worth only \$0.65. His million has shrunk to \$650,000 and he is glumly contemplating a return to work.

Portfolio Value



Identical retirement strategies implemented just twenty years apart - yet with dramatically different outcomes. With hindsight, we now know that Jim and Jane Smith had the good fortune to have retired just prior to the great stock bull market of the 1980's. They also caught a once-in-a-lifetime uplift in bond prices as inflation fell. Conversely, Bill had the horrible luck to have retired on the cusp of the tech meltdown, itself followed by the greatest global financial crisis since the 1930's.

The paradox is that in each case the outcome was polar opposite of the investment sentiment at the time of retirement. Jim and Jane retired in troubled economic times where fears of inflation and chronic slow growth were rampant. Stocks and bonds had done poorly for years. Bill retired in a bullish era of prosperity and stunning returns.

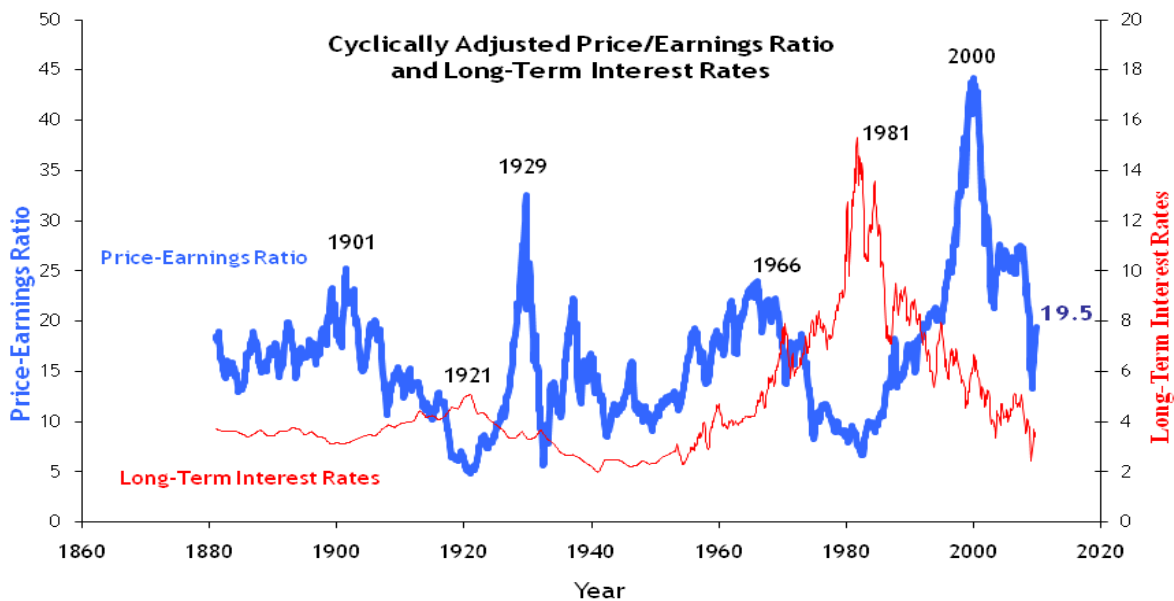
Unfortunately, investor sentiment is usually in direct contrast to asset valuation levels and it is valuation levels that are of primary importance in assessing the risk of a retirement plan. The Exhibit following displays the rolling 10-year real price-earnings (PE) ratio of the S&P 500 and long-term interest rates, prepared by Robert Shiller, the noted finance professor.¹

When Jim and Jane retired, stocks were the most inexpensive that they had been in four decades while bond prices, offering double-digit yields, were the lowest on record.



Although there was no guarantee that these bargain valuations would translate into high realized returns, cheap acquisition prices created much greater upside than downside. It would only take sound monetary and taxation policies - something about to occur under the helmsmanship of Fed Chairman Volcker and President Reagan - for falling interest rates and rising PE ratios to fuel superior returns.

Bill, on the other hand, bought stocks at their highest valuation level in history. His entry pricing was fraught with risk - anything but economic perfection would result in subpar returns. The bursting of the tech and credit bubbles was ruinous as valuations plunged.



Investors need to know that retirement is a lottery where the chance of winning is more dependent on asset valuations at the time of retirement than the soundness of the investment plan. Individuals planning for their retirement today need to soberly assess their return expectations since stock prices are moderately above the historic average while long-term interest rates are near record lows. Winning tickets will only be available to those who can keep their expenditure levels in line with this reality.

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ⁱ Robert J. Shiller <<http://www.irrationalexuberance.com/index.htm>>