DSA Communiqué

June 2014

Last year was a great year in both the U.S. and international stock markets, and so far this year, things are looking pretty good. As of mid-June, the US stock market is up over 6 percent and the international stock market, as measured by the EAFE (Europe, Australia, and Far East) Index is up nearly 5 percent. Even the bond market is doing well so far, with our flagship Pimco Total Return Fund up over 3 percent. With the stock markets hitting new highs in June, we certainly would not be surprised to see some retreat in prices over the course of the next few months, so we continue to rely on broad diversification to mitigate risk in an always fluctuating market.

Thinking about cash flow projections

Last Saturday's edition of the Wall Street Journal ran an article entitled "Retirement Income: How to manage your withdrawals." The article was based mainly on a paper published last year in the Journal of Financial Planning (JFP) by Michael Finke, Wade Pfau and David Blanchett. Since the three authors are all very well known in the financial planning academic and practitioner communities, we went back and reviewed the original article to see what lessons we could draw from the original work.

The original article focused initially on safe withdrawal rates. The classic study, undertaken 20 years ago, set out to determine what withdrawal rate from a portfolio could be sustained if a retiree happened to retire in the worst year in history to retire based on subsequent investment returns. Basically, this study showed that a retiree who happened to retire at the beginning of the worst sequence of historical returns for the subsequent 30 years, who withdrew 4 percent of his or her portfolio in the first year and increased that withdrawal every year by the rate of inflation, would not run out of money. This "worst year test" gave rise to what is known as the "4 percent rule." The authors then go on to demonstrate that since bond returns are currently very low, even this 4 percent rule may not be conservative enough.

A number of issues are important here. First, the 4 percent rule is extremely conservative since it is based on the worst possible retirement financial scenario and assumes that the retiree never changes his or her behavior in response to a sequence of very bad market returns. Second, most retirees will not accumulate a large enough lump sum to fund their retirement with a 4 percent payout rate. Third, the current very low interest rate environment makes retirement income planning more difficult and uncertain than periods of "normal" interest rates.

The big takeaway from the JFP article is that if rates stay as low for the next ten years as they are now, then a 4 percent withdrawal rate may be too aggressive. This is a good theoretical assumption, but in practice, what is really means for us is that we cannot take any assumed withdrawal rate for granted and we need to monitor retirement and other cash flow projections (e.g., education funding) as the projections age and revise these projections as time passes.

The Wall Street Journal article makes various suggestions to help keep some flexibility in retirement financial planning as time progresses. These suggestions are modified by an important caveat: as the Journal states, "Clearly, there are too many unknowns – market returns, health care costs, how long you will live – for any person or any system to predict your precise income needs, let alone the optimal amount you should withdraw from your nest egg over the course of a long retirement."

In spite of the uncertainty, we all need to have a plan so that we can at least know whether or not we are on track with our plan and we can make adjustments as appropriate. Planning should start out with a projected budget that outlines in broad terms what our spending needs are expected to be in retirement. We have been preparing projections for our clients for the past twenty years taking into account your projected spending needs, available assets, expected inflation rate and assumed rates of return on your investment portfolio to project how your spending and assets will evolve over your retirement time horizon.

No one could expect that this kind of forecast will turn out to be exactly right, in fact, we know that virtually every number will be different than projected but these projections do provide a baseline document that illustrates what your retirement income stream, spending needs and investment asset balance might look like during your retirement years. Armed with this information we believe that this allows each of us to make adjustments to our spending and investing plans as the years unfold. If we have not prepared a retirement projection for you or, if your plan is more than 5 years old and you would like an update, please call anyone at the firm and let us know. Similarly, if you have friends or family members who you think would benefit from beginning to do long-term planning for retirement or for funding education costs, please call us and we will reach out to them and offer to assist them with their financial planning.

What's happening at DSA

The most exciting news this year is that Anthony and Silke Gennaoui became new parents on June 8th. Their son, Michael Charles Gennaoui, arrived weighing in at an even 8 pounds and standing (well, not quite standing yet) 20 inches. Mother and baby (and Dad) are all healthy, happy and looking great.

DSA is also excited to report that just two weeks ago we closed on the purchase of an office building that will soon become our new home. After spending our first twenty years renting office space in Clayton we decided it was time to become our own landlord. Over the course of the next several months we will be doing extensive renovation and we are planning on moving sometime in October to our new offices located just a few miles west on Lindbergh Boulevard in Creve Coeur.

On a much less exciting front, Steve, Bill and Anthony attended the Advanced Personal Financial Planning conference put on by the American Institute of CPAs earlier this year. Both Bill and Steve have been active participants in these meetings since the inception of the conference over 20 years ago and both have invested some time making presentations at the conference. This year was Bill's turn, and Bill along with his daughter Courtney (a Business School Professor at Butler University) gave a talk on the relationship between risk tolerance and market activity.

Bill also was a speaker last month at the Financial Planning Association Retreat in Miami where his topic was "Investment Management in Turbulent Markets." The FPA is the parent organization for the Certified Financial Planner designation and publisher of the Journal of Financial Planning.

Referrals

Please take a moment to recommend us or share contact information for an individual, family or a business colleague you think could benefit from working with us. Be assured that we will regard your friends, family and business colleagues with the highest level of consideration.

Sincerely,

DROMS STRAUSS ADVISORS, INC.

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