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Outlook 2009

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January 1, 2009

Volatility is up, rationality seems down. Stocks soar and sink (more sinking, to be sure) from hour to hour, even minute to minute. From mid-May to mid-November last year, the benchmark Standard & Poor's 500 Index went from flat for the year to down more than 40% year-to-date. Understandably, investors' focus has been on those savage six months.

Is the Panic of '08 an anomaly—or a signature episode in a long period of subpar stock market performance? Certainly, as the market seeks its level, unhappy clients and many advisors are wondering. After all, since the dot-com wave crested in March 2000, the S&P 500 has spent most of the past nine years below—often way below—that bull market peak. We could be midway into an extended stretch of asset price stagnation similar to the one investors endured from the late-1960s to 1982, when the last big bull market began.

"We believe that we are in a prolonged secular bear market, during which we'll have to struggle with declining earnings expectations and the shrinkage of price-earnings ratios," says Mike Martin, president of Financial Advantage in Columbia, Md. "That would be a painful blow to stockholders."

If stocks are likely to be disappointing for a while, financial planners may decide to adjust their investment strategies. Before making any major shifts, though, it's valuable to review the debate about long market cycles.

Peaks and Plateaus

In March 2000, the S&P 500 topped 1550, up more than 15-fold from its low in mid-1982. Although there were several bumps along the way (let's not forget the Crash of 1987, for instance), there was only one calendar year out of all 18 in which the S&P 500 dropped: 1990, when it lost 3.2%. Overall, for calendar years 1982 to 1999, the S&P 500 enjoyed an annualized return of 18.5%, according to Ibbotson Associates. Over that same period, inflation was 3.3% a year.

Prior to that great boom, though, stocks had gone nowhere for more than a decade. The S&P 500 first hit 100 in mid-1968; 14 years later, in mid-1982, the Index was still in the same neighborhood. During the calendar years 1969 to 1981, the S&P 500 had five negative years out of 13, losing as much as 26.5% in 1974. Annualized returns were 5.6%, while inflation was 7.8%.

Going farther back into Ibbotson's numbers, you can find a bull market that ran from the late 1940s to the mid-1960s, as well as the horrendous bear market that produced nine down years out of 13, from 1929 through 1941.

Are we in a long down cycle? How bad will it be? There's no way to be certain. "No one knows how long this difficult time will last," says Marilyn Capelli Dimitroff of Capelli Financial Services in Bloomfield Hills, Mich. "It's possible that we'll see a repeat of 1929, followed by a depression, or we'll experience a [stagnant] period like the one that ran from the mid-1960s to 1982."

The Econo-Bears

Woody Brock, founder of Strategic Economic Decisions, a research firm in Scottsdale, Ariz., studies similar time periods (which he calls "dated regimes"), then looks at bonds and housing as well as stock market returns for each one. What he has found is decidedly bearish—at least for the near future. "From 1981 to 2000, wealth in the U.S. grew much faster than growth in gross domestic product (GDP)," Brock points out. During that same period, he calculates that real household asset wealth grew by 9.6% a year, vs. 0.6% a year in the 1966-1980 "dated regime."

"We grew rich because of changing valuations, not fundamentals," Brock continues. "P/E ratios went from 8 to 33. If the long-term average P/E is around 15, we might see much lower P/E ratios in the future, to revert to the mean." (As of early December, the market's P/E was around 18.)

The recent wealth buildup also resulted from higher home prices, the result of a real estate run-up that lasted nearly four decades. Obviously, this is no longer the case in many areas. Brock predicts that housing will remain a poor investment until at least 2025. He sees low or even negative real returns from long-term bonds, which are now at high inflation-adjusted prices. "Wealth growth in the U.S. over the next two decades is likely to be painfully slow," Brock says, "less than the growth in GDP."

Martin cites different metrics to reach his bearish conclusion. "Debt in the U.S. increased from 125% of GDP in the early 1980s to 350% of GDP as of late 2007," he says. "Thus, debt has grown more than twice as fast as the economy for the past 25 years."

The bursting of the credit boom in 2007-2008 may generate years of stringency, as consumers struggle to repay debts and lenders cut their losses, Martin contends. "Paying down and writing off debts, along with a renewed awareness of the need to save, will probably slow global economic growth to a crawl for a few years," he says. "This is a wrenching reversal from credit abundance to penury." Slow growth is likely to produce smaller profits, investor pessimism and slumping stocks.

Right now, Martin expects another four to five years of bear market malaise. If earnings are hurt severely by a global slowdown and P/E ratios also fall, Martin believes that the S&P 500 could fall as low as 300, from its current level around 850. At 300, the S&P 500 would be about 80% below its bull market peak.

Planners who, like Martin, have serious doubts about investment returns for the next few years should share their concerns with clients. "If an advisor thinks that the market outlook is grim," he says, "I can't imagine why he or she would not communicate that." But informing clients has risks as well: They may decide that they don't need to pay an advisor to deliver a long period of low earnings. "They might just put all their money into bank CDs," Martin says.

Battling the Bear

Should clients who fear a long period of stagnation hide in CDs? Pessimists offer some alternatives. Brock suggests looking overseas. In much of Western Europe, Japan and many emerging markets, he says, wealth hasn't grown as fast as in the U.S.; as a result, foreign countries might produce better investment returns going forward.

Young clients may benefit from an eventual rebound but retirees and pre-retirees face difficulties, Brock says. "Not only are stocks down now, but retiring baby boomers may also not be able to sell their homes at the prices they expected to get. My advice to them is to work longer, save more and scale down their lifestyle."

Martin employs a long-short investment strategy that reflects his cautious outlook. "About half of our clients' money is held in cash (mostly Treasury money market funds), high-quality short-term bonds and gold bullion," he says. "For the other half, a typical position is 30% long and 20% short, so we're only 10% net long now."

To get that 20% short position, Martin holds the Leuthold Grizzly Short Fund, a mutual fund that sells stocks short. He also holds inverse exchange-traded funds from ProShares and Rydex. If indexes such as the NASDAQ 100 and the Russell 2000 go down, their inverse ETFs will move up, and vice versa. "ETFs are very helpful when markets are so volatile during the trading day," Martin says. "Mutual funds can be very frustrating due to their end-of-day pricing."

For his long position, Martin disdains index funds. "By definition, you get competitive and not-so-competitive companies" in favor of individual stocks, with selected themes such as energy, healthcare and emerging markets. He has been rebalancing between these long and short positions, just as many planners will sell stocks and buy bonds when their equity/fixed income asset allocation goes off target.

To illustrate, suppose the goal is to be 20% short when a market slide brings those short positions to 25% of a client's portfolio. "We take gains when positions move more than 20% above our target," Martin says. In this case, he'd sell off bear market holdings to bring the short position back from 25% to the 20% allocation. Proceeds from the sales would go into selected stocks that had declined. "When stocks rise and the shorts lose ground," says Martin, "we do the opposite."

Skeptics Have Their Say

Not everyone readily accepts the idea that we're in the midst of a long-term period of stock market stagnation. Ken Eaton, principal at Stepp & Rothwell, a financial planning firm in Overland Park, Kan., asserts that the past eight years have been different from the 1968 to 1982 period because we have not had the same problem with inflation as we did then. Glenn Frank, a senior vice president at Wachovia Wealth Management in Waltham, Mass., contends that the numbers from the late 1960s to the early 1980s are distorted by the 1973 to 1974 oil price shock, which led to two negative years for stocks and a surge in inflation that reached 12% in 1974. "We could be in a period of long-term stagflation," says Frank, "or equities could beat inflation by several points over the next 10 years." There's no certainty about the next decade.

Diahann Lassus of Lassus Wherley, a wealth management firm in New Providence, N.J., is also not convinced that designating long periods of stock market stagnation is especially meaningful. "We all look at history," she says, "and can find some periods that were better than others. I have my own gauge of where the market is: client calls."

When clients are most aggressive, Lassus says, stocks are close to a top. When she hears, "Are you sure I should stay invested," we're near the bottom. "I've had more calls from nervous clients in the past few weeks than I've had in years," she says. "So I think the bottom can't be far away."

Whether the bottom is near or far, Harold Evensky of Evensky & Katz, a wealth management firm in Coral Gables, Fla., says you can only see long-term market trends in hindsight. "For now," he points out, "it's forward-looking returns that matter."

The Fixed-Income Fix

On the investment side, Peng Chen, president and chief investment officer at Morningstar's Ibbotson subsidiary, thinks some lessons have emerged from the recent turmoil. "Diversification helped," he says, "especially if you had fixed income in your portfolio. Many people don't appreciate bonds, which may seem boring. This time, bonds provided valuable non-correlation."

In late 2008, every category of stock funds tracked by Morningstar was down 23% to 58% for the year. General bond and government bond funds were down a comparatively modest 7% and 2%, while some short-term bond categories enjoyed small gains. Therefore, bonds proved to be a much more effective diversifier last year than did foreign stocks, precious metals, energy, real estate and other supposedly non-correlated asset classes.

Some planners bolstered their bond positions in fear of the market's further drop. "In 2007, we moved about 10% of clients' assets from equities to fixed income," says Cheryl Holland, president of Abacus Planning Group in Columbia, S.C. "For a moderate-risk investor, that might have meant going up to 35% in fixed-income."

Among bonds, Holland believes that Treasury inflation-protected securities (TIPS) are especially appealing right now. "TIPS will outperform standard Treasuries if inflation is over 1%," she says, "so there's little downside." Moreover, TIPS provide a valuable hedge against much higher inflation.

Caution on Cash

If bonds are helpful, how about cash? "If you have short-term needs, building up cash makes sense," Chen says. "Long-term investors should maintain an adequate cash reserve, but holding on to extra cash probably will hurt returns."

Some planners concur that sitting in cash is not the best way to ride out this uncertain market. "For clients who are so worried they can't sleep, we're ratcheting back their equity allocation. But we're not going to zero," Dimitroff says. "Few people can go to cash and have enough money for the rest of their lives. We're suggesting that clients hold enough cash to meet near-term expenses, and that they watch their spending. We don't want to liquidate assets at these low values if we can avoid it."

Similarly, Evensky doesn't think this is a good time to go to cash. "Most people, when they move from stocks to cash, focus on the reduction in risk," he says. "They might have to drop their expectations, too, because going to cash also means a reduction in the things they can do." In fact, Evensky thinks this might be an excellent time to invest, considering today's low asset values.

Time to Buy?

Chen also says that buying stocks may make sense now, as long as investors have asset allocations that match their tolerance for today's volatile markets. "It's hard to time the markets," he says. "When do you get out? When do you get back in? In stock market recoveries, major moves can happen in a few days or weeks. Over time, investing in risky assets pays off."

Because bonds outperformed stocks in 2008, an enthusiastic stock market bull would be rebalancing now, selling fixed-income holdings and buying equities. However, some planners have been reluctant to move money from categories that have lost relatively little to those that have done much worse. Holland, for example, says her firm stopped rebalancing portfolios last year, concerned about clients' anxieties and possible downside momentum. "Now that we've had an opportunity to talk with our clients, we're starting to rebalance again and we're starting to invest some cash we were holding. We explained to clients how lower valuations improve the long-term outlook. In particular, dividend-paying stocks look good now-with their prices down, some are yielding more than Treasuries."

Lassus also says that some clients are so nervous that her firm slowed down its rebalancing. "Suppose a client has a position that would generate profit-taking if it moves four percentage points above its allocation," she says. "When that happens, we might sell just enough to lower that position by one point. Over time, we'd do another point and gradually get down to the target."

In effect, this is a dollar-cost averaging approach to rebalancing, to soothe clients who'd object to selling assets that have done relatively well. For younger clients, such as those in their forties, Lassus' firm is rebalancing more actively.

Dealing with Doubts

Planners who are cautious, but not extremely bearish, need a two-pronged strategy for 2009. First, it's vital to develop a realistic investment plan. Second, that plan must be paired with creative communication with clients, so that they feel comfortable. Buying stocks gradually might be perfectly logical now, and might pay off in superior long-term returns. However, planners have to deal with clients who, as Dimitroff notes, may be terribly worried about their finances. This money represents their future, after all. "Our job is to prepare folks for reality," she says. "We're telling clients that this down period could last for an extended period of time."

Indeed, many people who are not familiar with the Ibbotson data fear that the worst is far from over. "I recently did a call-in show with some other NAPFA members," says Lassus, the association's current chair. "The question we heard most often from consumers, regardless of age, is whether they should stop putting money into their 401(k)s. They'd ask, 'Why should I keep contributing when the account balance keeps going down?'"

This concern is more acute now than it was in the past, when 401(k) and other investment statements were delivered monthly or even quarterly. "A lot of companies have stopped mailing 401(k) statements," Lassus says. "Instead, employees can get current account balances online, all the time."

Lassus reports hearing from a client who is a partner in a law firm that has endured lost productivity since the market crash, adding insult to the injury. "Employees spend their time talking about how much money they've lost," she relates. "When my client walks through his office, all the computers are turned to the employees' 401(k) statements."

How can planners reassure clients as they watch their portfolios shrink? "We're telling clients that diversification doesn't always work but it still will be worthwhile over time," Frank says. "With the huge drop in values, comfort levels have been tested as they never have been before. We say you should not stay invested just to get your money back—if you are not sleeping, we need to change things."

Frank says that clients who are comfortable may find this to be the buying opportunity of a lifetime. "They need to ignore markets in the short term. Once a decision is made, they shouldn't read a newspaper or watch TV."

Some clients may need more communication than others. "Long-term clients know asset classes may go through cycles but they'll come back to the mean," Eaton says. "They've seen markets go up, down and back up. Newer clients are more anxious, so we've had to spend more time explaining things to them."

According to Eaton, his firm has discovered that clients need more than their regular quarterly meeting and their ability to call for reassurance. "We've been calling all of our clients during the past few months," he says. "The old ones might say that it was nice to hear from us, but the newer ones have said, 'I'm glad you called-I didn't know what to do next.'"

Long Story

Of course, planners don't absolutely "know" what to do next, just as they don't know what will happen next in the markets. We may already have hit bottom; the bear market might continue for four or five years, as Martin expects; or we might not resume strong growth during the first quarter of this century, as Brock estimates.

In any case, though, the long-term outlook is brighter than the current vista. Markets have always turned up after downturns and there's no reason to think this pattern will end. In hindsight, some of the best times to invest during the 1968-1982 time frame were in 1975 and 1976, right after a brutal two-year bear market.

Looking at an even worse scenario, consider a hypothetical investor who bought the equivalent of the S&P 500 in early 1929, just before a three-year bear market that took 90% of stocks' value. Such an unlucky individual, pursuing a buy-and-hold strategy, would've shown profits after 15 years, according to Ibbotson. After 17 years, stocks' return was five times as much as cash; after 24 years, stocks' annualized returns were twice as much as "safe" intermediate-term government bonds. Time may not heal all wounds, but a sufficient amount of time probably can heal any injuries suffered by patient, well-diversified investors.

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