Financial Advisors

Independent Objective Advice

New England Capital Times

New England Capital Financial Advisors, LLC

Registered Investment Adviser

October, 2014

Volume 31

Special Interest Articles:

- The Retirerment Income Dilemma
- The Looming Stock Market Drop

(Front Page)

The Retirement Income Dilemma

By Christopher W. Beale, CFP®

My fundamental assumption about income is that there are only three sources. The first source of income is from our **Labor**; wages, salary, commissions, tips, royalties etc. We work, we're productive, we add value to society and we earn money from our labor. Money is used to either consume currently or to save for future consumption. The second source of income is income which comes from **Capital** or savings. If we don't create and save enough capital from our labors we are forced to use the third source of income which is **friends, relatives or charity**. Social Security and Medicare are savings, albeit forced savings through our tax system. Government programs such as Medicaid are instead a form of government charity.

So the retirement income goal is to build up enough capital to provide an income source which will replace our income from labor, thereby not having to rely on friends, relatives or charity. It sounds simple enough in theory, so where's the dilemma?

The dilemma comes from transitioning from labor income, which is typically more consistent (although anyone downsized in the Great Recession would disagree), to capital income which can be more variable. The purpose of this article is to identify certain risks associated with transitioning from labor income to capital income such as market risk, longevity risk, sequence of returns risk, purchasing power risk, and behavioral risk.

Market Risk is the risk of losses due to movements in market prices which occur daily and are inherent to all investors. Accounts subject to market risk are certainly a cause for concern when we attempt to take a steady distribution from a variable account. One solution to this problem is to vary the distributions when changes occur in market prices. I don't think this a practical solution as most retirees could not live with such uncertainty in income and spending. A better solution would be to reduce volatility in investment accounts through proper diversification and asset allocation. Two simple examples are not having more than 10% of your assets in any one stock or bond or fund, and allocating among investments with low correlation, meaning one investment should zig when another zags. In our practice we have identified 19 distinct asset classes inside 4 broad categories. The 4 broad categories are: Stock, bonds, alternatives, and cash. Chris Lee did a wonderful job explaining how we manage money in our newsletter dated January 2014. We understand that reducing (please note that I did not say eliminating) market risk can add consistency to those clients receiving income from their accounts. We account for market risk when building our portfolios. We understand your account will fluctuate. Short term fluctuation is the admission price for long term returns that have historically been greater than returns from non-fluctuating investments.

(Continued on page 2)

The Looming Stock Market Drop

By Christopher M. Lee, CFP®

We have been in a 5½ year bull market (which is broadly defined as a period where the S&P 500 gains 20% or more without a decline of 20%) since March of 2009. At this point, we may be due for a bear market, which is a market drop of 20% or more. There are many factors that can cause a 20% drop in the stock market including over-inflated prices, geo-political threats, and of course "the unknown". Before I talk about some ways that could potentially minimize your losses in a downturn, let's look at some previous declines and what we know of them

(Continued on page 3)

The Retirement Income Dilemma

(Continued from Page 1)

Longevity Risk is the risk that we under estimate how long we will live, thereby outliving our capital. Based on the 2000 mortality tables the joint life expectancy of a 65 year old couple is 27.1 years. On average women live 6.5 years longer than men. Average life expectancy for women has increased 25 years from a century ago, from 56 years in 1914 to 81 in 2014. Of course I've always said average people don't walk through our office doors. Our clients tend to be healthier, happier, wealthier, better educated and have access to better medical care including complementary or non-traditional medical care. These factors lead to longer life spans.
How we manage your money and allocate your account is key to countering longevity risk. So too is our method and amounts of income distribution. I still believe a valid rule of thumb or starting point for retirement income distribution is the "4% rule". 20 years ago Financial Planner, William Bengen studied historical returns over a typical retirement time frame and concluded a 4% withdrawal rate adjusted for inflation would be deemed safe in all 30 year timeframes since 1926. The body of research has been expanded and modified over the last 20 years by many academics and practitioners. Again, the much larger number of asset classes we use in our models increases diversification and reduces portfolio volatility.

Last month I had the pleasure of listening to and speaking with Dr. Wade Pfau, Professor of Retirement Income at The American College, at an industry conference in Dallas, TX. His research has appeared in such diverse publications as The Journal of Financial Planning, Money Magazine and the AARP Bulletin last month alone. His concern was "**Sequence of Returns Risk**" or starting retirement distributions when the market is overvalued. His presentation which should be published by the end of this year concluded that sequence of returns risk could be alleviated by decreasing distributions during times of poor market performance and increasing distributions during times of good market performance. Another solution he stated was to reduce portfolio volatility. Since the vast majority of our retired clients don't want significant disruptions to their income, (or spending), we at New England Capital have attempted to reduce portfolio volatility through dynamic asset allocation and investment selection.

While annuities can be part of the solution, they are not without risk or cost. Fixed annuities eliminate market risk and longevity risk, but the income stream is subject to **Purchasing Power Risk** or inflation. Even the relatively benign 2.8% inflation rate (which Social Security now uses as their future inflation assumption) would cause a more than doubling of prices during retirement. Think of only buying half the food, buying half the medicine, or only being able to pay half your property taxes in retirement! Annuities also reduce terminal wealth, so if passing on an inheritance to your children or grandchildren is one of your goals, it would be reduced or eliminated by the use of annuities. Annuities certainly can reduce some risks by transferring that risk to insurance companies. Of course like all insurance, this risk transfer has costs which must be weighed against its benefits.

The last risk we work with daily is **Behavioral Risk**. Many investors are their own worst enemy by wanting to do the wrong thing at the wrong time. The Boston research firm Dalbar, Inc. shows that investors prefer to buy hot performing funds after they have gone up in price and sell after they've gone down in price. Over the last 20 years the average equity investor has made 5.0% annually while the stock market has averaged 9.2%. Watching one of my sons, Michael's, high school soccer games made me think of soccer/investing analogy. A study showed that when an elite goalie is defending a penalty kick, they will leap to either side of the net 95% of the time when the ball is kicked in the middle 30% of the time. Why? Because even if they miss the ball, doing **something** feels better than doing **nothing**. That same feeling of needing to leap to do something has typically hindered investor's long term success. To counter behavioral risk, we at New England Capital attempt to set appropriate expectations, control risk and reduce portfolio volatility relative to the overall market, and monitor risks in the portfolios continuously.

Emotions can be wonderful, and I wouldn't want to live my life without emotions. In investing however, they could lead us to act in a way we wouldn't act if we simply took time for thoughtful reasoning, and a thorough assessment of all options. After more than 31 years as an investments professional, I still need to keep my emotions in check with investment decisions I make on your behalf. Luckily, I must have been born with a counter intuitive gene, because my goal for you is to do the opposite of the average investor. I like to buy low and sell high, but only after thoughtful reasoning and a thorough assessment of all our options.

"Life is like riding a bicycle. To keep your balance you must keep moving."

-Albert Einstein, theoretical physicist and philosopher of science.

“Never doubt that a small group of thoughtful, committed citizens can change the world; indeed, it’s the only thing that ever has.”

-Margaret Mead, Anthropologist

The Looming Stock Market Drop

(Continued from Page 1)

As you can see, market declines are historically normal as seen in the chart below:

A history of declines: 1946-2013

Size of decline	Number of declines	Average frequency
5% or more	174	2½ times a year
10% or more	55	About once a year
15% or more	21	Once every 3 years
20% or more	12	Once every 5½ years

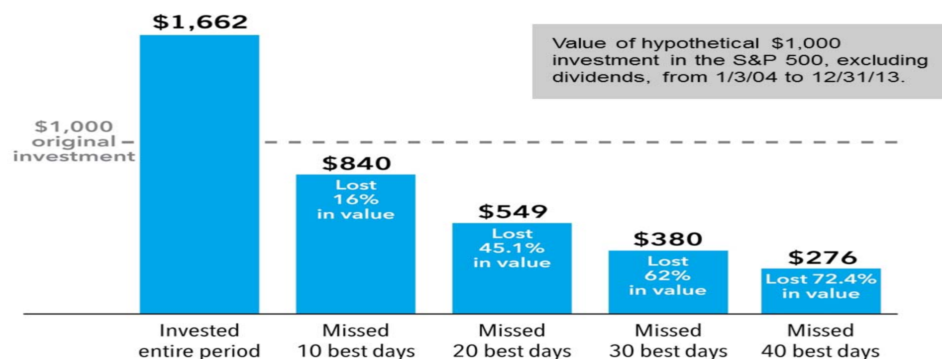
Source: American Funds, Intrayear gain and decline reflect largest price changes within each year. S&P 500 annual returns are based on the price index only and, therefore, do not include dividends. Average frequency of declines, as shown in the table, assumes 50% recovery of lost value. The index is unmanaged and, therefore, has no expenses. Past results are not predictive of results in future periods.

Since 1956-2014 (or the past 58 years) there have been 12 bear markets (market drops of 20% or more) or one bear market every 5 years. There are still many nervous investors after the 2008 market decline (understandably) and many investors are still nervous in today’s markets as some of those wounds have not healed. For those clients who have been with New England Capital through those times and stayed the course (and did not react on emotion), they have been greatly rewarded. Unfortunately, many investors get caught up in headline news/risk. Over the past 58 years, there has been significant headlines including: Cuban missile crisis in 1962, Vietnam war in 1966, President Nixon resigning and the oil embargo in 1974, Black Monday in 1987 (stock market plunged 23% in one day), Gulf War in 1990, and September 11th in 2001 are just some of them.

So we now know that since 1956 there have been 12 bear markets. What has happened following those declines? The **average** annual gain 10 years after those market lows has been approximately 12.1%.[1] What else is amazing is that if you looked at the average gain 10 years after a market high (or peak to peak) over those same 58 years, is that the market still averaged 7.8% (for those investors who are possibly worried about “buying high” right now).

We believe that clients need to get away from the short term noise (aka headline risk) and focus on the long term goals. Would it be safe to say that a lot of investors think the last 30 years have been tough to invest in? What is fascinating is that returns over the last 30 years returned10.8% in stocks, 9.9% in bonds and 4.3% in cash equivelents.[2] In fact if you invested $1,000 into the S&P 500 from 1984-2013, generated annual returns ranging from -37% to 38%, but over 30 years it grew to $23,401.[3]

I think the power of staying the course and staying invested (not trying to “time” the market) is shown in the graph below:



The Looming Stock Market Drop

(Continued from Page 3)

"If we did all the things we are capable of, we would astound ourselves."

-Thomas Edison, American inventor; Businessman

The old adage to "buy low and sell high" is easier said than done. Market movements can be difficult to predict, even for the experts. It's much better to focus on how much you're regularly saving and how long you remain invested in the market.

With that being said, the following are some ways to take the emotion out of investing and focusing on your long-term goals:

- A key to controlling behavior is understanding the emotion behind it. It's natural to feel worried. Even people who are aware of the market's historical cycles may feel torn between emotions and knowledge. If you're scared, you're likely to make poor decisions, which you can be very tempted to panic and either reduce or sell positions. As a result, you won't be in the market to participate in the rallies that often follow market declines (and miss some of the best trading days listed above).
- Sleep on major decisions before taking action. A 24- to 48-hour window of reflection may help you avoid making short-term decisions during volatile markets which may negatively affect the value of your portfolio and your long term goals.
- Call us! That's what we are here for (and what you pay us for). If you are concerned or worried about something – call us. We are more than glad to explain things to you. Knowledge is power and can reduce your fears of the "unknown".

With all of that being said, a bear market may not be right around the corner. In fact, this bull market ranks as the sixth longest since 1928 -- just behind the bull market from 1982 to 1987, according to Bespoke Investment Group. The current run is now longer than the bull market from 2002 to 2007, when the housing bubble inflated.

But this bull market has a long way to go before it becomes the longest -- that honor goes to the epic rally that began shortly after Black Monday in late 1987 and lasted until the tech crash of 2000 – **or almost 13 years**. Who knows how long this bull market will last?

At New England Capital, we are constantly looking for new ways to reduce risk and increase returns in the portfolios through diversification that spreads your money among different asset classes, sectors and countries. We know that the next bear market is a "when" and not an "if". We just don't know the exact timing of it, no one does - neither do the economists nor the "experts" on CNBC. As the great Warren Buffett once said in a shareholder letter (in 1988) was "*We do not have, never have had, and never will have an opinion about where the stock market, interest rates, or business activity will be a year from now."*

We take your hard earned money very seriously at New England Capital and we take great pride and stewardship in managing it. We are here, working hard, to help you achieve ALL of your life goals.

1 Represents average of the annualized total returns of the Dow Jones Industrial Average with all distributions reinvested over the 10-year periods following the 11 bear markets. Excludes the most recent decline in 2007–2009. Market downturns are based on a decline of about 20% or more in the Dow Jones Industrial Average, excluding dividends and/or distributions. A new decline is considered to have begun only after the market has recovered 50% of the value lost in the previous decline. Source: American Funds Distributors, Inc.
2 Stocks — Standard & Poor's 500 Index; bonds — Ibbotson Long-Term Corporate Bonds Index; cash equivalents — Ibbotson U.S. Treasury bills Index. Data from Ibbotson Associates. The indexes are unmanaged and, therefore, have no expenses. Source: American Funds
3 Returns in this hypothetical example are based on an investment of $1,000 in Standard & Poor's Composite Index from 1/1/84 to 12/31/13. The index is unmanaged and has no expenses. Past results are not predictive of future results. Source: American Funds

IMPORTANT DISCLOSURE INFORMATION

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by New England Capital Financial Advisors, LLC), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from New England Capital Financial Advisors, LLC. Please remember to contact New England Capital Financial Advisors, LLC, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. New England Capital Financial Advisors, LLC is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the New England Capital Financial Advisors, LLC's current written disclosure statement discussing our advisory services and fees continues to remain available upon request.