

Perspectives

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Retirement Without a Gondola

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Each year an estimated 500 climbers set out to fulfill a promise they have made to themselves by conquering the world's most formidable peak, Mount Everest.¹ For most, succeeding in this challenge is the experience of a lifetime—the culmination of years of hard work, preparation and sheer determination. While those who reach the 29,029-foot summit will feel an overwhelming sense of achievement, the skilled climbers know that the most dangerous risks, including frostbite, avalanche, injury and high-altitude illness, remain during the descent. In fact, 80 percent of all climbing accidents occur while descending from the summit.²



Similarly, retirees have spent their lives preparing for their golden years by building their nest eggs in the accumulation phase prior to retirement. When they retire and reach the top of that metaphorical peak, they may feel the same sense of accomplishment as the Mount Everest climbers, but this feat will be short-lived if they are not prepared for the risks they will face during their descent down the mountain—the distribution phase of retirement.

Modern medicine and technological advances in recent years have contributed to Americans' longer life expectancies. Statistics show that a 65-year-old couple has a 50 percent chance of at least one spouse living into their 90s.³ While retirees should anticipate that their assets will need to provide 25 to 30 years of income, they should also expect less assistance than previous generations received in retirement. Previous generations had shorter life expectancies, and many had the luxury of receiving a majority of their retirement income from employer-sponsored pensions and Social Security. It's as if previous generations climbed Mount Everest and, upon reaching the 29,029-foot summit, were safely escorted down the mountain in a gondola. Most retirees today will not be able to rely on income from a pension, and the Social Security letter they receive each year clearly states that "the Social Security system is facing serious financial problems, and action is needed." Since the gondola

option is no longer available, retirees will need to prepare for the new risks they will face during their 25- to 30-year descent down the mountain.

The skilled Mount Everest climber understands that he will face numerous risks during the climb and, as such, prepares for them several years prior to ascending the mountain. He will complete intense training to put his body in the right physical condition; he will consider the timing of the climb; he will pack aid kits, medications, thermal mountain clothing and oxygen bottles; and he will work with a team of experienced guides that will help him reach the peak and safely descend from the summit. Likewise, retirees can prepare for their climb by addressing the multiple risks they will face in retirement. If a retiree tries to hedge only against the risk of volatility, much like a climber who prepares only for the risk of an avalanche, then his plan will be more vulnerable to other risks that can cause it to fail.

Sustainable Income Solutions™ is a five-step income planning process that identifies and seeks to hedge against the risks that are unique to each retiree.

Longevity Risks		Market Risks	
Entitlement Risk	Excess Withdrawal Risk	Sequence of Returns Risk	Asset Allocation Risk
Inflation Risks		Confiscation Risks	
Purchasing Power Risk	Medical Expense Risk	Tax Risk	Relationship Risk

This process helps retirees address how to maximize Social Security income and spousal benefits, identify the most tax-efficient way to distribute their assets and mitigate the risks they face in retirement so that their income will be sustainable for the rest of their lives. Contact us today for more information on the risks that may affect your ability to maintain sustainable income for life and to find out how Sustainable Income Solutions™ can help mitigate these risks and enable you to fulfill your vision of retirement.

¹ McGraw-Hill. "Earth Science: Geology, the Environment, and the Universe." http://highered.mcgraw-hill.com/sites/0078664233/student_view0/unit5/webquest_projects_1.html

² The Discovery Channel. "Everest: Beyond the Limit." <http://dsc.discovery.com/convergence/everestbeyond/about/about.html>

³ "Lifetime Income Planning." Dolan and Harlow, Fidelity Management and Research Company, 2004.

The Unintended Consequences of Expected Outcomes

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Investors today look to the latest economic data in an attempt to discern any information that might provide guidance on how to better position their investments for the risks ahead. The risks that many investors fail to consider, however, are risks that they themselves add to their own portfolios.

Investors, being human, are driven by very strong instincts when it comes to taking risks. Aside from having the benefit of opposable thumbs, humans, as a species, have climbed to the top of the food chain partially due to an incredible and innate ability to discern patterns. While many other animals can identify patterns, humans take it one step further and attempt to predict what will come next. This, unfortunately, can be a detriment to our perceptions of probabilities, as demonstrated by an experiment in which humans were asked to look at two randomly flashing lights, one green and one red.¹ Eighty percent of the time the green light was flashed. To predict which light would flash next, the best approach might be to always select green because you would be right 80 percent of the time. In this experiment, however, human participants underperformed pigeons and rats because they got caught up in trying to predict when the red light was going to flash next, even though they knew the probability of it doing so. Apparently, pigeons and rats are better at understanding probabilities than are people.

In other studies, two noted psychologists, Daniel Kahneman and Amos Tversky, showed that humans tend to be far from rational in how they make long-term predictions, relying on surprisingly short-term samples of data and/or data that are simply not relevant.² These findings have some very interesting implications for investors and risk. Not convinced? Let's look at the chart below for a more recent example with real implications.

	Estimated Net Flows (\$ Millions)		Representative Index Returns	
	2008	2009	2008	2009
U.S. Stocks (S&P 500)*	-\$96,560	-\$25,748	-37.00%	26.46%
U.S. Taxable Bonds** (Barclay's Capital Aggregate Bond)*	\$27,127	\$284,465	5.24%	5.93%

Source: December 2009 Morningstar DirectSM Fund Flows Update

Past performance does not guarantee future results.

Using Estimated Net Flows, a measure of how much money flowed into or out of open-end mutual funds, as an indication of the investment decisions made by individual investors, what we find over the past two years is absolutely staggering. As markets fell in 2008, investors rushed out of riskier assets, selling

slightly less than \$97 billion in domestic stock funds. As markets recovered in 2009, investors piled into the relative safety of bonds, buying a remarkable \$284 billion in taxable bond funds and missing out on the significant returns posted by stocks. Needless to say, most investors fared poorly in predicting market outcomes and paid a significant price for doing so. Now consider the outcomes for investors who followed a disciplined and well-diversified investment approach. These investors experienced the negative market of 2008, as did the investors who abandoned or never had such an approach, but the well-diversified investors benefitted from the significant stock returns of 2009.

As investors, taking risk means betting on outcomes that will result from the decisions we make, even though we do not know for certain what those outcomes will be.³ Unfortunately, as humans, we often find certainty where none exists and do not necessarily understand that we are actually adding risk to our portfolios. In the instance above, investors who followed their instincts did just the opposite of what the age-old investment adage of "buy low, sell high" indicates. While the risks investors add to their portfolios are most often measured in regret rather than dollars, this example shows that these risks can have very real consequences as to whether or not you achieve your financial goals.

The amount of information available to investors today is greater than ever in history. As such, so is the temptation to bet on a prediction about the future. So, the next time you feel the urge to abandon your well-diversified portfolio and your financial plan because of the latest reports on economic data, consider visiting with your financial advisor. We'll remind you that predicting the future is for the birds.



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¹ Zweig, Jason. "Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich." Simon & Schuster, 2007.

² *Ibid.*

³ Bernstein, Peter L. "Against the Gods: The Remarkable Story of Risk." Wiley, 1998.

* Indices are unmanaged and cannot be purchased directly by investors.

** Investing in fixed income securities involves credit and interest rate risk. When interest rates rise, bond prices generally fall.