The Patient and Disciplined Investor…

Ruminations on long-term wealth building

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"If you think it's expensive to hire a professional to do the job, wait until you hire an amateur." - Red Adair

Products or Strategy – Which One Are You Choosing?

Here is a typical client scenario. A hypothetical couple named Barb and Sam comes into the office to discuss their financial situation. They're in their 50s and doing reasonably well, but the various financial and insurance products they've accumulated over the years are spread out over many providers. They bought life insurance here, an IRA mutual fund there, an annuity somewhere else, have three 401(k) plans with their current and past employers, and perhaps they have some insurance with us. Beneficiaries haven't been updated in years or coordinated with their will or trust, investments are disjointed, and Barb and Sam are unknowingly widely exposed to a couple of insurance risks. Barb and Sam claim that they're "working" with a financial person, but they don't seem clear on exactly what this person is supposed to be doing for them.

I haven't officially measured this over the years, but I would say that Barb and Sam are more the rule than the exception. If you're reading this, then I very well could be describing you.

But here's what I do NOT want to do with Barb and Sam…sell them yet another product that only adds to the complexity and inefficiency. Barb and Sam need a strategy and, more importantly, they need someone they can trust to help guide them through a financial world that is increasingly asking them to do these things for themselves.

This was most likely a terribly inefficient way… to accumulate wealth and buy insurance protection.

The government or a corporation is not going to take the time to get to know Barb and Sam and remind them of some things they don't want to consider, ask the questions that are uncomfortable, and protect the interests of those who don't have a seat at the table…namely, the 80-year old versions of Barb and Sam and perhaps their future grandchildren. A trusted, competent financial professional is what they need.

If you're younger – or older - don't let this happen to you. This was most likely a terribly inefficient way for Barb and Sam to accumulate wealth and buy insurance protection. But if this is you, so be it -- start where you are. Find a financial professional who you think you can trust, who knows what he or she is talking about, and – most importantly - who you feel will genuinely take an interest in your financial well-being. Develop a strategy with that professional that will help keep emotions out of future decisions the next time a fearful, bear market – or euphoric, bull market – hits. Focus on the longer-term trends that – in my opinion are much more interesting and potentially more profitable – than the addictive, economic "crisis" of the day. Stop adding products and chasing past investment performance while reacting to media hyperbole. Rather, call me today to schedule some no-obligation, personal time. It could be the best hour you spend all year.

Bottom Line: It's the strategy - not another product - that really counts.

It's Hit High and Deep…it's Going, Going, Going…it's Gone!! – And I'm Not Talking about a Home Run

The baseball season is kicking off, and I like the Colorado Rockies' chances this year. Let's hope they have a good ball club. Otherwise, with all the veterans they've added, they might just end up being old and hurt with young, ineffective pitchers. But that's why they play the games.

Instead of baseball, look around, and you'll see many important retiree protections that are going, going, going….and gone. Kodak and American Airlines are the latest bankruptcies of iconic American brands that are burdened with retiree and labor promises. Let's start with what's gone and work towards what's going.

GONE

Health insurance benefits for retirees. Does any private company still offer these benefits to their retired employees?

PERA inflation-protection for retirement benefits. The Colorado state PERA retirement plan used to protect their retirees from the full onslaught of inflation. Now there is a formula depending on when you started participating in PERA.[1] In effect, PERA participants can expect up to 2% annual increases in their benefits. Inflation has averaged about 4.3% since 1970.[2] In other words, something that cost $1 in 1972 would cost $5.42 today. Compare that to a PERA participant who retires today – if she experiences the same inflationary effect, that $1.00 retirement benefit will only buy her $2.21. That is a serious erosion of purchasing power.[3]

Old-fashioned calculation for CPI. The government measures inflation differently today than it did in the 1970s. Many would argue that this hides the true effects of inflation. For example, the government assumes that you will substitute less expensive products when prices increase. Let's say steak increases in price…the government assumes you will buy something else, such as hamburger instead. Quality improvements in products are also being backed out of inflation statistics. Let's say a car has increased in price 10% from $30,000 to $33,000 and that the manufacturer added side air-bags this year. If half of that 10% increase in price was due to the air bags being added, then the government might say prices only increased 5% instead of 10%. Perhaps it's no coincidence that Social Security checks are tied to the government's calculation of CPI.

The Number of Workers Supporting Retirees. You've seen the numbers…something like 1,537,041 workers were supporting every one retiree when Social Security was introduced and soon it will be two workers supporting one retiree in need of serious health care. Okay, so I'm exaggerating the first number. But Houston, we have a problem. As Scoobie Doo would say, "Rut-Row" – however you spell that. The luxury of many workers supporting each retiree is gone. There is a lot of ink spilled on current government deficits, but the spending party hasn't even started. Every voting American should have at least a passing interest in the Annual Trustees Report that is released annually on Social Security and Medicare.[4]

MOSTLY GONE AND GOING

Defined-benefit retirement plans. I still see quite a few of these plans with clients, but clearly employers are not in the mood to keep these plans as originally intended. Even if you have one of these plans and it's properly funded, keep in mind that most all of them pay a fixed benefit to the retiree in a world of rising prices. If you have one, you're fortunate…now make sure your other assets can keep pace with inflation.

GOING?

You've Earned Your Social Security and Medicare. You've worked hard, saved, and controlled your spending. No matter…the government now says you're not entitled to the same benefits you otherwise would have been entitled to

[1] http://www.copera.org/pdf/2/2-247.pdf

[2] http://www.bls.gov/data/inflation_calculator.htm

[3] Inflation has averaged approximately 3.8% since the end of World War II. Americans experienced significant inflation in the 1970s. The government, however, has more recently revised CPI – many who would say that underestimates the true effects of inflation. See the same website mentioned in footnote 4.

[4] Here is a link to the latest summary: http://www.ssa.gov/oact/TRSUM/index.html

under Social Security and Medicare because, well, you really either don't need these benefits or you can afford to pay more for your Medicare. Fantasy? Hardly – it's been happening since 2007 with Medicare Part B premiums.[5] If it happens with Social Security, people might throw tea in the harbor. But we aren't doing that now with the massive transfer of wealth from savers to debtors via the Fed's policy of rock-bottom interest rates that are allowing banks and other debtors to repair balance sheets while savers are getting hammered in savings products. Also see footnote 6 in this newsletter.

Tax-free Roth IRA Distributions. I sense there would be hell to pay if Congress reneges on its pledge to keep qualified Roth IRA distributions tax-free. I'll share what my crystal ball is saying – but first let's consider how a politician thinks. He wants to go back to his constituents and tell them that he fought to preserve their tax-free Roth IRA distributions. True enough, but he's under enormous pressure to raise revenue. I therefore see Congress keeping tax-free Roth IRA distributions, however, I see them counting any and all Roth IRA distributions for purposes of taxing your Social Security (perhaps even means-testing it – i.e., do you really need it because you have other savings). I also anticipate that Roth distributions will be counted towards determining how much you pay for Medicare premiums, the new Medicare tax kicking in next year, and the rates you pay on your capital gains and qualified dividends. For many investors, this would not be an insignificant event.[6]

[5] https://questions.medicare.gov/app/answers/detail/a_id/2099/~/2009-part-b-premium-amounts-for-persons-with-higher-income-levels. For now, income that determines your Medicare Part B premiums are indexed to inflation and is relatively high, but this could change.

[6] Social Security was a tax-free benefit until 1983. At the time, Congress passed a law taxing a portion of Social Security benefits of "high-income seniors" but did not index the law to inflation. By 1993, another law was passed taxing up to 85% of one's Social Security benefits…again, not indexing it to inflation. Fast forward to today, few seniors are experiencing tax-free Social Security benefits.

Favorable Rates on Qualified Dividends and Capital Gains. This might be gone as soon as this coming January. Stay tuned.

Bottom Line: We are more and more responsible for savings, investing, and getting it right when it comes to our retirement and financial well-being. Don't go it alone – call today, and let's get a strategy in place to deal with these issues.

Buffet Says Bonds are the "Most Dangerous of Assets"

I've sounded the alarm bells in this newsletter many times before, and now Warren Buffet seems to agree. Mr. Buffet, citing inflation and low interest rates, said:

> [Bonds] are among the most dangerous of assets. Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as these holders continued to receive timely payments of interest and principal.[7]

Wow, I couldn't have said that near as succinct and pithy as Mr. Buffet. But I understand that he knows a thing or two about investing and has been known to deliver complex ideas in understandable ways.

In early March, Putnam Investments invited me back to Boston to meet and listen to their fund managers. I was most intrigued by the comments regarding bonds - or fixed income. In essence, they were talking about the risks associated with U.S. government and investment-grade corporate bonds and how many other pension funds and investments must maintain a certain percentage of these highly-rated bonds in their portfolios. In addition, they said many large, well-respected bond funds are not small and nimble enough to get away from these types of bonds without causing price distortions in the markets. They believe that the current scenario presented many unique risks and opportunities. Neither they nor I am predicting a similar disaster that befell AAA-rated mortgage-backed securities in 2008,

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[7] http://www.financialadvisormagazine.com/fa-news/9944-buffett-inflation-risk-makes-bonds-dangerous.html

but the term "return-free risk" should be resonating with more investors.[8]

Recent economic data has caused stocks and interest rates to go up since last fall. As of this writing, a popular bond fund that holds mostly long-dated U.S. Treasuries is down 7.47% year-to-date in 2012.[9] And interest rates haven't even started a serious march upwards…yet.

Wrap-Up

Average rates on "jumbo" CDs are 0.22%.[10] Five-year jumbo CDs are 1.14%. U.S. inflation averaged 3.0% in 2011 with food prices increasing 4.7% and energy prices increasing 6.6%.[11] How is it that a "safe" investment loses this much purchasing power in one year?

27% of student loan borrowers are delinquent.[12] The total market for student loans – now backed nearly 100% by your federal government – is approaching $870 billion. Do you smell another "bailout" like me?

Technology continues to evolve in the emerging markets. The Economist ran an article in the January 14th edition describing a program in India that will enable up to 400 million poor people this year to be identified and become eligible for government aid. To date, this has been a massive problem. Many Indians are now having their fingerprints and irises scanned and entered into a system that will cut down on corruption and enable the poor to participate in the economy.

Check out the outstanding article "Oil and Gas Boom Lifts U.S. Economy" in the Wall Street Journal on February 8th. I continue to believe this is one of the major underlying, positive trends that will drive U.S. economic performance for many years. Stay invested, my friends.

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[8] Please remember, as interest rates rise, bond values decrease – all things being equal. If your bond is a long-dated bond – for example, a 30-year U.S. Treasury bond – then the fair market value of these bonds are more sensitive to rising interest rates than a shorter-term bond, such as a 10-year U.S. Treasury bond.

[9] http://www.google.com/finance?client=ob&q=MUTF:VUSTX#, March 20, 2012.

[10] Wall Street Journal, page C3, March 14, 2012.

[11] http://www.bls.gov/news.release/cpi.nr0.htm, February10, 2012

[12] Wall Street Journal, page A12, March 14, 2012.