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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Bubbles, Volatility, and Your Retirement Nest Egg

By Casey Clarke

One investment theme that will continue to be with us in 2025 is that of a market that just won't quit. How far into 2025 we'll have to see, but it's fair to say that this stock bull market is so long in the tooth that it's already elicited protestations similar to Irving Fisher's famous "the stock market has reached a permanently high plateau" comment in the days preceding the 1929 peak and subsequent Great Depression. Whether it can continue on much further and for how long isn't the question we should be asking, however. The important consideration is what it will do to our portfolios and retirement plans when it turns the other way. The answer to the latter is best answered by looking at actual points in history that resemble where we are today. There are a few to choose from, where financial assets are bubbliciously expensive, real assets aren't, and sentiment resembles more that of a gambler than a calculating investor, but we'll pick the most recent – the tech bubble of 2000. Many seasoned investors remember how that one played out - what it felt like along the way, as well as afterward, and the effect it had on either themselves or people they knew.

Let's agree on a premise before getting into it: We are talking about money we can't afford to lose, which means if we lose it, we would be affected both emotionally and financially in deleterious ways. We sometimes hear clients say, "I'm okay taking risk with this money, because I don't need it" to which my first reaction is, "so you wouldn't miss a beat if you lost all of it?" Usually, the answer changes once they consider the possibility of losing it all, a thought which when chasing hot investments with crazy return potential seems distant if not impossible. With the idea of wishing to avoid unnecessary losses in mind, let's look at three different portfolio strategies one could have, and in fact did adopt in late 1999 in preparation for the decade ahead, starting with the most common two.

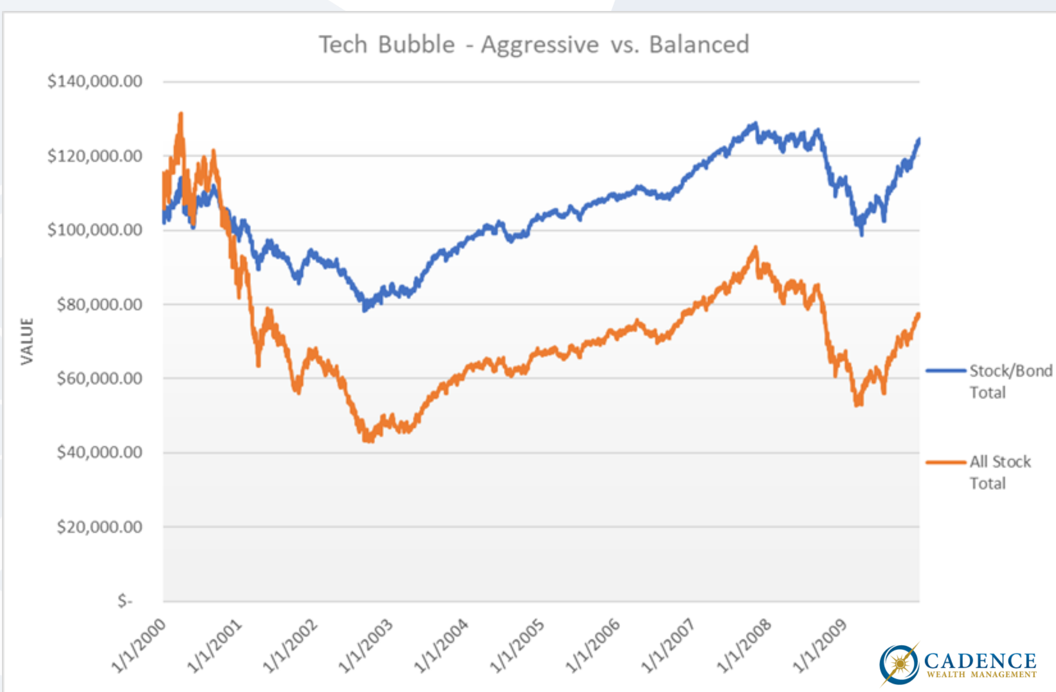
First, we have an all-stock portfolio which appealed to the aggressive investor who wanted to earn returns similar to those most recently experienced – high double-digit ones, year after year. The thinking of course was that the internet was going to change the world (as well as the laws of valuation and finance) and make this extrapolation possible. Of course, our aggressive investor focused on where those returns were highest and best and invested heavily in technology. The second common approach was a bit more prudent; to incorporate some bonds into the mix. This more conservative and better diversified portfolio had 50% invested in bonds. So, our two hypothetical portfolios break down as follows:

	Aggressive	Diversified
Fidelity U.S. Bond Index	0%	50%
Rydex Nasdaq 100 Fund	50%	20%
Fidelity 500 Index Fund	50%	30%

(As simplistic as these two portfolios are for illustrative purposes, they capture very effectively the actual experience of investors during the decade of the 2000's).

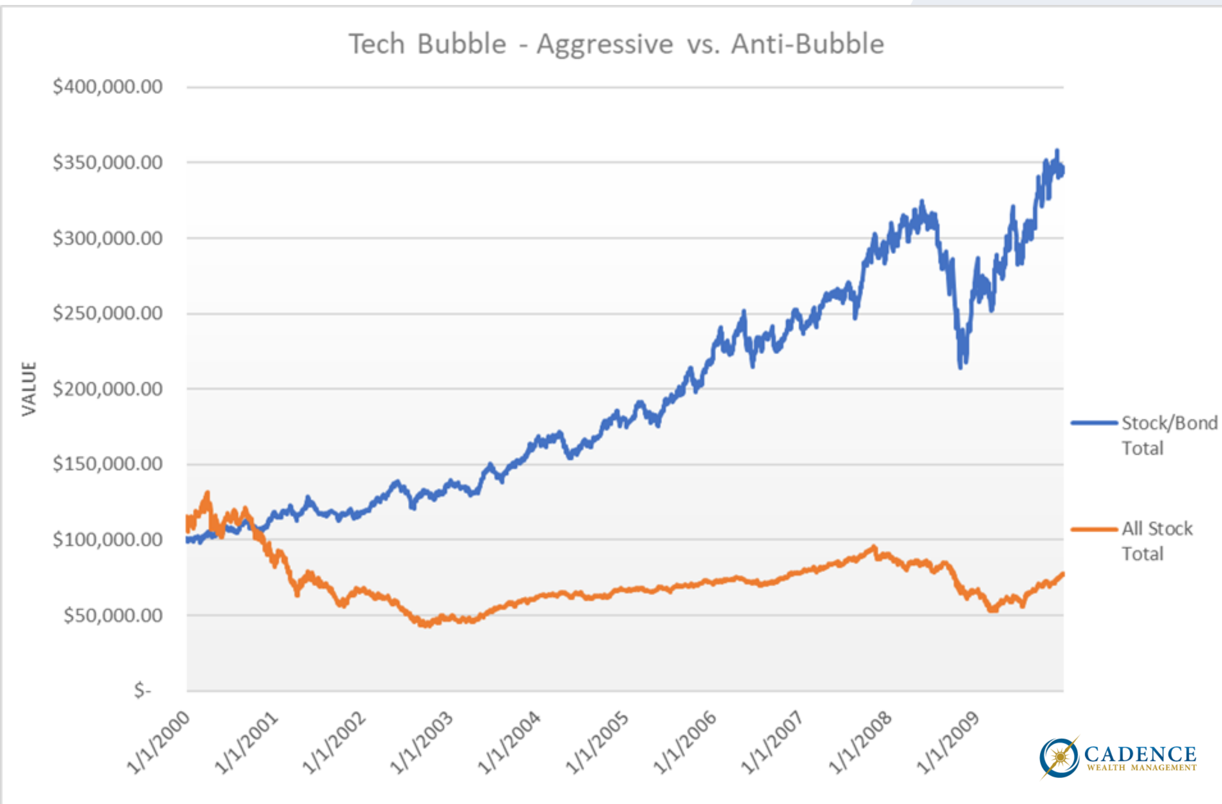
What we notice in the chart below is that even though the diversified portfolio would have avoided the huge losses that the aggressive portfolio sustained, it still declined more than one would like and stayed down for an extended period of time. Keep in mind, these portfolio illustrations are simplified for illustrative purposes and also don't take into account any fees. The reason this is important isn't because fees would have made it worse, but because horrible results can be accomplished all by themselves by being in the wrong markets at the wrong times. The moral of the story for investors coming into the 2000's is that basic stock and bond diversification didn't do much to help the situation. Having any meaningful exposure to large (tech) stocks, given the magnitude of their valuation excesses, was enough to do fairly significant damage.

(The balanced portfolio was a mere 25% higher ten years later, while the all stock and technology-heavy portfolio was still more than 20% lower!)



What was the alternative, third, option in early 2000? Of course, it was the stuff nobody was talking about at the water cooler, in the lunchroom, or in financial media. The categories that would provide the most protection against what was to come, and actual opportunity for gains, were those that were most neglected and unpopular in the years prior. It's somewhat akin to the high school quarterback or prom king and queen being outdone years later by the class nerd. In some ways, too much attention and success early sows the seeds for difficulty and challenges later on. In markets, where that success can be measured and quantified with price and value metrics, this is almost always the case. The quiet, nerdy kids of the late 90's were natural resource stocks and treasury bonds, much the same way they were in previous stock market bubbles like the late 1920's and late 1960's. Below is a graph showing a portfolio over the same timeframe as the prior two invested 50% in the Vanguard Long Term Treasury Fund, 25% in the Franklin Natural Resources Fund, and 25% in the Franklin Gold and Precious Metals Fund. We've left the all-stock portfolio in the graph for comparison and to highlight just how different an outcome it would have been for an investor opting for the nerd over the prom king in late 1999.

The nerd finally got his time to shine, big time.



The Added Complexity of Income

Things get a little more complicated when it comes to structuring a portfolio for income. There are a host of tools and factors to consider, but when it comes to structuring an investment portfolio, there are a few important concepts that need to be kept front and center. They are as follows:

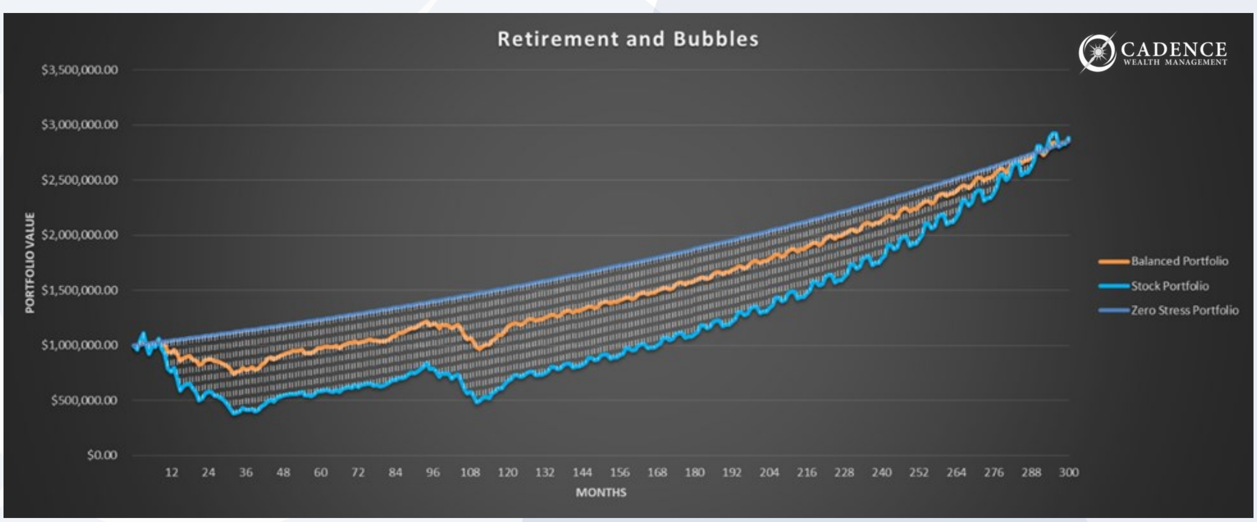
- Big losses early on in one's retirement are much more damaging than big losses taken late. This essentially means that anybody who's financial plan couldn't absorb losses of 30-50% should have very limited exposure to overly expensive assets (bubble assets).

- The more volatility a portfolio experiences, the more systematic withdrawals will hurt it. For example, a portfolio that averages 6% over time with low volatility could actually be more favorable than a volatile portfolio that averages 8% when you incorporate regular withdrawals. The reason for this is because when the latter loses a lot, and money is taken out, it becomes harder to get back to where it was. Withdrawals on heavy losses, especially repeatedly, aren't good.

- That said, sometimes the safe, fixed investment, although it might feel nice from month to month, isn't the best option either. Inflation can increase the size of withdrawals from a portfolio over time, and if we're not growing the portfolio sufficiently in the early years to account for that, we can fall behind.

- Finally, returns that are too low over time can be detrimental as income is being systematically withdrawn from a portfolio. Usually, the reason for this is simply too much exposure to something that is too expensive and ultimately declines a lot in value. In this case, even the "balanced" stock and bond portfolio can get us into trouble if enough of the assets in it decline in value too much and stay down for an extended period of time.

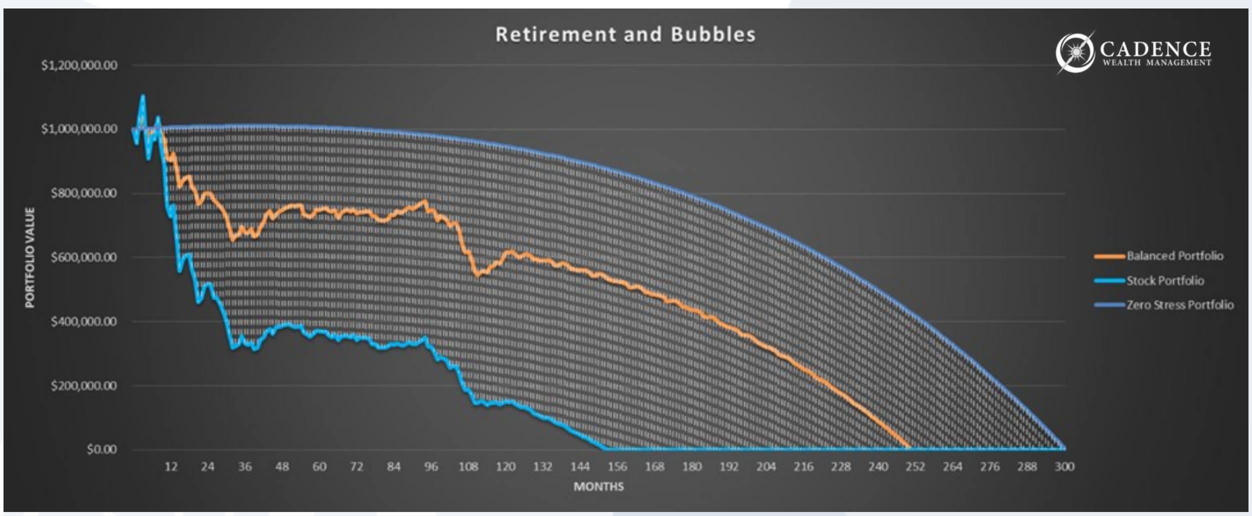
The graph below shows the two portfolios we discussed earlier with actual returns for the first 10 years, then hypothetical returns for the remaining 15 years. Those hypothetical returns average 6% for the balanced portfolio and 10% for the all-stock portfolio with monthly volatility levels that resemble those which one would expect. The third, steadier, blue line in the chart represents a fixed investment earning 4.2% annually. What we can see here is that all three portfolios after thirty years end up in roughly the same spot. How is that possible, you wonder? Because the risky ones had maximum risk baked into them at the beginning of this time period. Another way to put this is that when markets become excessively priced (bubbly), they have essentially stolen returns from the future much the same way over-indebtedness steals consumption from the future. It takes years to deal with this before getting back to a more typical pattern. The result is much lower long-term returns than one was accustomed to before (if they overstay their welcome).



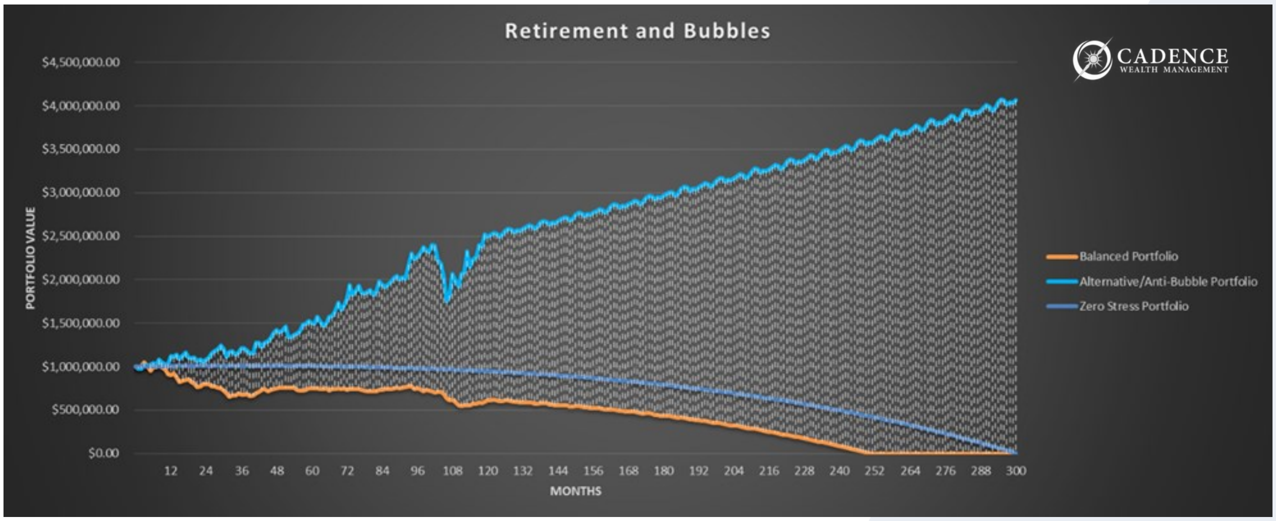
Fair enough. I can wait it out, you say. Remember the bullet points above about taking income from a portfolio that suffers big losses early on and/or poor long-term returns as a result of assets being too expensive. If you have too much exposure to expensive assets that go down and stay down, this can be problematic as the distributions you're taking effectively amplify the losses within the accounts. When you have income needs, waiting out long-term losses isn't an option. The graph below shows the three portfolios we discussed and what happens to them if we take a very modest and typically sustainable 3.6% of the portfolio value out beginning in year one, and adjusting upward with inflation every year. Here's the scenario:

	Value	Inflation
Starting Portfolio Value	$ 1,000,000	
Monthy Fixed Income	$ 2,000	2%
Monthly Expenses	$ 5,000	4%
Monthly Port Withdrawal	$ 3,000	

What we can see is that the most aggressive 2000 Tech Bubble scenario does the worst, fully depleting the initial $1,000,000 after roughly 13 years. The balanced portfolio provided an extra 8-9 years of income, but also runs out after about 20 years, and the fixed option depletes after 25 years. The first two portfolios get into trouble due to heavy losses early and poor long-term returns as a result of investing too close to the end of a financial asset cycle, while the safe fixed option, even while earning more than our initial withdrawal rate (4.2% vs. 3.6%), eventually gets overtaken by inflating expenses. So, our retirement plan gets affected by both of the standard stock/bond options as well as the safer, non-market option. Fortunately, there is the nerdy, quiet kid.



The graph on the following page is the same as above, but swaps in our treasury bond and natural resources portfolio from the 2000's for the all-stock portfolio. After ten years of actual returns, we switch over to our hypothetical balanced, stock/bond returns of 6% per year with some volatility. Keep in mind, this is completely hypothetical and intended to illustrate a couple important points. First, just as there was in 2000 and in other major asset bubbles in history, there are always alternatives. Second, if one focuses on owning investments rather than speculations, she will naturally reduce the likelihood of something going down a lot in price and staying down for an intolerable length of time. Volatility from month to month can't be avoided, but fortunately it isn't nearly the problem that the other factors are. As long as volatility is likely to be skewed to the upside rather than down (overall trend is up), then we can look at it as par for the course. The alternative is the safe depletion of our capital to inflation. At any rate, what you'll notice in the chart below is a completely different retirement scenario. The first 10 years is what an investor in this mix of investments would have actually experienced (before fees), after which point we can see that the modest swings of a hypothetical balanced portfolio don't detract from progress one bit. The portfolio value is more than sufficient to support any income withdrawals needed.



<u>The Important Takeaway for 2025</u>

Until the stock market bubble pops, the emotional pressure to participate will continue to be heavy. That pressure will increase further during periods when the alternative investment categories experience weakness; bads days, weeks, and months. We need to expect this and remember that it doesn't matter much at all relative to the bigger picture. That bigger picture is summed up in the charts above, and more broadly in what every post-bubble period in history does to the average investor; especially those who are retired and can't replace losses in the portfolio with additional contributions. As we've highlighted plenty in prior Clips, if we remain focused on where we are in various cycles and investment versus speculation, what happens over the short term need not affect us. If the decades of the 1930's, 1970's, or as we looked at today, the 2000's, are any indication of how adopting an alternative investment approach in these crazy times might ultimately play out for us, there's plenty to look forward to.

Happy New Year to you from our team at Cadence!

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