<u>The key to financial security - managing the balance between returns & expenditure.</u>

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In the 10th February 1998 newsletter the lead article was a discussion entitled *"What amount of assets do you need to have accumulated so that you can retire with financial security?"* In that article I discussed the concept of "retirement ratio", being the ratio of "investment assets/cost-of-living" to enable me to gain a quick assessment of whether you are likely to achieve financial security for the rest of your life.

Key points:-

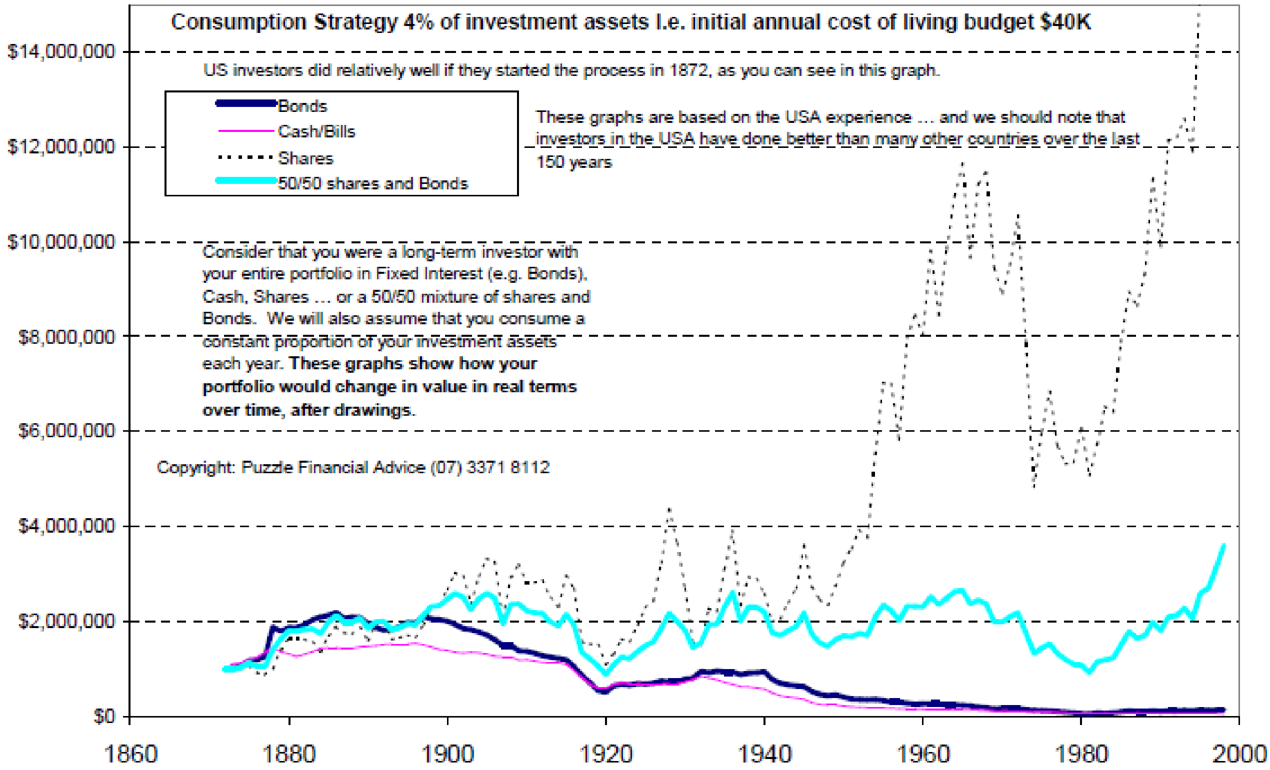
- In retirement, during an average period, a retirement ratio of around 23 would indicate that you can live with financial security for the rest of your life, as long as your portfolio was sufficiently weighted towards growth assets. This assumes that your affairs are well organised so that you will be paying minimal tax ... and effectively maintaining your capital in real terms for the rest of your life ... on the basis that we don't know how long you might live ... and that we do not want to put a date in your diary that you need to die before.
- Over 30-year periods (an approximation for the rest of your life - the period you will be investing for) **there is significant variability in the real rates of return that have been available.** Therefore, for people retiring now or in the future, there is no way of knowing precisely what retirement ratio you need in order to achieve financial security.
- Clearly a higher retirement ratio provides higher financial security.
- Clearly, unless you have a very high retirement ratio, because of the long-term variability of real investment returns, **your financial security significantly depends on the ongoing management of the ratio between spending and assets for the rest of your life.** *This was the most important message from this analysis.*

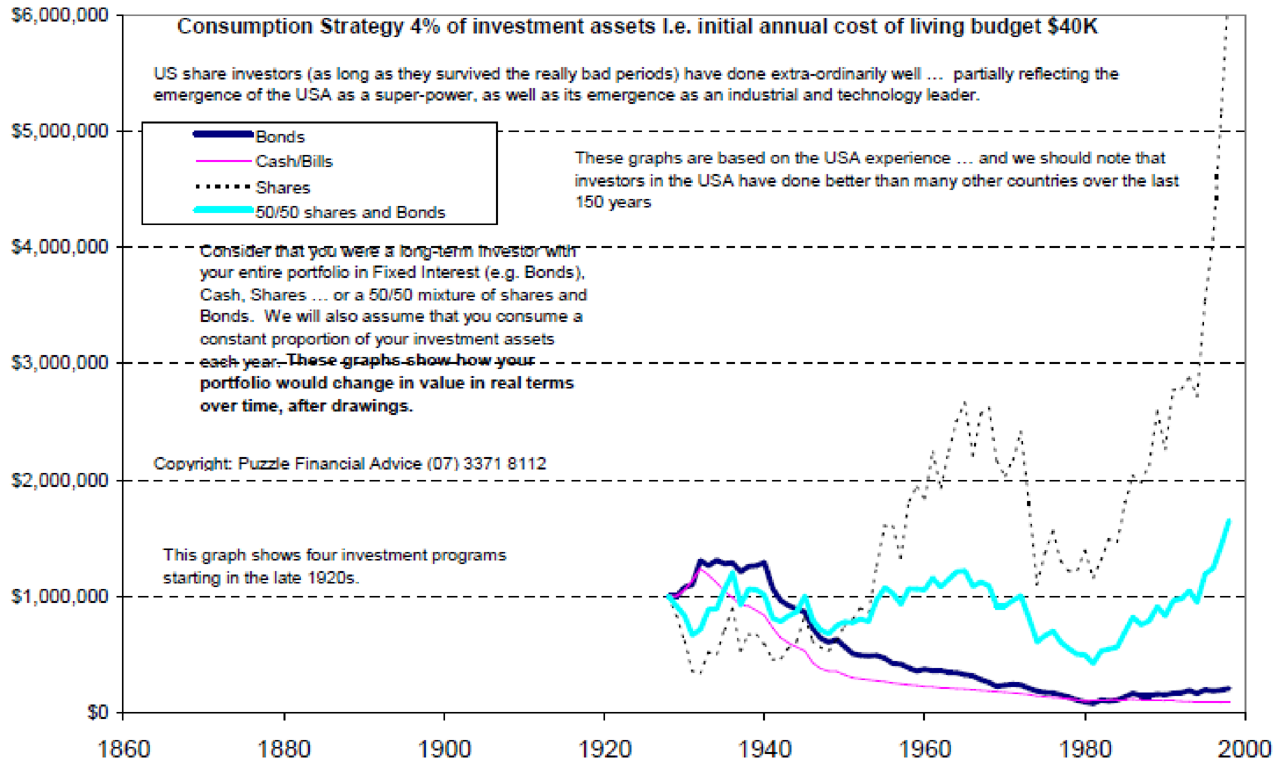
One point to emphasise from my analysis. ***The extent of variability of returns makes it crucial that,*** **in retirement, you define your consumption objectives in terms of a proportion of your total assets rather than in terms of a flat-dollar amount in real terms.** In bad times, if you have defined your consumption pattern in flat real dollar terms, the results can be catastrophic.

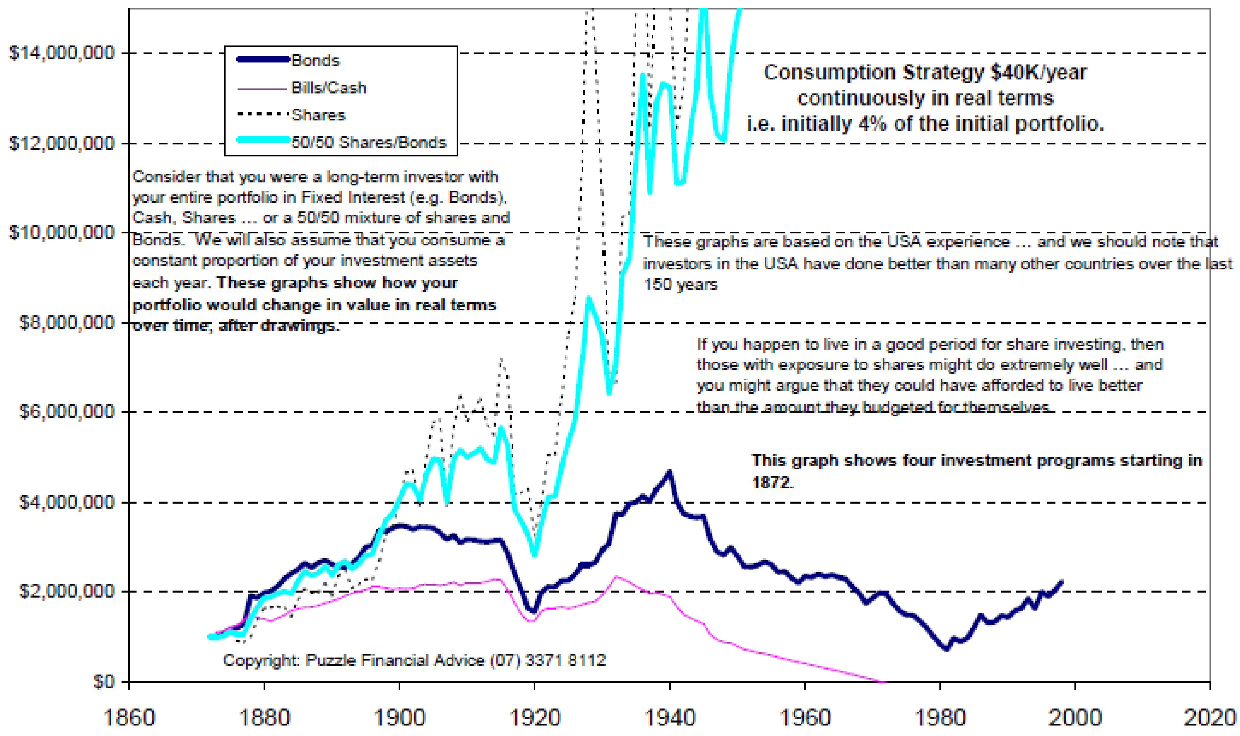
However, if you define your consumption objective (lets call it your budget) as being a proportion of your total investment portfolio, you will be automatically be tightening your belt in the bad periods and you are more likely to maintain a reasonable lifestyle for the rest of your life. **This is a crucial issue in my advice to many of you.** Except for those of you who are clearly financially secure (i.e. portfolio of many millions), a major financial objective is usually "financial security for the rest of your life". Therefore, if you are in this latter category, I would like to ask you to reconfirm for yourself that this is an important objective. If this is an important objective then clearly this research shows that it is crucial that you track your cost-of-living ... even if your portfolio is in the $1-2million level. If financial security is your objective, it should be important to you to know that your consumption intentions (or consumption strategy) are not putting your financial security in jeopardy.

As an advisor, I cannot change the future. My objective is to help you deal with the realities that we have to face.

The following graphs show how various consumption strategies might have worked. Observe how portfolio values change, assuming we start with a $1million portfolio.






Bonds
Bills/Cash
Shares
50/50 Shares/Bonds
Consumption Strategy $40K/year continuously in real terms i.e. initially 4% of the initial portfolio.
Consider that you were a long-term investor with your entire portfolio in Fixed Interest (e.g. Bonds), Cash, Shares ... or a 50/50 mixture of shares and Bonds. We will also assume that you consume a constant proportion of your investment assets each year. **These graphs show how your portfolio would change in value in real terms over time, after drawings.**
These graphs are based on the USA experience ... and we should note that investors in the USA have done better than many other countries over the last 150 years
If you happen to live in a good period for share investing, then those with exposure to shares might do extremely well ... and you might argue that they could have afforded to live better than the amount they budgeted for themselves.
This graph shows four investment programs starting in 1872.
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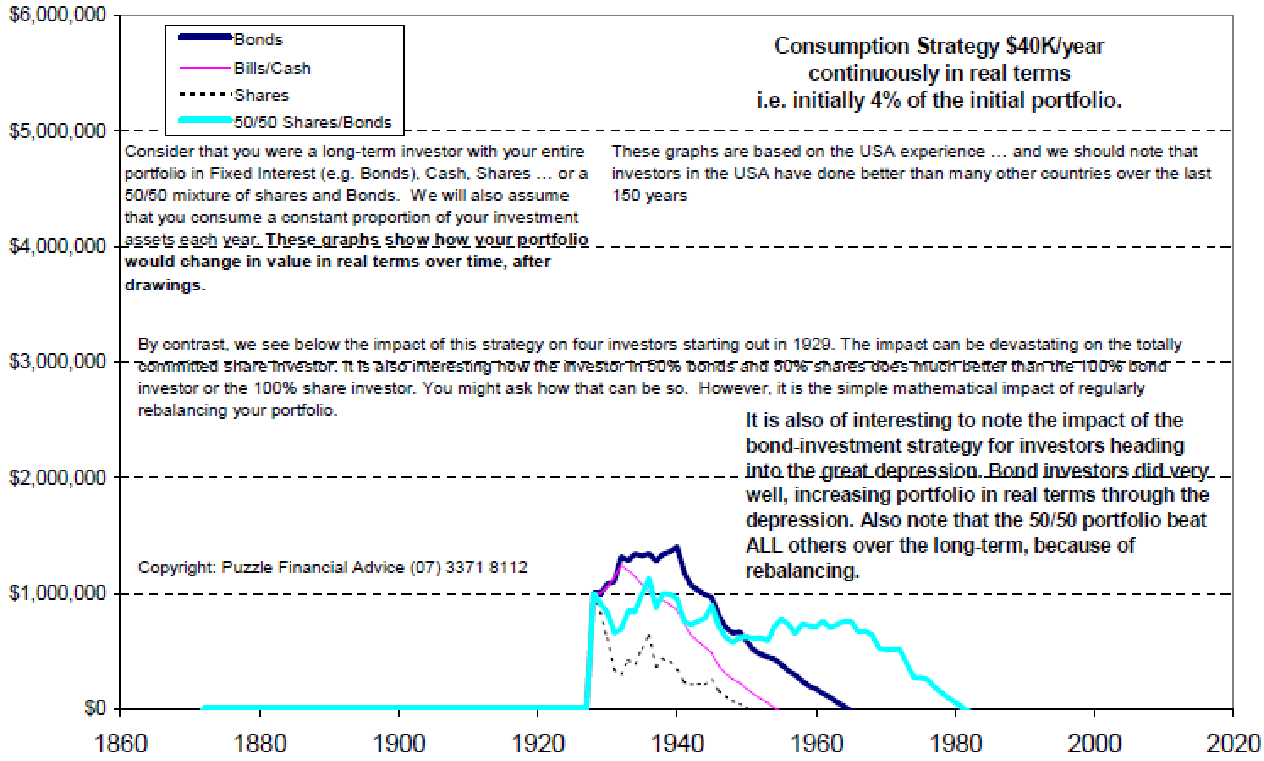
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By contrast, we see below the impact of this strategy on four investors starting out in 1929. The impact can be devastating on the totally committed share investor. It is also interesting how the investor in 50% bonds and 50% shares does much better than the 100% bond investor or the 100% share investor. You might ask how that can be so. However, it is the simple mathematical impact of regularly rebalancing your portfolio.
It is also of interesting to note the impact of the bond-investment strategy for investors heading into the great depression. Bond investors did very well, increasing portfolio in real terms through the depression. Also note that the 50/50 portfolio beat ALL others over the long-term, because of rebalancing.
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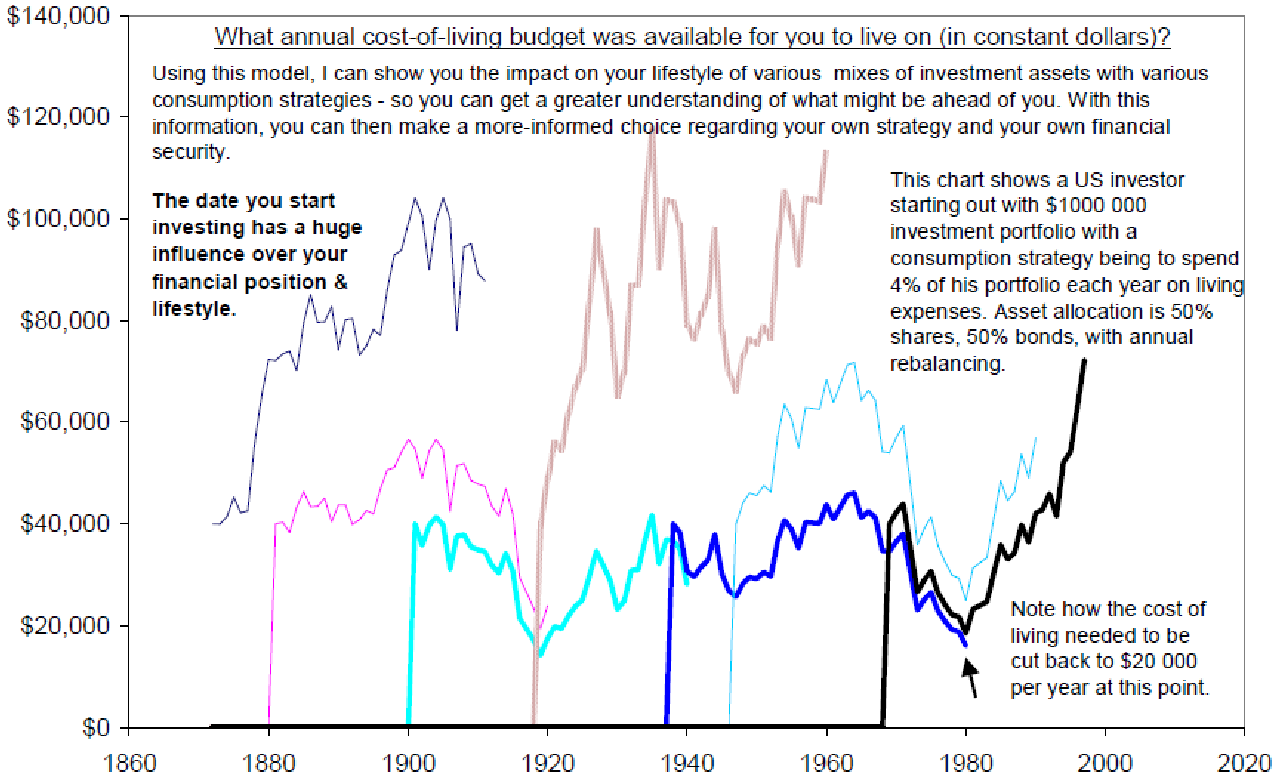


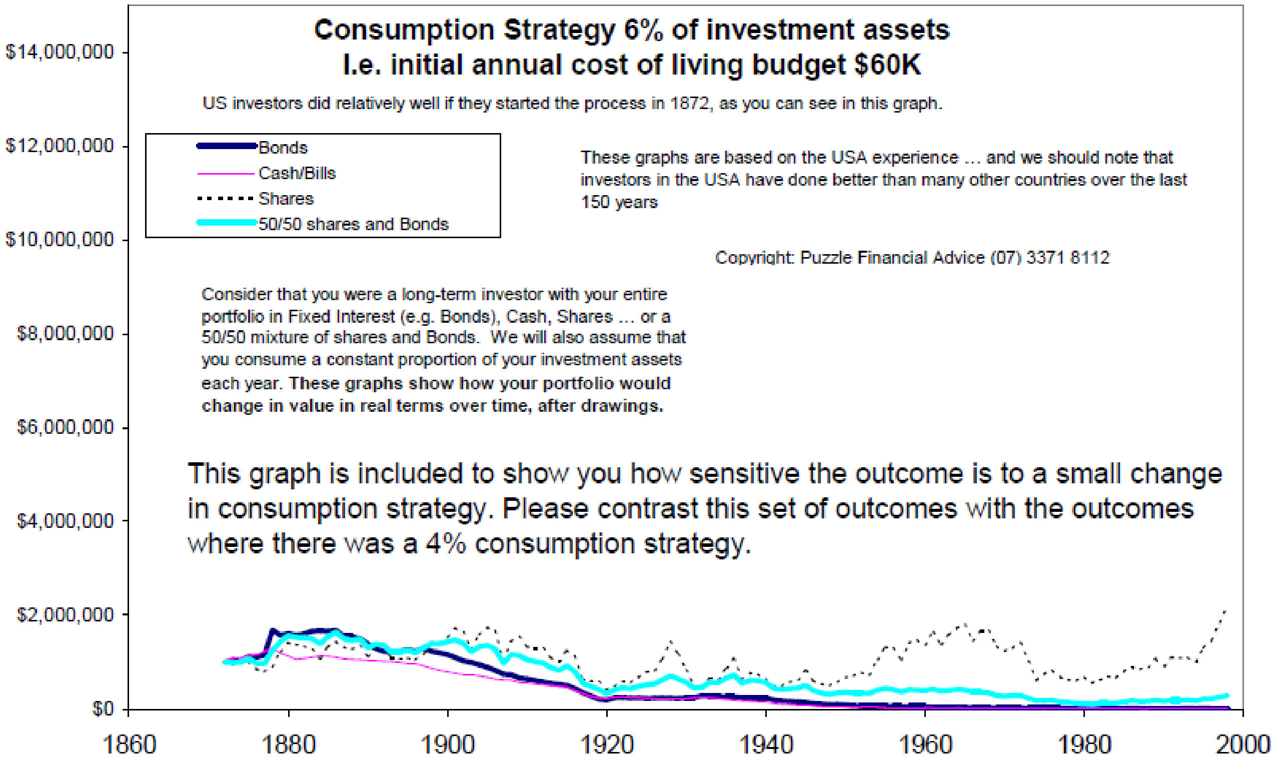
Bottom line points:

1. In retirement, for those of you where there is any question of whether you are financially secure, you need to consider carefully your consumption strategy. Your consumption strategy can have a huge impact on your financial security. For this group, if you are seriously committed to your own financial security, you/we need to monitor your consumption patterns, to ensure that you are not jeopardising your financial security.

For those still in the accumulation stage of life, there is no certainty of any given life-style if you manage to achieve any particular level of assets by the time you retire. However, from a financial-security perspective, more is better. I.e. the more you have accumulated, the more financially secure you are likely to be ... and the less you will need to tighten your belt if we experience tough times.

VERY IMPORTANT: **It is VERY CLEAR that setting your cost-of-living budget as a percentage of your investment assets (and living within your budget) is definitely a much more robust strategy than defining your budget as being a flat dollar amount in real terms. For most people, you DO need to adjust your living standards to the level dictated by the investment markets during the times that you are investing.**

If your consumption strategy is inflexible, a bad period can be very damaging. For example, if you started with a $1million investment portfolio and stayed with a consumption budget of $40K through a very bad period (hoping that it would be OK over the long-run), you might find that you might run out of money much quicker than you expected. By contrast, if you adopted a more flexible strategy (such as consuming a fixed percentage of your assets each year, e.g. 4%), then you can survive the bad periods much better and be in a much better position to take advantage of the good periods which often follow. From the graphs above, consider the situation where you have a 55 year-old, US, investor starting out in 1929 requiring $40000/year in real terms to live. If he invests entirely in shares, he needs to die before he is 75 years old (or he will have run out of money). If he invests entirely in bonds, because the 1930s was a good period for bond investors, this gives him an extra buffer, but he still needs to die before he is 90 (or he will have run out of money). And if this investor chose a higher standard of living, he would have run out of money sooner.



It is also clear that **your long-term financial well-being is very sensitive to small changes in consumption strategy.** I refer you to the impact of changing from a strategy of 4% consumption to a strategy of 6% consumption in the graphs above.

2. One of the current investment dogmas is that “Time in, not timing, is the key to investment success”. The thinking is that if you invest for the long-term (e.g. 10 years, or even 30 years) into a well-diversified shares and property portfolio, then over time you will get a good result. The long-term historical data suggests that this dogma has worked well over many periods but it sometimes does not. So we need to be a little careful with this dogma.

There can be long periods of very bad returns, such as in the UK (at the beginning of this century), where there was a 30-year period with an average real return of -2%pa for shares. Unfortunately very bad 3-7 year periods have not been that uncommon.

Clearly, therefore, investors who “invest and forget” can come to grief - even where the initial strategy was designed well. At the very least, some simple re-balancing techniques can help ensure a good long-term result. To go beyond this simple technique can be fairly challenging. However, I believe that history suggests there is often warning signs before many of the major bear markets - for investors who are prepared to listen to the warnings, and to step out from the investment herd.

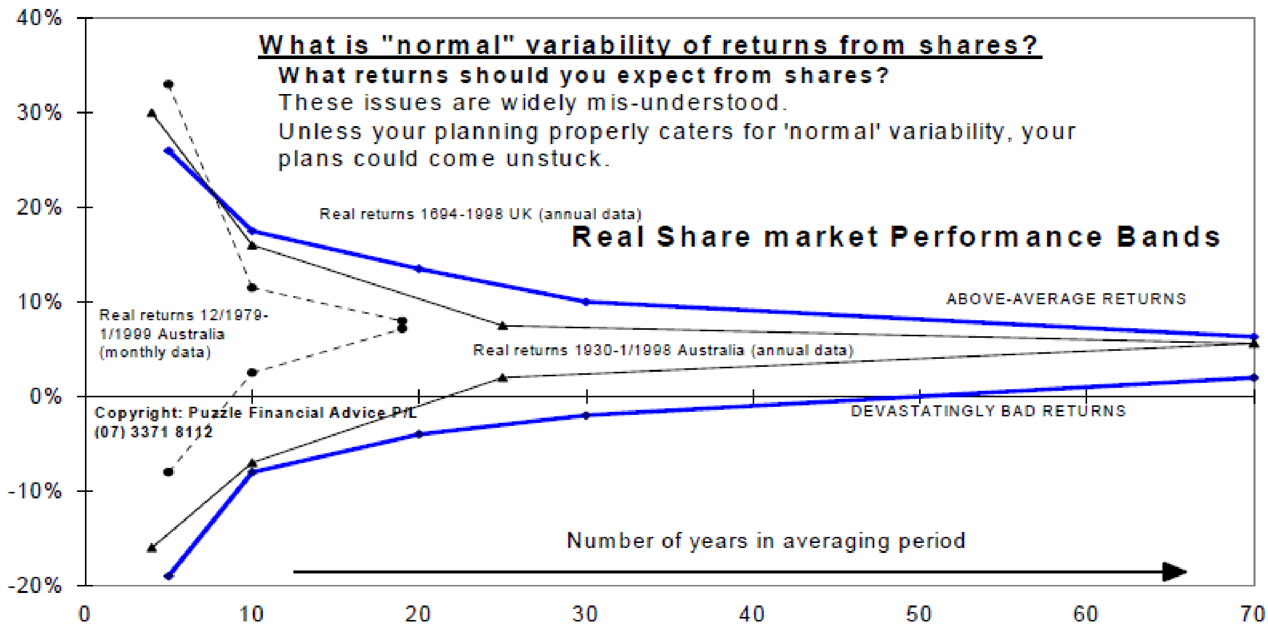
3. If we have a particularly bad period ahead by historical standards, then even people who feel they have accumulated enough assets might find that they need to tighten their belts.

4. I do not need to highlight how nasty it can be if people have borrowed money to invest in shares (i.e. they are geared into the share market, including those using warrants and derivatives) if we have a nasty period for shares. Holding on for the long-term is clearly not a reasonable strategy for these people. Previous analysis which I have done shows that, in most cases (perhaps except where there is a massive side-effect like large tax savings) geared share investors need to be good market timers if it is to achieve a positive result.

Other points reinforced by the above graphs:-

1. **Regular rebalancing can add a lot of value.** I.e. By following some simple strategies, those who manage their portfolios can do a lot better than those who "invest and forget".
2. **Bond and fixed interest investors can do very well at times when an economy goes into depression.** It can not only preserve the value of your assets, but capital gains can increase the value of your portfolio ... depending on the profile of fixed interest investments that you have made.

Finally, let me leave you with one more graph:-



The above data suggests that Australia's experience with shares is within the bounds of the longer UK experience. **It also suggests that it is possible to have periods much worse than we have experienced in Australia's brief history so far.**

Historical data is not a spotlight to the future. But by analysing the past 300 years of data from the UK and the past 200 years of data from the US, we can get a greater sense of what can (or might) happen. This is particularly important for Australians, because Australia's brief economic history has all occurred during the last major western price wave ... a price wave which seems to be coming to an end.

By looking at the US and the UK, we need to be cognisant of the following points:-

- **The USA has been one of the star economies of the past century, and the results that they have** achieved are therefore likely to be biased towards the more optimistic outcomes.
- Also, I note that Dr Bryan Taylor suggests (from his analysis) that the commodity economies of Australia, Canada, South Africa, Norway and New Zealand have performed relatively strongly in the 1930s, 1940s and 1970s, when most of the world's stock markets were in savage bear markets. Implicit in this is that the Australian share market has not experienced the extremes of bear markets that have been experienced in many major industrial nations. In this context, it is interesting to note that Australia has changed from being a commodity economy. According to Jonathan Pain of Rothschild, in 1980 the Australian stock market was 60% resources stocks (by market capitalisation), but resource stocks in 1999 only accounted for 16% of Australia's share market capitalisation. There is an implication here therefore, that since our share market is now less of a resources share market and now more an industrials share market, we might now be more likely to experience more of the extremes of share markets that we have been sheltered from in the

past.