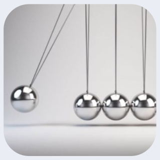

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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Retirement Uncertainties: Why Financial Planning is Necessary

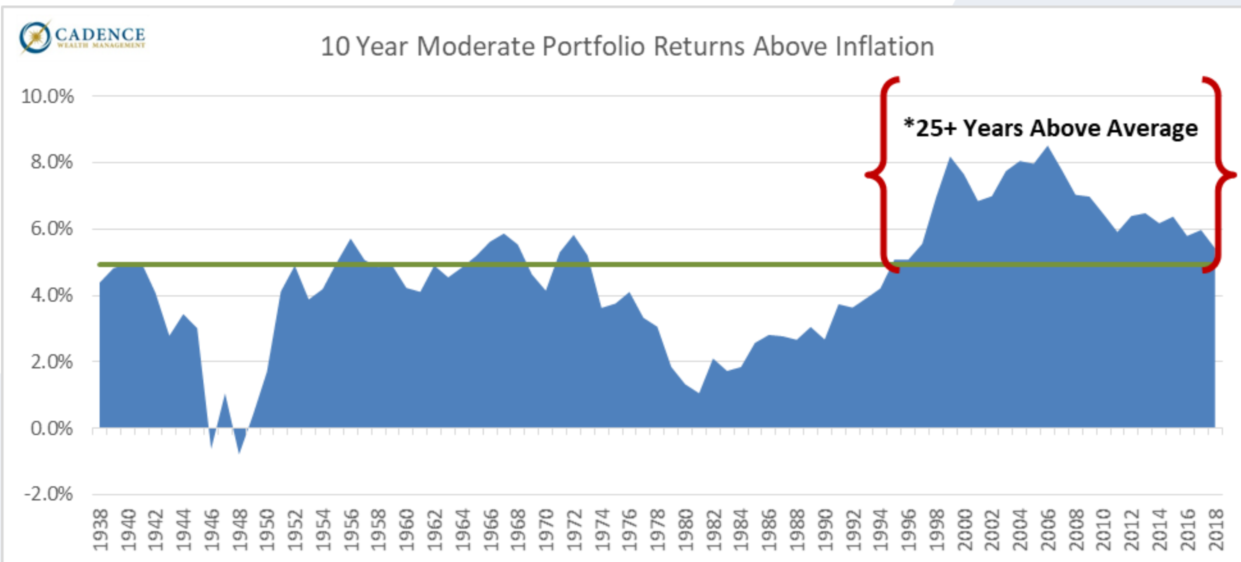
The only certainty about the future is that it is uncertain. When it comes to retirement planning, identifying the uncertainties and their potential financial impacts are our best shots at protecting ourselves from those things that could prevent us from reaching our retirement goals. Researching the "top issues facing retirees" yields list after list of future uncertainties, everything from living too long, to the solvency of the Social Security system, to speculation around future asset prices. While we reviewed many of the issues facing retirees today, we saw some we thought important enough to highlight, but we also noticed some important omissions.

It seems many of these articles are not written by financial planners that are sitting face to face with retirees and near-retirees on a daily basis. As professionals who possess specific knowledge of retirement finances and planning, we'd like to highlight those things that we as actual financial planners and retirement income specialists would like you to know. This list is not comprehensive, there are things on this list that may not apply to you, and there are things not on this list that may apply to you, but we believe these areas of concern are not given the attention they deserve, or aren't explained to the degree they should, or are just flat out overlooked.

1 *Retirees' expectations are based on a past that will probably not be the future.*

Our expectations on what will happen in the future are shaped by many things, and one of the most prominent is something called "Recency Bias". In a nutshell, we assume things will continue as they've been recently, so our assumptions around retirement are shaped by the fact that the U.S. stock market is currently enjoying its longest recovery ever from a bear market, Social Security is paying out its benefits as promised, and inflation remains near historic lows, among other things. Few are the people who assume, based on current conditions, that U.S. stocks and other investment assets will face below average returns, that Social Security benefits will drop, and that inflation will once again spike. For different reasons, all three of these scenarios are more likely now than they were ten years ago. The extent to which all of these things turn unfavorable at the same time is unknowable, but as all three are currently in retirees' favor, it is not at all a stretch to assume they could all break in the wrong direction.

After a record decade-plus bull market, investor expectations have been conditioned for this favorable environment to continue. In fact, moderately-allocated portfolio returns above inflation have been above average for over 25 years, even taking into account the two market crashes in that time period, because returns have been relatively high and inflation has been relatively low. Add to that reliable social security checks, reduced income tax rates, and a host of other factors, and it is easy to understand why most people assume these favorable conditions are "normal", as opposed to historically great as they have been. At some point, many of these favorable conditions will have to once again be "bad", and retirees who have used rosy assumptions unknowingly could easily find themselves in worse shape financially than they'd anticipated. Assuming a 7.5% rate of return above inflation on a half stock, half bond portfolio is understandable when considering the past 25 years, but we are already trending lower, and there have been many 10 year periods where returns above inflation have been much lower than that.

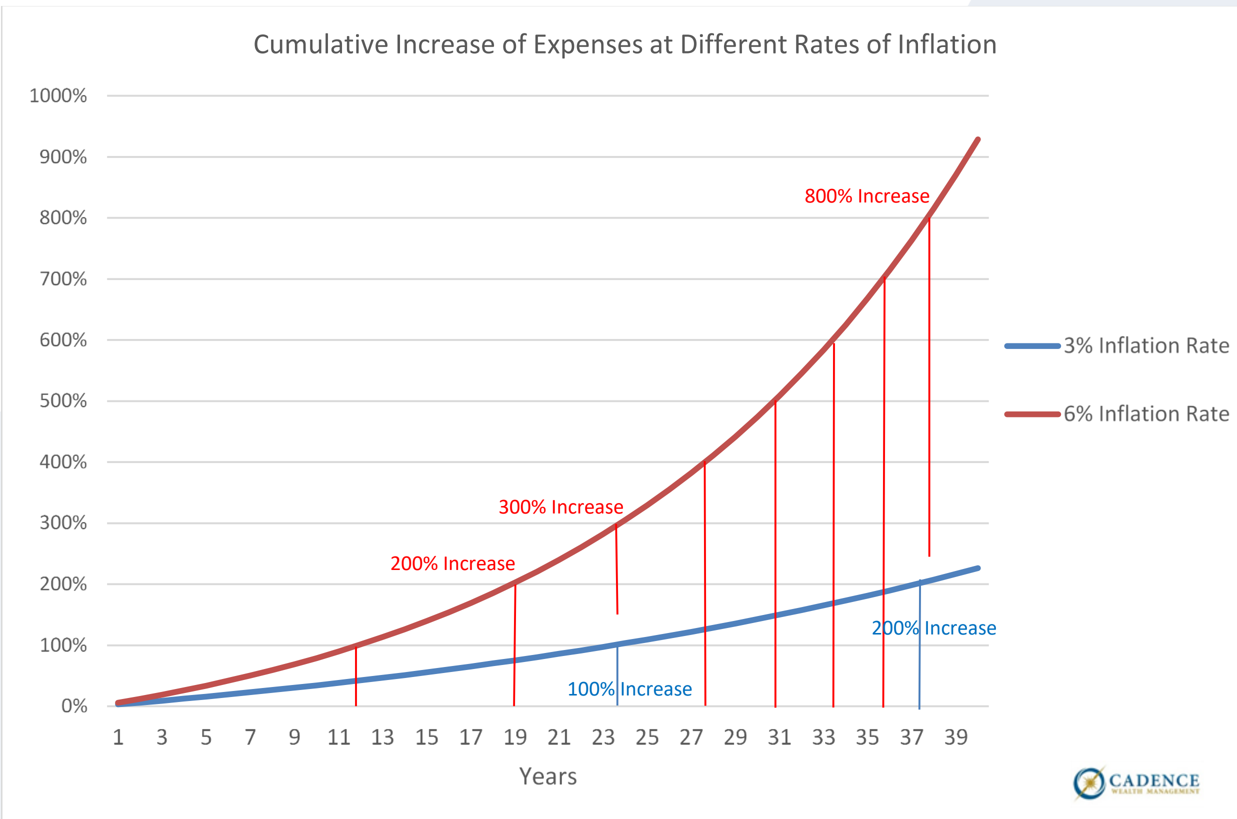


2 *Healthcare Spending Is Increasing Faster Than the General Inflation Rate.*

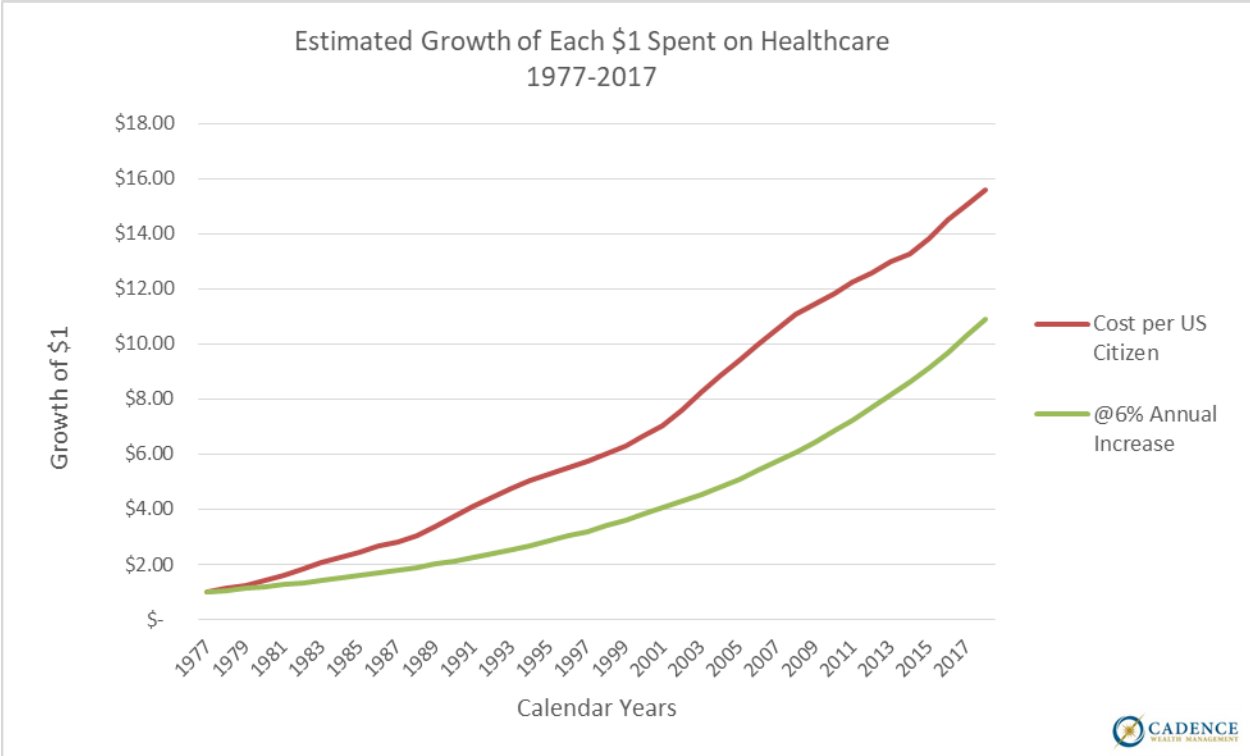
The changes to what we pay for the goods and services we buy do not increase by the same rate every year; some years they go up slowly, some years they jump up, and some years the cost of certain goods or services even goes down. However, the longer-term trend is that the cost of the goods and services we purchase to live our lives is increasing. For most items that historic increase is around 3% annually. However, healthcare costs have been rising much faster over the past 40 years, with many estimates falling in the 6% to 8%+ per year range. This is concerning enough when considering how expensive the cost of care will be for a 75 year old for the next 20 years assuming a nice long life. However, it's even more concerning for a 55 year old, because the younger you are, the more these costs could grow due to the compounding nature of annual increases.

For illustrative purposes, consider the cumulative growth over time of expenses growing by 3% and 6%, which are the assumed rates of increase for non-healthcare and healthcare expenses accordingly. The curved blue line is the cumulative increase in expenses experiencing a 3% annual rate of inflation, and the vertical blue lines underneath it mark the years in which the costs have increased an additional 100% over the original amount. So at 3%, the original cost has increased by 100% by around year 24, as noted by the first vertical blue line. 13 years later, that original cost has increased another 100%, as noted by the second vertical blue line. So the first 100% increase took 24 years, but the second 100% increase only took 13 years at a 3% rate of increase.

But notice what is happening to those expenses growing by 6% on average per year. It only took around 12 years for those expenses to increase 100% from their original cost, and then only another 7 for them to go up another 100% of that original cost, and then only another FOUR for them to increase 100% yet again. It is such that the 6% expenses have increased nearly 800% by the time the 3% expenses have increased 200%. If this is roughly how non-healthcare and healthcare expenses are going to behave in the future, a 65 year old retiree could see his or her healthcare costs increase 300% by age 88.



That seems incredible, doesn't it? Healthcare expenses can't possibly increase 6% per year for decades and decades, or it will eat our economy! That may end up being true, but consider this: according to the Center for Medicare & Medicaid Services, the cost of the amount spent on healthcare in the United States per person since 1976 has actually increased FASTER than 6%:



Hopefully healthcare costs increase at a slower rate in the future, and estimates suggest this has actually happened on a per capita basis the past handful of years. Unfortunately, many of the legislative accomplishments that made that possible have now been stripped away, so do not be surprised if those costs start increasing at a faster rate once again.

3 *The Potential Pension Bomb.*

Most American workers received pensions in past decades. When pensions started becoming more scarce, it forced Americans who had no real knowledge of saving and investing to manage their own money they would need to secure their retirements. By most accounts, this shift of responsibility has not worked out well for a large percentage of American workers. There are many current retirees with corporate and government pensions paying for part of their retirement, and there are also still a few companies offering future pensions along with most state and federal departments. That's the good news. However, not all is rosy with the state of current and future pensions. Approximately two-thirds of pensions are underfunded, which means their current balances appear inadequate to pay all their required future benefits. Additionally, most pensions are also assuming relatively high annual rates of growth on their investments, somewhere in the neighborhood of 7-7.5%. Even with those high assumed growth rates, most pensions appear to be under-funded. The remedy for that is those companies or government entities will either have to add more to their pension systems or they will have to reduce benefits. And that's IF they get that 7-7.5% annual rate of growth.

But, what happens if the rate of growth is lower than that? Well, an even higher amount of pensions will be considered under-funded, and the more under-funded a pension is, the more drastic the measures are that the obligated company or government entity must take. What's more likely: they add additional dollars to those pensions, or that they find ways to reduce the benefits to at least future, if not current recipients? How safe is your pension?

4 *When Should Someone Start Taking Social Security?*

There is an abundance of online advice on this topic. For every year beyond your full retirement age you delay taking social security benefits, those benefits go up 8%. As a result, many Internet experts say that's the way to go, as you can't guarantee getting 8% increases on your investments in any given year so you might as well take advantage of a guaranteed 8% increase in your benefit. Likewise, because you receive permanently reduced benefits by taking Social Security before your full retirement age, many Internet experts also caution about that strategy. Well. . . it's just not that simple. Financial need, health concerns, the state of the Social Security system, income tax rates, and many other variables that constitute your situation are too complex to solve with the cookie cutter approach "wait as long as possible, never take early". The full discussion on this topic is beyond this piece, but when it comes time to decide when to take your social security benefits, you should ask the help of your Cadence Wealth advisor, and we even suggest game planning that scenario in the years before you retire. We would highly advise against using Internet-provided rules of thumb to help you decide when to start receiving your benefits.

5 *How Much Home Equity Can Be Unlocked?*

For many years now, home-owning Americans had more equity in their homes than they did in their retirement accounts. In order to afford their retirements, they would have to find a way to unlock that equity, either by selling their homes and renting or moving in with family, or by downsizing to a cheaper home and netting the difference in the sale and purchase prices. Even for home-owning Americans with healthy retirement accounts, unlocking home equity by downsizing is a common strategy to increase retirement assets. Unfortunately, with so many baby boomers selling bigger and buying smaller at the same time, the forces of supply and demand have awakened to reduce the amount gained from selling a bigger home and buying a smaller home. Additionally, a low supply of cheaper homes in most metropolitan areas, competing with younger people looking at the same size houses as their starter homes, and the potential for rising mortgage rates all add up to the potential for retirees to not be able to count on supplementing their retirement savings with as much home equity as they thought.

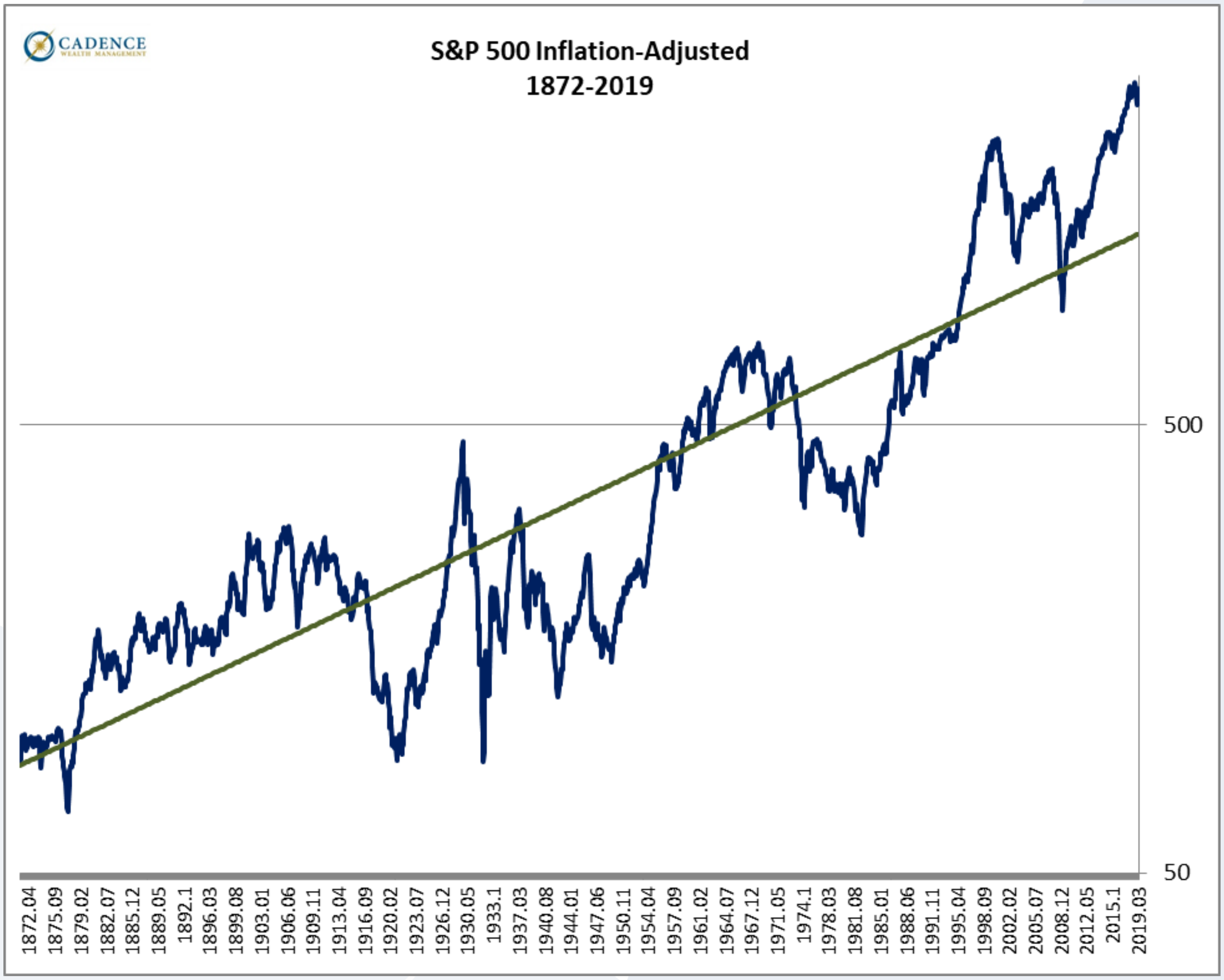
We are beginning to read more and more stories along this line, and as more Baby Boomers retire and put their larger homes on the market with an eye toward smaller homes, this trend is only going to pick up speed. The more large homes there are on the market, the lower those homes have to be priced to move. Likewise, the higher the demand for smaller homes, the higher their prices will move. Retirees will be getting pinched in both directions on that swap. There are ways around this, including moving to lower populated areas, but those moves come with their own tradeoffs. With real estate forces being a localized phenomenon, it very much depends on where a seller is selling and where a buyer is buying, but in general, retirees may not be able to count on unlocking as much home equity to supplement their savings when it comes time for them to make the swap.

6 *The Investment Elephant in the Retirement Room.*

You may have to account for at least one, but probably more of the preceding issues before and during your own retirement. However, the biggest threat that we can think of is also the one that gets almost no attention in the "biggest threats facing retirees" research we conducted, and it illustrates the need for people to work with a professional more than any of the items mentioned in the preceding paragraphs.

With the U.S. stock market currently enjoying its longest and largest bull market in history, the potential for large investment losses is very high. The last two major market losses, the Tech Bubble Burst and the Financial Crisis, saw stocks lose more than -50% at their worst, however they bounced back relatively quickly from a historical perspective.

The chart below shows the inflation-adjusted price of the S&P 500 since the 1870's (in blue) versus its long-term average (in green). The three peaks on the upper right represent the Tech Bubble, the Financial Bubble, and where we are today. You can see with the two previous large losses, the price of the S&P 500 did not lose enough or it rebounded quickly enough to not stay below average for long. This cannot continue. You cannot stay above average forever, and the history of the S&P 500 price moves shows it as plain as day: at some point this bull market will end and we will face a protracted period moving below average.



Just to get back to average, the S&P 500 would either have to lose a little over -50%, or it would have to lose a substantial amount with inflation rising to concerning levels once again. And that's just to get back to average; getting below average would be an even more stomach-churning combination of those two things.

So while lower than expected investment returns, paying for more and more expensive healthcare, reduced pension or social security benefits, and accessing less home equity than planned are all factors that could impact someone's retirement in a meaningful way, they do not compare to the prospect of losing half your retirement savings. An investor would have to be pretty aggressively invested to lose that much, and hopefully those close to retirement know better (though we know many, many Americans are currently taking much larger risks than they should), but even someone with only 60% of their investments in stocks would have lost almost -40% during the Financial Crisis of 2007-2009. Most retirees and near-retirees could not financially and/or emotionally handle losing -40%, and the likelihood of reacting to that loss by doing the wrong thing at the wrong time would only compound the problems losing that much would create.

If "safe" investment vehicles were paying more than they currently are, then some of this risk could be reduced, but with interest rates being so low for so long, conservative investors have been tempted to reach for more yield and higher returns by exposing themselves to more risk than they should. When all the stock market seems to do is go up, many other investment areas also appear less risky than they are. Many issues facing retirees are manageable by cutting back here and cutting back there, but large investment losses are a game-over situation for many investors.

All of these conditions highlight the need to work with a professional who can help navigate the dangers currently facing retirees and near-retirees. Identifying these and any other issues that may keep you from reaching your retirement goal, and then strategizing and implementing a solution to these and other issues make successfully navigating these dangers possible. There is an abundance of "What Every Retiree Should Know" type articles out there, but which of their highlighted concerns apply to you? Which of them apply to your parents, or your children? And, what are they leaving out that may be even more important for your specific situation? Although the only certainty with the future may be its uncertainty, we can still reduce the risks of those things most likely to threaten your retirement, even stomach-churning financial market moves. Though we may not be able to predict the future, we CAN plan for it.

Stocks – Guarding Against the Equal and Opposite Reaction

Over the last month the U.S. stock market has continued to rebound from its fourth quarter sell-off. The S&P 500 and Nasdaq have made new price highs, while the Dow Jones Industrials and broader NYSE Composite still remain below their highs set in the third quarter of last year. Although we still continue to feel that the odds are good this rally will end up being shorter lived and part of a larger downward trend, it has been very explosive and there's certainly a possibility that the other indexes and broader stock market continue higher from here. As we've discussed in the past, there are forces at work in today's market that have clearly distorted what we'd consider normal and rational price discovery. Although these factors have and could continue to cloud important market signals over the coming days and weeks, they won't forever. As Sir Isaac Newton put it, "for every action, there is an equal and opposite reaction". This market to us reflects a spring that has been stretched to its extreme. The forces acting in the opposite direction already exist and they are great. This is why central banks around the world are unwilling to "release" the spring. It's becoming increasingly clear it will have to break on its own.

<u>Stocks and GDP</u>

One way to think about the extent to which the spring is stretched is by looking at the performance of stocks relative to the underlying economy. In general, the growth rate of a large group of companies profits should approximately equal the growth rate of the economy over time. By extension, the growth rate of those companies shares should approximate the growth rate of the economy. From 1955 to 1985 the average two-year rate of growth for the economy (before inflation) was ~16.5% while the S&P 500 grew at ~15% on average. Close. However, since 1985, those growth rates changed to ~10% and ~20% respectively. So, for the past 34 years, the stock market has been growing at a rate nearly double that of the economy. How can this be?

<u>Debt</u>

First, the use of debt and leverage within the economy has picked up considerably over this period of time. In 1955 total debt across consumers, corporations, and government in the U.S. was 135% of Gross Domestic Product (GDP).

This grew marginally over two decades measuring 190% of GDP in 1985. However, since 1985 the total debt expanded to $72 trillion dollars representing 345% of GDP!

With leverage comes increased profits and returns. Here's how it works: Consumers can buy more stuff when they borrow money to do it. When the government borrows, it can also buy more stuff or pay for more services than they'd otherwise be able to. This increase in consumption increases corporate profits. When corporations themselves borrow, they can boost profits by making productive investments. When profits go up, stock prices go up. Corporations can also create the appearance of bigger profits by borrowing money to buy back their shares. This reduces the number of shares that profits are divided between which leads to more profit per share. The bottom line is that debt can boost profits – for a while.

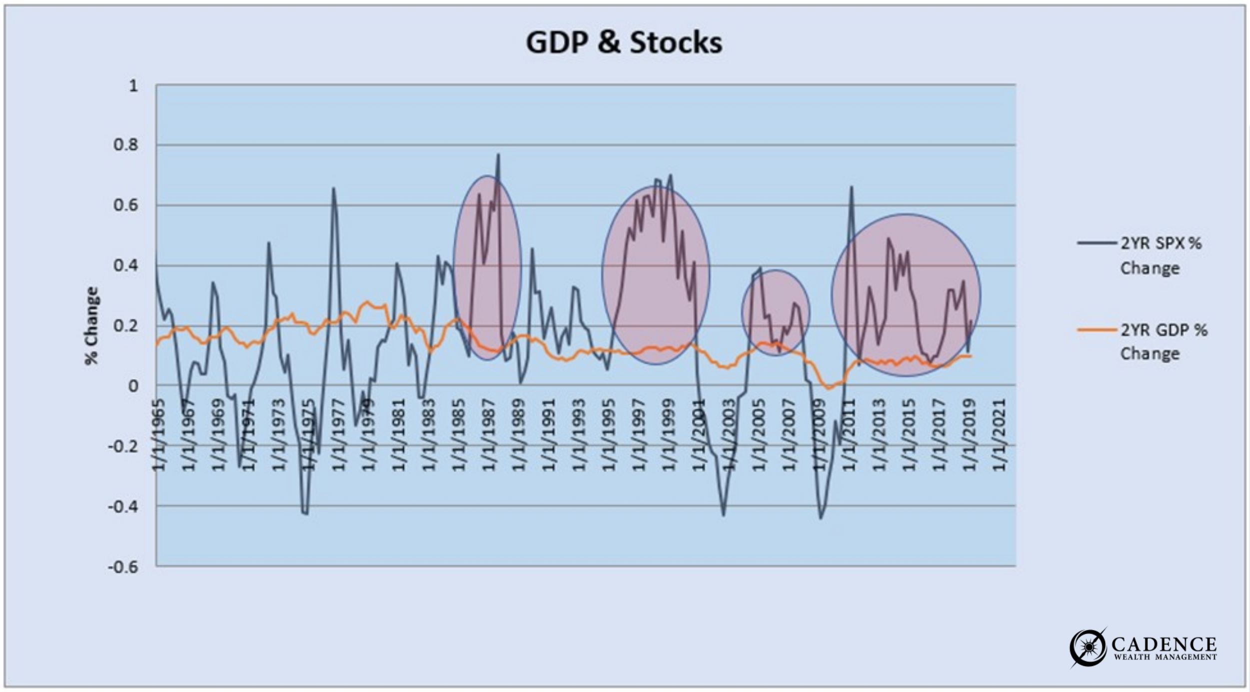
At the same time, this debt eventually leads to slower economic growth since borrowing has its limits. Payments made to service interest can no longer go toward other productive purchases or investments. This phenomenon is referred to as "Peak Debt" and represents that point where additional debt no longer creates positive economic benefit. It's where the system is simply maxed out. The sluggish economic growth despite drastic central bank intervention over the last 10 years suggests we have in fact reached "Peak Debt". It's interesting to think about where the stock market and economy would be without all the debt that's been added to the system. We won't get into the math, but one could make a strong argument that most if not all of the growth we've seen in markets and the economy over the years has been directly attributable to the growth in debt.

<u>Profit Margins</u>

The other factor that can lead to stock market returns outpacing economic growth is corporate profit margins. If a company experiences a 10% increase in sales, but by cutting costs and increasing efficiencies, raises its margins from 6% to 10%, then profits jump by not 10%, but a whopping 67%. Here's the math: At $1 million of sales, after applying a profit margin of 6%, profits would be $60,000. If sales go up to $1.1 million, then profits increase to $66,000. If however the profit margin rises from 6% to 10%, then without any increase in sales, profits jump to $100,000. After increasing sales by 10%, profits jump to $110,000, an increase of 67% over where they were initially. This example illustrates the power of an expanding profit margin on corporate profits.

Corporate profits as a percentage of GDP up until 2005 averaged 6.3%. Since then they've averaged just under 10%. This represents a roughly 60% increase above what historically has reflected an average and balanced margin level. Another interesting question to ponder is what happens to corporate profits if and when these margins begin to contract. From our example above, it's pretty clear that all else being equal, stock prices would have to reflect a whole new level of profitability. A significantly lower one at that.

These issues of debt and profit margins are longer-term considerations. They can manifest in very long cycles that take decades to play out. In fact, these very two issues are probably the two biggest contributors to the Japan story that we highlighted last month. Very long periods of time where markets outpace the economy can lead to equally long periods where market returns lag economic growth. This was clear in Japan leading up to the 1989 peak as well as after it. These are factors that shape our outlook over 10-20 years, which we've discussed and will continue to. For the investor more concerned with where markets may be headed over the coming weeks, months, and handful of years, the chart on the following page may help. What you'll see is stock market returns and nominal (before inflation) GDP returns for 2 years at a time. You'll notice that they tend to ebb and flow in the same direction, but can vary in the degree to which they move. You'll also notice that up until the mid-1980's, any significant swings associated with underlying economic fundamentals tended to be short-lived. If things got too positive in markets, they came back down to reality before too long. Same when they got too negative – they snapped back before too long and at least approached the direction of the fundamentals – those things driving corporate profitability and by extension, stock market performance.



However, something changed in the 1980's. The periods of stocks outpacing economic growth became more frequent and longer term. You'll notice the shaded areas represent those periods – they are the mid 1980's, the late 1990's, the mid 2000's, and essentially the last 8 years. Importantly, each of these periods led to eventual market adjustments that could be categorized as panics. Black Monday in 1987, the Tech Crash in 2000, the Financial Crisis in 2008 all brought stock prices back toward the gravitational pull of the underlying economic fundamentals. It remains to be seen what type of situation manifests in bringing today's prices back to Earth, but there should be no doubt that what we've seen in stocks here in the U.S. is absolutely detached from economic reality.

In summary, the proliferation of debt and elevated profit margins have led to a very long period of stocks outperforming the underlying economy. This has created the perception that the two have little to do with one another. This is recency bias in action relative to the last 100 years of market and economic history. As we've learned from other advanced economies such as Japan who've walked this path before us, the two come back into alignment eventually. In the shorter term, market performance tends to move in the same direction as economic performance. Although they can drift apart for years at a time, they tend to snap back together one way or another. Stocks here in the U.S. have outpaced the economic reality for more than 8 years. This is the aberration. A drastic realignment would be more the norm. Big market bounce notwithstanding, investors would be well-served staying focused on the facts, not the hype. At some point, if natural market forces aren't allowed to play out with respect to this realignment, the spring will simply break. As wealth managers, we are consumed with guarding against this scenario for the simple reason that it's the one that will most egregiously derail investors from their financial goals.

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