

THE Retirement Report

Retirement Transition Planning

508.481.2299

www.polarisadv.com

First Quarter 2010

Bear Markets Are Good For Long-Term Investors

This is a great time to be young—particularly if you have the means and the foresight to invest in the stock market and the patience to let your investments work over time. Though the bear market has scared off many would-be investors, putting money into stocks during and after a downturn has historically been a winning strategy, according to a study by investment company T. Rowe Price. Long-term investors who systematically invest in equities during a bear market are actually better off than those who start investing during bull markets.

The T. Rowe Price study focused on four hypothetical investors. One began investing in 1929, another in 1950, the third in 1970, and the last in 1979. Each “investor” put \$500 a month into a portfolio that replicated the performance of the Standard & Poor’s 500 stock index for 30 years. The study assumed a \$10 share price at the beginning of each period, and all dividends were invested in additional shares.

Two of the hypothetical investors—the one who started investing in 1929 and the other who began in 1970—entered the stock market just before two of the worst bear markets in history. During the decade of the Great Depression, from 1929 through 1938, the S&P 500 had a negative annualized total return, losing almost 1% per year, and the 1970s were only slightly better to stock investors, with the S&P averaging a 5.9% annual total return during years of exceptionally high

inflation that reduced the value of market gains. Yet the investors could take solace from three positive factors during those dark days.

1) Investing during a bear market, they were able to buy shares of stock at depressed prices, and that let them accumulate more shares than they could have if prices had been higher. This positioned their portfolios for outsized gains when stocks recovered.

2) By dollar-cost-averaging—making regular, equal investments regardless of whether the market was up or down—and reinvesting dividends, the two investors who started during the bear markets would have posted small gains after the first decade. They would have done better than investors who had narrower portfolios or who had invested their money as a lump sum rather than as a series of periodic investments.

3) Compared with the two other investors, who accumulated fewer shares at a higher average cost during the rampaging bull markets that began in 1950 and 1979, the bear market investors fared much better after 30 years. The advantage of the investor who began in 1970 was particularly pronounced, thanks to stocks’ exceptionally strong performance during the 1980s and 1990s.

For the 30 years beginning in 1929, the S&P 500 provided a decent 8.5% annualized return, rewarding that

(Continued on page 4)



Normal Volatility Or The Trinity Of Risk

James Montier of Grantham, Mayo & Van Otterloo recently wrote on the company website that commonly used measurements of risk miss the mark. We agree. Convention has it that risk is volatility, or how much a security’s price fluctuates up and down. Mr. Montier redefines that to address the chance a security’s value will go down and never come back up.

While investors have to accept some fluctuation in the value of their accounts, they shouldn’t have to suffer a permanent loss. Montier puts forth a “Trinity of Risk,” or three areas where investments go permanently wrong. First and foremost, we can overpay. Second, the business becomes non-viable, like a buggy whip maker after the advent of automobiles. And third, the business takes on too much debt and can’t survive a downturn.

We’ve said many times that the game of investing is won by not losing. Mastering risk requires both a sharp eye and nerves of steel. A great ability to analyze risk isn’t worth a penny if we’ve decided beforehand that there isn’t much risk to measure; such is the nature of “investment bubbles.”

Risk is a seductive thing. It hides when it’s high and it is most visible when it’s low. It takes a concentrated focus to see it the other way around. We’ll have more on this subject in our Quarterly Investment Letter.

Be Well,

Ric and Trang

A Welcome Spike In Personal Savings

Are you looking for something good that may have come out of the recession? As a result of the economic downturn, Americans have generally been spending less and saving more. The savings rate in U.S. households in 2009 reached a high point of 6.9% of after-tax personal income in May. Even though the savings rate has slipped slightly since then, the watershed mark was the highest rate since 1992, when savings peaked at 7.7%.

While it's not an exact measure of fiscal health, the savings rate is the percentage of household disposable income that is put into savings rather than consumed. Mortgage payments are not considered savings, but retirement plan allocations (not capital gains) are. Although a sub-7% savings rate isn't much to brag about in most parts of the world—the annual percentage in other countries routinely hits double digits—it marks a dramatic shift in our personal financial habits. During recent years, the percentage of savings actually dipped below 1%, bottoming out at 0.4% in both 2006 and 2007. In 2008, the saving rate was still only 1.8%.

What's behind the trend towards

more savings? During the preceding two decades, rising stock market values and home prices had enticed consumers into thinking they had money to burn, and they became less and less inclined to save for retirement and other needs. Even retirees were encouraged to spend like there was no tomorrow.

But the recent precipitous decline in household wealth ended the wild spending spree. Real estate values around the country have dropped by an estimated 35%, and during the past two years, U.S. household wealth has been reduced by a whopping 140% of annual disposable income. That's a total of \$14 trillion.

Faced with daunting economic news, people have been forced to rein in spending, while increasing their efforts to prepare for a secure retirement. For instance, instead of buying goods with their checks from the economic stimulus package or taking advantage of other tax incentives, many people have chosen

to hold on to the money. And it doesn't look as if things will change radically anytime soon.

How long will the latest trend last? Most economists predict a slow, steady climb back to better times rather than a quick return to another financial boom. But cutbacks in domestic consumption

will also slow down the economic recovery. In the meantime, the savings rate is expected to rise gradually until it hits the 10% mark at some point during the next 10 years. Other financial experts believe the recovery period

could last even longer.

Of course, an increased savings rate is to be applauded, especially after it had plummeted dangerously close to zero. Americans will have to adjust to a lower standard of living compared with the heyday of 2007. But if forgoing a few luxuries is the price you have to pay for protecting your financial future, that's probably a trade-off you'd be willing to make. ●



Do You Really Need That Inheritance?

Sometimes it pays just to say “no thanks” to a generous bequest—even from your own spouse. There may be estate planning benefits to having the assets go directly to contingent beneficiaries named by the decedent. If those beneficiaries are your children, this strategy could help them keep more of the bequest.

Officially declining an inheritance involves executing a legal document known as a “qualified disclaimer.” This refusal, which can apply to all or part of a bequest, must be executed within nine months of the donor's death and before you've

received any income from the inheritance. While this is generally a reactive measure, similar results can be obtained setting up a disclaimer trust as part of your estate plan.

One factor in deciding whether to refuse an inheritance is the uncertain future of the federal estate tax. Repealed for 2010, it will be revived in 2011 under unfavorable conditions.

The amount of an estate that's exempt from federal tax, which was gradually increased to \$3.5 million for those who died in 2009, will drop back to \$1 million for 2011, unless Congress enacts new legislation.

Also, after gradually being

reduced to 45%, the top estate tax rate will return to 55%. The Obama administration and Congress will likely adjust the rules or change the timetable, but most experts expect the estate tax to continue to exist in some form. A qualified disclaimer or a disclaimer trust could help you prepare for whatever comes.

Suppose that under your current will, all of your assets are to go to your spouse if you die first, and vice versa. Then, at the death of the surviving spouse, the remaining assets will be divided among your children. With this arrangement, there's no estate tax due after the first

Best Times Often Followed Worst Times

These have been tough times for strategic long term investors. While it may seem logical to stay the course through the market's inevitable ups and downs—taking advantage of stocks' tendency to deliver strong returns over very long periods—that logic was little comfort during the bear market, when some portfolios lost more than half their value. Wouldn't it have been better to bail out in, say, late 2007, replacing stocks with cash or with bonds, which have outperformed equities during most of this decade?

Of course it would have been better, but myriad problems stand in the way of executing a successful market timing strategy, which calls for getting out of investments before they swoon and getting back in when they're ready to rise. To investigate market timing's feasibility, Donald Bennyhoff and Yan Zilbering at the Vanguard Group recently examined the performance of the Standard & Poor's 500 stock index from 1928 through 2008 and reported their results in a research note, "Market-Timing: A Two-Sided Coin." Looking only at prices—they left aside dividends because of a lack of data on daily total returns before 1980—Bennyhoff and Zilbering found that the index had returned an average of 5% a year during that 81-year stretch. A clairvoyant investor who had managed to be out of

the market on just the 20 worst trading days—avoiding an average loss on those dark days of 9.2%—would have gained 7.5% annually. Anyone who had missed the 20 best days, on the other hand, would have gained only 2.6% a year. That amounts to a 50% swing, up or down, in portfolio performance.

No one could ever hope to forecast all of the market's best and worst days. But given that infinitesimally small changes—being out of the market on just 20 of 20,340 trading days during the 81 years the researchers considered—can have a profound impact, it may seem worthwhile to try to identify some of them. What if, for example, you got out of the market after it had a particularly bad day, or got in after a really good one? Wouldn't more of the same be likely to follow?

Often that's not the case, according to Bennyhoff and Zilbering. Frequently the best and worst days happen within shouting distance of one another, and some of the best days have been particularly likely to follow hard on the heels of some of the worst. In dramatic turnarounds, eight of the 20 best days occurred within 10 trading days of one of the worst 20 days. On October 29, 1929, the S&P sank by 16.1%; the next day, it soared 12.5%. In 2008, a 7.6% loss on October 9 was followed by an 11.6% gain on October 13.

Post-plunge rebounds often last more than a day, with the market frequently recouping, during the next few weeks, a significant fraction of what it has lost. For example, the worst sell-off in the Vanguard study—on October 19, 1987, when the S&P 500 lost 20.5% of its value—was quickly followed by a lot of buying. Within 20 trading days of Black Monday, the market had rebounded by 9.6%. A similar thing happened during the 1929 crash; after that 16.1% free fall on October 29, the S&P stabilized temporarily, regaining 2.5% during the 20 trading days that followed. And in 2008? Twenty days after December 1, when the market fell 8.9%, it had regained 9.1%. Looking at the S&P's performance following all 20 of the worst days, the market regained an average of 2% during the next 20 trading days.

For would-be market timers, those tendencies make a difficult job virtually impossible. While it may be feasible to anticipate broad market shifts and to make tactical adjustments to a portfolio based on certain metrics like price-to-earnings ratios, any attempt to time a wholesale market entrance or exit will probably fail. Few people expected the stock market to surge when it did in the spring of 2009, or to advance as much as it did during the next several months. Investors who had cashed out their portfolios during the market rout almost certainly missed some (if not all) of the rally.

The recent volatility of the S&P 500—from day to day, week to week, and month to month—only reinforces how unlikely it would be for anyone to get in or out at just the right time. Rather than try to time the market, which almost always backfires, most investors would do better to stick with a well-diversified portfolio with regular asset allocation rebalancing to keep volatility in check and increase potential long-term gains. ●

Performance data quoted represents past performance and does not guarantee future results. Indices are unmanaged and do not reflect the payment of fees and other expenses associated with an investment. Investors cannot directly invest in an index.

death—because a spouse can inherit an unlimited amount tax free—and the surviving spouse's estate can be reduced, for tax purposes, by whatever individual exemption is in effect at the time.

But this wastes the exemption of the first spouse to die. Instead, the surviving spouse could disclaim an amount equal to the estate tax exemption, passing it directly to contingent beneficiaries. The first spouse's exemption relieves the heirs of any current estate tax liability, and later the surviving spouse's own exemption can be used.



Before disclaiming any assets, one's current and future potential need for the disclaimed assets needs to be carefully analyzed by a financial planner, since this is an irrevocable decision. We can work with you and your attorney to consider whether turning down an inheritance might make sense for you, and help you follow the rules that govern the process.

Also, if your net worth nears or exceeds federal estate tax exemption limits, we can discuss how setting up a disclaimer trust now can benefit your heirs. ●

New COBRA Benefits For Those Laid Off

If you're one of the millions of Americans who have lost jobs during this recession, finding a way to keep employer-provided health benefits is probably a top priority. The American Recovery and Reinvestment Act of 2009 could make that much easier, reducing your cost in most cases by almost two-thirds.

Under a 1986 federal law commonly known as COBRA (Consolidated Omnibus Budget Reconciliation Act), an employer with 20 or more employees must offer full-time employees the option to continue group health insurance coverage following a "qualifying event." (Other employers may volunteer to provide COBRA coverage.) If that event is a termination or reduction in hours, you're eligible for 18 months of extended coverage, which could be extended to 29 months if you've suffered a disability or 36 months if you're a spouse or dependent facing loss of health coverage because of an employee's death, divorce, or legal separation. Although a

company has to let you keep your insurance under those circumstances, it doesn't have to pay for it. You'll generally be on the hook for the full cost of coverage plus a 2% administrative fee.

Under the Recovery Act, your former employer may have to share that burden. Anyone who is involuntarily terminated from employment during a 16-month period—from September 1, 2008 through December 31, 2009—can elect to pay only 35% of the cost of continued health insurance coverage for up to nine months. The employer is responsible for the other 65%, though it can offset that obligation through a payroll tax credit, reduced withholding, or both.

There are income limits, however. If, during the year you claim the new COBRA benefits, you still earn \$125,000 in modified adjusted gross income (MAGI) for

single filers or \$250,000 if filing jointly, you'll get only a partial benefit, and you'll get no help if your MAGI exceeds \$145,000 for single filers or \$290,000 for joint filers. If you received the reduced premium and then exceed the income ceilings, you'll have to pay back the money when you file your taxes. The IRS is also expected to provide further guidance on the definition of "involuntary termination." It's likely to cover layoffs or job eliminations but not firings with cause.

Finally, the new COBRA relief can be combined with another tax break if you lose your job. This year's recovery law allows you to avoid income tax on up to \$2,400 of unemployment benefits in 2009. For more information about the COBRA premium reduction, go to <http://www.dol.gov/ebsa/faqs/faq-cobra-premiumreductionEE.html> or call 866-444-3272. ●



Bear Markets Are Good

(Continued from page 1)

period's systematic investor with a total return of 960%. Even more impressive, the investor who began in 1970 would have earned a 1,753% total return during the next three decades. And the investors who started during bull markets? Each earned total returns of less than 400% during 30 years of investing, according to the T. Rowe Price study.

The bear market investors thrived because they began when times were tough, rather than despite that apparent misfortune. To prove that point, the study also examined what would have happened if the first two decades of each period had been reversed—so that, for example, the tough sledding of the 1970s had been preceded by the strong market

performance of the 1980s, rather than followed by it. An investor beginning \$500 monthly contributions in 1970 would have had \$589,707 after two decades—but only \$358,972 if the decades had been reversed. That was true even though, in both cases, the S&P 500's annualized return for the 20-year period would have been an identical 11.5%.

Investing in the stock market during a bear market—and during the hard economic times that led to the downturn—requires a leap of faith for new wage-earners as well as for older investors stung by recent losses. But down cycles for stocks and the economy have always been followed by rebounds,

and equity markets tend to recover months in advance of a return to economic growth. As the T. Rowe Price study shows, it can pay to take advantage of those trends by beginning a program of long-term, systematic investing just when conditions seem worst. That's a lesson even middle-aged investors could take to heart as they look to regain their investment footing after the historic market plunge.



Performance data quoted represents past performance and does not guarantee future results. Indices are unmanaged and do not reflect the payment of fees and other expenses associated with an investment. Investors cannot directly invest in an index.