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Has the Potential for Stocks Changed?

Since the turn of the 21st century, it has been tough for investors in U.S. stocks. If you include the year 2000 (technically, the last year of the 20th century), the Standard & Poor's 500 has had four losing years out of the last 12. In two of those years, the index had large losses: 22% in 2002 and 37% in 2008.* And, over those dozen years, the S&P 500 has generated an average total return (price change plus dividends) of just 0.6%.

What's dismaying is that Baby Boomers have been raised to believe that stocks return an average of 10% a year and handily outperform bonds. Yet, since 2000, the opposite has been true. Intermediate-term government bonds have returned an average of 6.5% a year, and long-term government bonds have returned an average of 9.5% a year.*

Now, having suffered through two recessions, Europe facing further financial and political upheaval, and concerns that the U.S. economy may be headed for another recession by next year, it's no wonder that stock investors are concerned. For many, the optimism cultivated over 22 nearly blemish-free years of positive stock market returns from 1978 through 1999 has substantially diminished.

So it's fair to ask: has the world fundamentally changed? Are stocks destined to have lower returns in the future? The answer is not if you put the last 12 years in perspective.

The Average Long-Term Return Hasn't Changed

Over the last 58 years, the stock market has certainly been volatile, but its long-term average annual return hasn't changed all that much. Using 1926 as a starting point, since 1954, the *average* annual return for the S&P 500 has ranged from a low of 8.45% (in 1974) to a high of

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Calculating Your After-Tax Rate of Return

To help make investment decisions, you should calculate your overall and after-tax rate of return on your investments. Conceptually, an investment's total return equals the change in market value plus any dividends, interest, or capital gains, divided by the beginning market value. Practically speaking, however, total return can be difficult to calculate, especially if you invested additional money or took distributions.

Once you know your total return, calculate your after-tax return. From your dividend, interest, and short-term capital gain income, deduct the amount paid in taxes at your marginal tax rate. From your long-term capital gains, deduct capital gains taxes paid. You can then calculate your after-tax return.

If there's a significant difference between your total return and after-tax return, reevaluate your investment strategy to make it more tax efficient. Emphasizing investments that generate capital gains or placing income-generating investments in a tax-deferred account are just two strategies you may want to consider. Please call if you'd like to discuss this in more detail. ○○○

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Has the Potential?

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11.30% (in 1999) and has a median return of 10.21%. That's close to the index's average annual return of 9.8% since 1926.

The Longer You Hold Stocks, the Less Risky They Are

One way to measure how risky stocks are is to look at the performance of the S&P 500 over increasingly long periods of time. Since 1926, the index has had 24 down years out of 86, so it has been down nearly 28% of the time.

If you look at rolling five-year periods — of which there have been 82 since 1926 — the index has had just 12 losing periods. Significantly, five of the last 10 have been negative. One of those ended in 2011, with an average annual loss of 0.25%.

But it's important to recognize both the fact that losing five-year periods have occurred before and they're rarer than one-year losses (14.6% versus 28%).

Studying longer holding periods improves the record even more. There are just four losing 10-year periods out of the 78 since 1926 (5.2% of the time), and not a single losing 15-, 20-, or 25-year period. As an asset class, stocks become less volatile the longer they're held.

The Outlook: More of the Same?

Does history repeat itself? Nobody really knows whether stocks will continue to behave over the next 86 years as they have over the last 86. If the U.S. is permanently descending into a lower rate of economic growth than it has experienced since 1926, it's possible that the long-term growth rate for stocks will, too. But the Great Recession of the 21st century still hasn't proven to be as bad as the Great Depression of the 1930s, so there's reason to think the U.S. economy will fully recover.

Likewise for the prospect that over the long haul from here, stocks will continue to return about 10% a year. In the short run, though, stocks may be laggards and returns more volatile than average. As they say, historic performance is no guarantee of future returns.

In the end, you have to balance your need for growth with your tolerance for risk. At the same time, it is important not to let recent history slant your views and make you unduly risk averse. Prudence, as always, is the right course, though what constitutes prudence is different for every investor. Please call if you'd like to discuss this in more detail. ○○○

* Source: *Stocks, Bonds, Bills, and Inflation 2012 Yearbook.* The S&P 500 is an unmanaged index generally considered representative of the U.S. stock market. Returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment. Investors cannot invest directly in an index. Past performance is not a guarantee of future performance.

Control Your Spending

If you're trying to increase savings, remember that savings are directly tied to spending — the less you spend, the more you have to save. Some tips to help you control spending include:

✔ Analyze your spending for a month. Are you surprised by how much you spend on dining out, groceries, entertainment, or clothing? Give serious thought to your purchasing patterns, looking for ways to reduce spending. Clean out your closet and really assess whether you need new clothes. Cut back on how often you dine out, or at least choose less-expensive restaurants. Rent a movie instead of going to the theater. Make a list before grocery shopping and don't deviate from it. Look for coupons and sales before shopping.

✔ Go over major expenditures also. When was the last time you comparison shopped your auto or homeowners insurance? Have you checked mortgage rates lately to see if you should refinance? Have you reviewed strategies to reduce your income taxes?

✔ Make a spending plan and put it in writing. Budget for all major expenditures and resolve not to purchase items that aren't in your budget.

✔ Throw out your credit cards (or at least hide them for a while). Most people find it more difficult to spend cash than to charge a purchase.

✔ Don't purchase items over a fairly low dollar amount until your second shopping trip. How often have you purchased something on impulse, only to realize when you got home that you really didn't need it? To control those impulses, compare price and value on your first shopping trip. Then go home, think about whether you really need the item, and purchase it on another trip.

✔ Think carefully before making major purchases. Often, upkeep and maintenance will add to your costs. Consider a less-expensive car or a used car. Keep your car for four or five years instead of getting a new one every two or three years.

✔ Figure out the maximum amount you can afford for a house and then buy one substantially less expensive than that. Not only will you save on your mortgage payment, other costs associated with owning a home will be lower. Living well within your means is one of the best ways to ensure you have money left over for saving. ○○○

Retirement and the 4% Rule

Wouldn't it be great if there was a nice, simple rule you could follow to know how much money you could safely withdraw from your retirement savings if you want it to last for 30 years or more? Well, it just so happens that there is.

It's called the "4% Rule," and it doesn't require much explanation. In retirement, take out no more than 4% of the combined value of all the financial assets you own and they'll last 30 years or more — more than the average length of time Americans spend in retirement.

However, the 4% Rule may be much more valuable as a guide rather than a steadfast rule.

The "rule" originated in a 1998 study by three professors from Trinity University in San Antonio, Texas. They tested five different portfolio asset allocation strategies using historical market index performance for stocks and bonds for the 70-year period from 1926 through 1995, and annual withdrawal rates ranging from 3% to 12%. They found that regardless of the asset allocation — from all stocks to all bonds and several mixes in between — capital remained in the accounts after 30 years if withdrawals didn't exceed 4% a year.

So, if you're 65, have a retirement portfolio of $1 million, and don't want to run out of money until you're 95, then you can withdraw up to $40,000 a year.

Right off the bat, a few things seem awkward about the 4% Rule:

- What if you need more than $40,000 a year?
- What do you do if you live to be 100?
- What if you get really spectacular returns in your first few years so that by the time you're 95, you find you have a much bigger surplus than you expected? You may realize, much to your dismay, that all along you could have afforded a more comfortable lifestyle.
- What if in the first few years of your retirement, the stock market drops by 45%?

Questions like these very quickly show the real value of the rule: it's a good place to start. As a starting point, the rule can be especially sobering for people who think they can withdraw 8% to 10% a year or more for 30 years.

Four percent is a good number to use to estimate how much you need to accumulate to retire. For example, if you want $100,000 a year, it's going to take a nest egg of $2.5 million in today's dollars.

The Better Way to Optimize Your Withdrawal Rate

The truth is that using the "right" withdrawal rate year after year is a lot more complicated than applying a simple rule of thumb. You need to take into account your health, your family history for longevity, variable rates of return, your risk tolerance, and all of your goals, including what kind of legacy you may want to leave.

Ultimately, the only right way to determine how much you need in your retirement nest egg before you retire and how much you can withdraw annually once you're in retirement is to create a comprehensive financial plan and then update it at least once a year. Please call to discuss this in more detail. OOO

Changing Life Insurance Needs

Your life insurance needs will typically change over the years:

Just starting out — Young, single adults may have little need for life insurance, since they have no major debts and no one else counting on their income.

Married with no children — You may think you don't need insurance if both spouses work. However, if it takes both salaries just to make ends meet, you may want to purchase insurance to replace your income.

Two incomes with children — This is typically the time when your insurance needs are the greatest, since several family members are depending on your income. The death of either spouse can create a financial hardship. Even if only one spouse works, the death of the nonworking spouse can require additional funds to take care of the children and home.

Middle age with children — You should reassess your insurance again as your children approach college age, since you may need to increase coverage to fund their education.

Children out of college — Your need for life insurance may decrease when your children become independent. On the other hand, you may find you now have different needs for insurance. You may want to provide additional funds for your spouse. Or you may have a large enough estate that you want to provide funds to help pay estate taxes.

Since your life insurance needs can change drastically over the years, you should periodically assess that coverage. OOO

News and Announcements

Again this year, the Holidays seem to have taken priority over completing the 4th quarter newsletter. So by the time you read this, we will be closer to Valentine's Day than Christmas.

As 2012 turned into 2013, I somehow found my free time unusually occupied with Fiscal Cliffs, family trees, and a very minimal amount of a good Scotch Whiskey. The cosmic connection to these three became very obvious after the minimal amount of Scotch Whiskey. I've written probably at nauseum about my family over the years. Please indulge me at least one more time. My paternal grandmother was a delightful woman named Everildus. Yes, very French and, in her later years, very proud of her French heritage. She would often say, "Honey, always remember you have some French blood in you"; anyway, more on that later. The second preoccupation for me was the never-ending debate/fiasco of the Fiscal Cliff. This to me was political theatre at its best, or should I say worst! Unfortunately, the consequences of this partisanship have grave consequences. Many battles remain as we approach deadlines again. I expect it will be business as usual in Washington D.C.

Ok, back to my French grandma Rilla, and how family trees mesh with Fiscal Cliffs. Another famous Frenchman was Charles de Gaulle. De Gaulle was a French general who led the Free French Forces during World War II and was the French President from 1959–1969. General de Gaulle had a terrific quote about politics and politicians. He said, "I have come to the conclusion that politics are too serious of a matter to be left to politicians." Perhaps we Americans need to pay a tad bit more attention to political events.

So, from an investment perspective: be smart, don't overreact, use common sense, and keep the lines of communication open with your broker. I suspect Sir John Templeton's words will again ring true: "The four most dangerous words in investing are 'this time it's different'."

Oh, one more thing, my new granddaughter further expands the bloodline to include German, French, and now Irish! I couldn't be happier!

Once again, thanks for your trust and confidence; we truly appreciate it. OOO

Dealing with Stock Losses

Typically, investors find it easier to sell a stock with a gain than to sell one with a loss. When selling a stock with a loss, we must admit that we made a mistake, which is psychologically difficult to do. Thus, investors have a tendency to hold on to a losing stock, hoping it will eventually get back to at least a break-even point.

However, this might not be the best strategy for your investment portfolio. While you are waiting for the stock to get back to breakeven, you could be invested in other investments that might earn a higher rate of return.

When evaluating your stock investments, objectively review the future prospects of each stock, making decisions to hold or sell on that basis rather than on whether the stock has a gain or loss. You can't change your past investment decisions, but you can come to grips with them so you can move forward and make appropriate investment decisions for the future.

Please call if you'd like help reevaluating your stock investments. OOO

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