April 2013

Quarterly Letter

By Martin Weil

"I'm not so much concerned about the return on my money as the return of my money."

~ Will Rogers

The US stock market continued to march higher as the S&P 500 index gained 10.6% during 2013's first quarter. The index then surpassed its all-time high as the new quarter began. Foreign stocks returned an average of 3.0% for the three-month period, weighed down by negative returns in emerging markets. Investment grade bonds were flat for a second quarter in a row.

Model Portfolio Performance[i]

Model Portfolio Performance
3/31/2013

	Risk Benchmark	1st Quarter	Trailing 12 Mos	Cumulative Since Inception	Annualized Since Inception
All Equity	100% Stocks	7.6%	9.1%	124.9%	5.9%
Growth	80% Stocks/20% Fixed Income	6.3%	9.3%	119.5%	5.7%
Balanced	65% Stocks/35% Fixed Income	4.8%	9.1%	130.0%	6.0%
Conservative	40% Stocks/60% Fixed Income	3.0%	7.6%	119.8%	5.7%
S&P		10.6%	13.8%	63.8%	3.5%

Our four portfolio models gained between 3.0-7.6% for the quarter, welcome numbers on an absolute basis, but lagging relative to stronger performances by the broad US stock market and our portfolio benchmarks.

We attribute this underperformance relative to our benchmarks to the ongoing cautious positioning in our asset allocations. This caution, based in the valuation discipline we follow, has cost us several percentage points of performance in each of our models the past few years.

The valuation data has suggested for some time that the potential longer-term upside to US stocks is not substantial enough to warrant a higher allocation. Moreover, with higher prices making valuations and future potential returns even less attractive for US stocks, our discipline is bringing us closer to the point where a further reduction in equity allocations may be warranted. This will not come as an easy choice in the face of rising markets. But it is one we may have to make, at least for those clients in, or close to, retirement and for whom substantial losses in their portfolios could be highly detrimental.

Portfolio Updates

During the quarter, we added the Goodhaven fund as a core equity position in our All-Equity and Growth portfolios. This relatively new fund is managed in a concentrated Large US Value style. As is the case at many of our funds, Goodhaven's lead managers have significant personal investments in the fund.

At quarter's end, all our models continued to be tilted towards funds owning larger, more established

companies, and we remain underweight US equity in our Conservative and Balanced portfolios. We are overweight emerging market stocks, an allocation we are adding to in the face of increasingly attractive relative valuations.

"Unusual" is I suppose the best word to describe our fixed income positioning. We divide our fixed income allocations into interest rate risk and credit risk exposures. Where we are underweight risk in our equity positioning, we are to a lesser degree overweight credit exposure risk in our fixed income holdings. We are extremely underweight interest rate exposure, but equally overweight credit risk. As a result, the fixed income portions of our portfolios should not be substantially hurt by a rise in interest rates. Conversely, they are exposed to economic downturns, which would negatively affect our positions.

Easy Money vs. Weak Growth

This phrase, borrowed from a colleague, pretty much sums up today's US equity market climate. Continued weak economic growth would suggest sub-par market returns going forward. Easy money (e.g. the Federal Reserve's policies) provides fuel for rising markets. So far, the Fed is winning this face-off and investors are moving back into equities and other risk assets. In spite of increasingly stretched valuations and weak economic growth, equity markets continue to exhibit substantial momentum to the upside.

Looking at the longer-term, valuations continue to indicate that returns for stocks will be sub-par for the coming 3-5 years, much as they have been over the past 10-year period. The potential for investment grade bond returns is even worse. If our valuation thesis is correct, then strong stock market performances such as we have enjoyed this past year will have to be offset by performances of a less welcome variety. If we could predict when and how these less welcome market conditions will unfold, we all could become very wealthy indeed. Unfortunately, there are no crystal balls. Therefore, we rely on our known discipline - diversified asset allocations, tilted to hold more of undervalued assets and less of overvalued ones - to manage risks to acceptable levels while earning a decent return in our client portfolios.

- Note that as of April 1, our minimum for new account relationships increased from $500,000 to $1,000,000.

The following is one of a series of "white papers" I have been writing on topics in the financial planning arena that might be of interest to individual investors.

"How Much Do I Need?"

Whether one works to 65 or 85 (see my recent quarterly letter), most of us are going to want to know that at some age, we will be able to live out the remainder of our lives, without running the risk of financial distress. "How much money do I need to save?" or its corollary, "How much money can I afford to spend?" are customary questions about retirement in any financial planner's practice.

For those who want a simple answer, and prefer to skip the rest of this lengthy discussion, the rule of thumb planners use is that you will need to have saved between 20-25 times the amount you intend to withdraw each year when you start retirement.[1] Put another way, you can safely withdraw between 4-5% per year of the starting value of your combined retirement and other savings when you begin regular distributions. For the more intrepid, please read on to understand the hows and whys of this answer.

The simplest approach to answering the questions is probably provided by the IRS via their Required Minimum Distribution tables for IRAs and other retirement accounts. Per the IRS, at age 70 ½, you start with a 3.6% withdrawal in year one. This percentage gradually increases each year (as your account balances presumably decline), reaching a 16% annual withdrawal rate at age 100. While you will never run out of money using this approach, most people will find the initial withdrawal amounts inadequate. Moreover, when starting withdrawals at age 65, the starting percentage is even lower. Finally, most of us prefer our income to be stable over the years, whereas the IRS approach makes the annual amount highly variable, dependent on the fluctuations of the value of your investment assets.

A more stable approach is to use your retirement assets to buy a life annuity. A single premium annuity is the simplest of these. Today, a SPIA for a married couple aged 70 would provide a nearly 5% annual payout for life. Not bad at all, until you realize that the amount will never increase with inflation, and so its spending power will diminish, perhaps dramatically so. Additionally, many people have an ingrained resistance to the annuity concept. While we think immediate annuities have a place in a retiree's plan, we are waiting for a rise in interest rates to make a stronger case for SPIAs to our clients.

In any formal planning scenario, planners look to determine what we term the maximum "safe withdrawal rate[2]." In our practice, we use Monte Carlo analysis[3] to help provide this answer. We work with the

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1 The amount you will need to withdraw each year is the amount of your routine annual spending plus reserves for things like major home repairs, care replacements, travel etc.,, less any income from other than your retirement and/or investment portfolio, e.g. Social Security, pensions etc.

2 This withdrawal strategy requires that an amount be fixed by multiplying the initial retirement account balance by the withdrawal rate. This amount becomes an annual withdrawal, with only inflation adjustments, that will be disbursed each year for the retirement period.

3 Monte Carlo was the code name given in the late 1940s by scientists at the Los Alamos National Laboratory to a process that helped model the uncertainty of random outcomes in a nuclear reaction.

client to determine what their needs will be in retirement. Then, using Monte Carlo, we can project expected required savings and tailor projected spending capacity over decades, incorporating non-recurring goals such as travel, a second home or a home downsizing, gifts to kids, and end of life medical costs.

However, without the benefit of a formal analysis tool, planners are quite comfortable citing the maximum safe withdrawal rate of 4-4 ½% of the value of savings at the start of retirement. This recommendation provides for a very conservative withdrawal amount, a mere $40,000-45,000 on each $1,000,000 of savings, but this annual payout, adjusted for inflation, is expected to survive for the client's lifetime.

Why does this recommended withdrawal rate have to be so low? In truth, it may not need to be. The 4 ½% rate is just the highest one that has been shown to withstand whatever markets bring over a potential 30-year retirement period. Obviously, some retirees will not survive for 30-years (though a 65-year old married couple has a 30% likelihood that at least one of them will live to 95). Markets may experience "the best" instead of "the worst." In either case, a higher withdrawal rate would have been perfectly safe. Planners, being naturally risk-averse, use the most conservative rate as insurance for the client against both longevity and the worst market conditions, while knowing that neither may in fact come to pass.

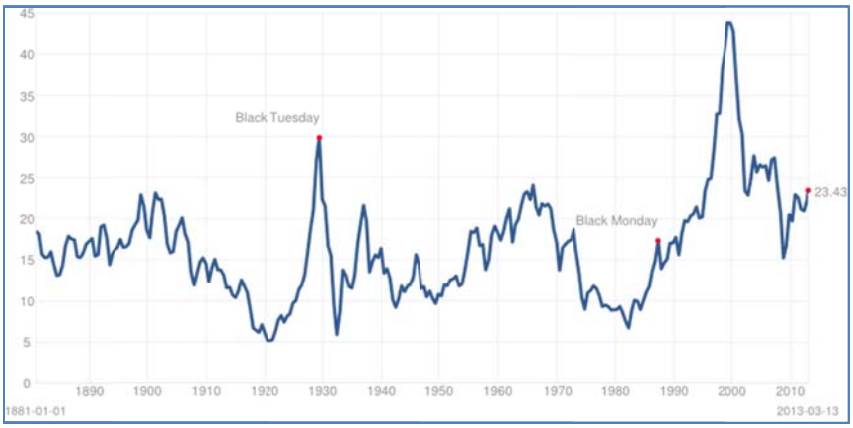
Are we planners being too conservative in planning for the worst? Michael Kitces, one of my favorite financial planning thinkers, does some of the best work on retirement withdrawal rates. Kitces examined 104 rolling 30-year periods going back to 1871. What he wanted to learn was, in retrospect, what the maximum safe withdrawal rate would have turned out to be for any of these particular 30-year periods.

The results, (seen in the graph[4]) are simply astonishing to one who has taken the 4% withdrawal rule as gospel. The actual maximum "safe withdrawal rate" during this span of 104 30-year periods was all over the map, from a high of 11% (starting 1876 & 1921) to a low of 4 ½% (starting 1936). Kitces here demonstrates here the dramatic difference, from $45,000 to $110,000 per year, in the amount that could have been safely withdrawn each year from a $1,000,000 portfolio over a 30-year period. All depending

4 Graph, courtesy of Michael Kitces, Nerd's Eye View, www.kitces.com/blog, shows the results retrospectively of the maximum initial safe withdrawal rate for 104 30-year periods that began in the years between 1871 and 1975 (retirements ending 1901-2005). The portfolio is presumed to consist of a standard 6/40 equity/bond mix.

on the random luck of when you started.

But the results – high or low - can only be known after the fact. So planners counsel the use of the lower rate, the one that has never failed in the past, come hell or high water (e.g. war, depression, runaway inflation). The downside is that clients may have less to spend than they otherwise might have, and are depriving themselves of a better lifestyle in retirement. On the other hand, using a higher rate than turns out to be unsustainable in the end, even just 5 or 6%, could mean financial ruin in one's 80s or 90s. Of course, spending can always be cut if things do turn out for the worst in this scenario. But such cuts may come inopportunely and at the cost of very large reductions in lifestyle or other planning goals.



What if we could identify beforehand whether we are at the start of period where a higher withdrawal rate will be sustainable, or one where only a lower one will be safe? Recent research points us to economist Robert Shiller's stock market valuation method. His 10-year trailing Price/Earnings ratio (graph at left[5]) - the same data series that I use to suggest that US stock market returns will be muted for the next 5-10 years - also has significant value in predicting what the maximum safe withdrawal rate is going to be.

There is a correlation between higher safe withdrawal rate periods and when the 10-year P/E ratio is lower than average. Conversely, lower safe withdrawal rate periods appear to occur when the 10-year P/E ratio is well above average. With Shiller's trailing 10-year P/E today at 23, far below its all-time high but well above average, it seems that 4 ½% is most likely today's maximum safe withdrawal rate for a retirement portfolio meant to last for 30 years. For those of you who read all the way through, I apologize that having covered so much ground, we ended right back where we started. However, hopefully, we have arrived with a somewhat better understanding of an unexpectedly complex planning challenge.

[5] Shiller 10-year Price/Earnings graph from http://www.multpl.com/shiller-pe/

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[i]**Model Portfolio Performance Disclosures:**

a) Performance shown is for each portfolio model and is not a composite of the performance of actual client accounts. While our goal is that each client account will closely mirror the holdings and performance of our models, client account performance may, and does, vary according to several factors. Some of these are listed below. In addition, there have been periods, and may again be in the future, when our evaluation of major economic and/or market events leads us to manage client account allocations in a materially different manner than is shown in our models. At these times, client performance results will vary from that of our models.
b) All MWI managed client accounts are based on one of four diversified model portfolios, composed of no-load mutual funds, exchange-traded funds and other publicly traded securities. These four models are geared to different levels of investor risk tolerance. New accounts are invested following one of these models, typically using dollar-cost averaging over a period of months, not to exceed one year. Once an account is fully invested, it is expected to track the performance of its underlying model. Exceptions to this include accounts with restrictions such as: the client-directed retention of legacy holdings and/or excess cash, substantial withdrawals or additions. Accounts smaller than $100,000 are restricted by purchase minimums at certain mutual funds and as a result do not hold all the same positions. The performance of these accounts may differ somewhat from these models. Accounts employing municipal bond funds in place of the taxable bond funds used in models will often slightly underperform on a pre-tax basis.
c) Benchmarks for each model are created to represent the neutral asset allocation for each portfolio. The Vanguard S&P 500 index fund is used to model the S&P 500 index total returns. This fund, the iShares Russell 2000 index, Vanguard Total International and Total Bond index funds are the components we use for our benchmarks.
d) Net of fees: The performance for MWI model portfolios is calculated net of our maximum annual management fee, and brokerage charges, if any. The returns of the portfolio benchmarks do not include any fees or charges other than those of the index vehicles employed in the benchmark. All returns assume dividends and income are reinvested.
e) Rebalancing: Model portfolios are routinely rebalanced every six to twelve months on the last day of a quarter. Actual client accounts may be rebalanced as needed. With tax-efficiency a part of our decision criteria, taxable accounts may be rebalanced less often and/or less completely than retirement and other accounts not subject to current taxation. This may result in performance discrepancies between taxable and non-taxable accounts managed following the same portfolio model.
f) Model allocation changes: Changes to our model allocations can and do occur at any time. When a model is changed, allocations to client accounts are changed as soon as is practical. However, changes to the model portfolios are only recorded for performance purposes on the last day of any quarter.
g) Closed funds: From time to time, mutual funds that form part of MWI model portfolios close to new investors. Clients already owning closed funds in their accounts will generally continue to hold and/or add to their positions. New client accounts will be invested in alternate funds. At year-end, MWI will substitute in its models for any funds that have closed during the year with the alternate funds available then to new clients. As a result, performance disparities may develop between older and newer client accounts, and between older client accounts and current model performance.
h) Historical performance is not a guarantee of future results. While the performance period since January 1999 includes both rising and falling stock markets, there can be no assurance that the portfolios will perform as well under future market conditions.