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TAMING A VOLATILE STOCK MARKET

The stock market's high volatility seen in recent months has been a sharp reminder that limiting losses in down markets can be just as important to long-term investment success as making money when markets are rising. In fact, it may be even more important.

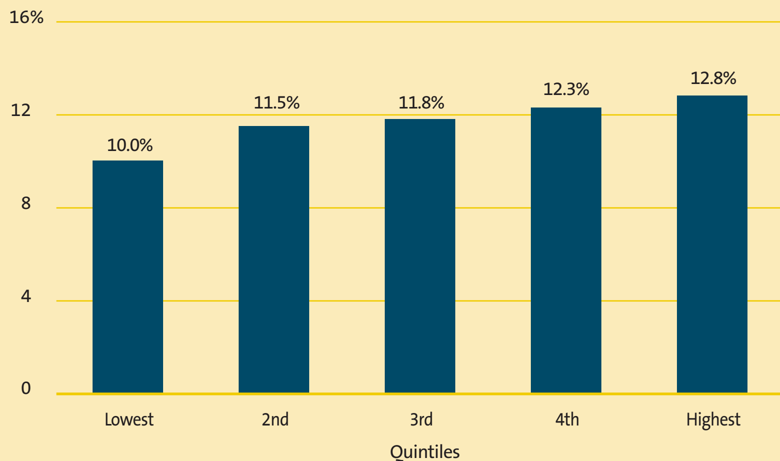
Our opinion is based on simple arithmetic: For any given percentage decline in portfolio value, investors have to achieve an even higher percentage gain just to get back to where they started. Holding losses to a minimum may be the best way to make the recovery less challenging.

Selecting mutual funds, for use in your retirement account, that are likely to weather the inevitable market downturns is an important part of retirement plan decision making..

Relative Performance of Higher- and Lower-Quality Stocks

Based on Return on Equity (ROE)

Largest 1,000 U.S. Stocks, Average Return Over 12-Month Periods, 12/31/85 Through 12/31/11



ROE—earnings as a percentage of shareholder equity—is a widely used measure of corporate quality because it can show how efficiently management is using a firm's resources. To test its value, T. Rowe Price analysts sorted the 1,000 largest U.S. stocks into five groups, or quintiles, based on ROE. Rolling 12-month returns were then calculated for each group. Over the period shown, the stocks in the highest ROE group outperformed the lowest group by an average 2.8 percentage points. Interestingly, most of the benefit of owning high-quality stocks came in down markets (see chart on page 16). Many factors—not just ROE—influence equity returns, and these effects have varied over different time periods and market cycles. Still, the study suggests that when searching for attractive stocks, ROE isn't a bad place to start.
Source: T. Rowe Price.

Plan participants should try to identify those mutual funds that have consistently shown price resistance when the stock market is in decline without sacrificing too much upside potential when the market recovers.

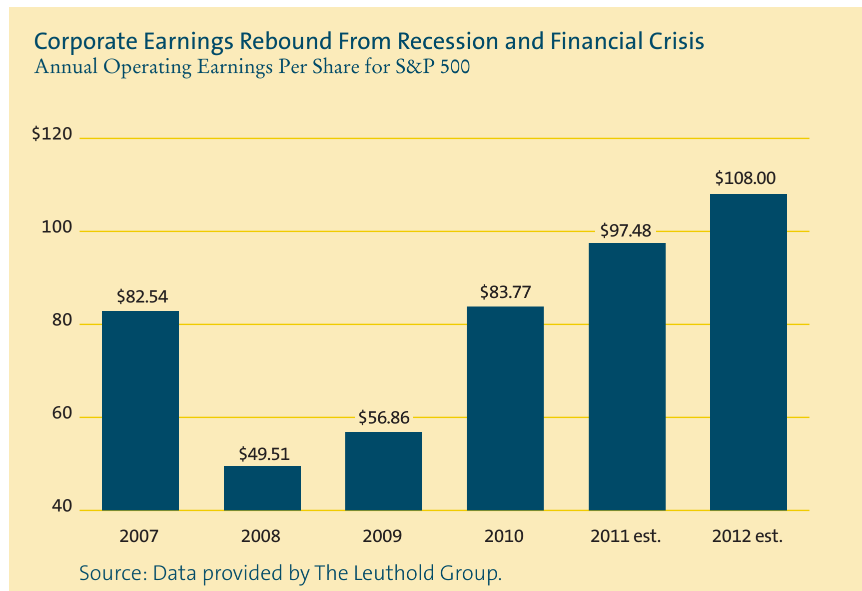
To this end, retirement plan participants may want to focus on those mutual funds that invest in high-quality companies with strong balance sheets, relatively high profit margins, and relatively stable earnings. Our work is suggesting that while quality companies generally tend to do well over time, the real benefits often come in down markets. That's when the performance gap between high quality and low quality tends to be the widest as the chart on Page 1 indicates.

VALUATIONS

It appears to us that the valuations of the mutual funds who invest in high-quality equities continue to be attractive.

While we are certainly aware that the stock market volatility that began in the year 2000 has been very frustrating for retirement plan participants, the good news is that stock valuations seem to be much improved as a result. For example, the S&P 500 Index of large-cap U.S. stocks topped 1,500 in the spring of 2000, as stocks traded at 25 times estimated earnings and 29 times trailing 10-year earnings.

The S&P 500 Index ended 2011 at 1,257, down 16.2% from 1,500. But corporate earnings per share are up 71% from the start of 2000, and the price-to-earnings (P/E) ratio is down 53%. See the chart below:



During this period, there has been such a significant compression of valuations that the index's P/E ratio is approaching a 60-year low, based on 10-year trailing earnings.

We would also point out that the S&P 500's dividend yield, another indicator of relative value, has been higher than the 10-year Treasury bond rate for only the third time in the last 50 years. More than 200 of the index's 500 stocks are now boasting dividend yields above the 10-year Treasury.

WHY INCLUDE EQUITY MUTUAL FUNDS?

We believe it's important to consider inflation and longevity risks when saving for a retirement that could last more than three decades.

Even modest inflation can erode purchasing power over time. At an average inflation rate of 3%, you will need nearly two-and-a-half times your current annual income to maintain your standard of living in 30 years. Longevity risk also may prove more significant than many investors realize. For a couple who are both age 65, there is a 52% chance that at least one spouse will survive to age 90 and a 23% likelihood that at last one will live to age 95. If you plan for a shorter time horizon, you're really throwing the dice, and younger investors need to plan to live even longer than someone who is age 65 today.

Craig Israelsen in an interview appearing in the July/August 2010 issue of the Journal of Indexes has said: "In 1930, it was anticipated, based on mortality tables, that a retiree might live three to seven years in retirement. Now, for women, it could be 30 to 35 years, maybe 25 to 30 years for men. That creates a need to accumulate an annuity stream to cover that many years of retirement income."

To illustrate the unique financial complexities facing retirees, consider 10 high school friends who decide to retire at age 65. Now, guess when the first of those 10 friends will die. As it turns out, the first death is likely to occur only four years into retirement, at age 69. Next, try guessing when the last person will die. The answer is 34 years into retirement, at age 99.

The first retiree to die probably had accumulated enough savings to last for his lifetime; four years; but the last to die probably had not. After all, it is difficult in a 40 or 45-year working career to accumulate the money needed for a 34-year, pre-paid retirement. Also, it is impossible to tell which retiree will be the first to die and which will be last.

JOINT LIFE PROBABILITIES

If the probable expectancies for single lives aren't dramatic enough, the probabilities for the joint lives of a 65-year-old couple are stunning. At 50 percent, at least one of the spouses will be alive at age 91; that's 26 years after retirement. There is a 25% probability that one of the spouses will still be alive at 95 and a 10% probability at 99.

The challenge, of course, is that most people do not know the probabilities for how long they will live and most people are under-estimating how long their funds will need to last.

WORKING LONGER

The important thing about saving for retirement is this: Most of us don't do enough of it.

According to the Center for Retirement Research at Boston College (the Center), the average 55 to 64 year old with a retirement account has accumulated less than $100,000.

If you think that this is a large figure; consider this: If you want to make that $100,000 last the duration of your retirement, you should only withdraw $4,000 per year; or $365 per month (many advisors suggest taking out no more than 4% of your retirement fund per year.)

One of the most powerful things you can do is to stay on the job as long as possible. You will have more years to contribute to your retirement account and a shorter period of time that you would be using your retirement money.

Delaying retirement by just four years could potentially boost the value of your nest egg by a third, according to the Center; working eight more years could help increase that by 75%.

BEATING INFLATION

Beating inflation over long periods of time generally requires a significant allocation to equities. Stocks, historically, have outpaced inflation by considerably more than other asset classes. Moreover, market volatility is reduced over longer time periods: Since 1926, the S&P 500's worst one-year return was -43.3% in 1931, but its worst 30-year return was an annualized gain of 8.5%. Of course, past performance cannot guarantee future results.

Yields are down for stocks and bonds, setting the stage for lower returns for retirement plan participants. Furthermore, the economic backdrop is likely to see reflation, where the Fed increases the money supply to stimulate the economy and keep interest rates down; thus compromising plan participant's ability to earn enough for their coming retirement, and the spending power of their eventual withdrawals. Most retirement plan participants are ill-prepared for inflation, and we believe that this common and costly mistake should stimulate workers to save as much as possible. Inflation is the biggest single enemy to long-term investors.

HAS ANYTHING CHANGED?

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Rollover IRA out of a Retirement Plan
Traditional or ROTH IRA
Taxable Accounts
Annuities
Insurance

Additionally, we can work with you on:
Managed Accounts

For Assistance call:
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