

NOTES FROM THE NORTH: MARKET OUTLOOK

February, 2020

One of the most basic questions we field is “How much money do I need to save for retirement?” or for those further along in the process, “Now that I am retired or about to retire, how much money can I take out of my accounts each year without running out?” Like most advisors, we can use a computer program to frame an answer to the questions, using estimated spending needs, actuarial lifespan expectations (about 95), and possible future market outcomes based on history to project the likelihood of assets successfully funding a lifetime of retirement income. The computer makes it all seem very simple, but let’s delve a little deeper into some of the variables.

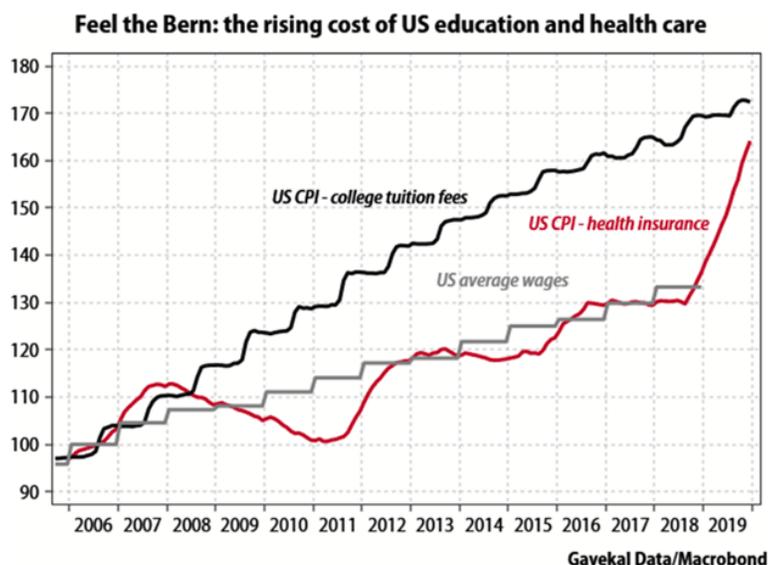
Spending: While the rule of thumb is that retirement will require about 85% of the income that was generated prior to retirement, spending in retirement can vary dramatically between individuals. The vast majority of our clients are prudent spenders, but it’s not hard to spend more than anticipated, particularly early in retirement. Travel, new hobbies (or more time to pursue them), family gifts, and even downsizing can make demands on your cash flow. Typically, discretionary spending does settle down over time, but at that point in the cycle, medical expenses tend to step up to fill the gap.

Inflation: Another variable to consider is the impact of inflation on spending needs over time. While it has been easy to ignore lately, inflation remains a meaningful consideration over the course of a 25-30 year retirement. How much inflation should we anticipate? The Federal Reserve focuses on Personal Consumption Expenditures price index (PCE). This index measures prices and it also incorporates changes in what we spend our money on (Netflix would be replacing movie tickets, for instance). The PCE Index has risen 1.6% per year since 2000. The more familiar Consumer Price Index (CPI) has risen 2.3% per year over the same time period.

Most of us would probably say we’ve been experiencing more than a 1.6-2.3% annual increase in our own expenditures every year. Is this an optical illusion? Probably not. The CPI may give an indication of price changes for the broad economy, but in the real world, one’s own experience of inflation can depend greatly on geography (where you live) and what you spend your money on. Location significantly affects the price of a home or of rent. Some big ticket items, such as college tuition and health insurance (highlighted right), will be experienced by some and not by others. A business owner that moved to San Francisco or Boston, bought health insurance for employees, and put kids through college would experience a boatload of inflation!

John Mauldin recently explored another reason behind the difference in our experience of inflation and the government’s reporting of it in a piece entitled “Nose Blind to Inflation.” One of the key mysteries is the impact of “hedonic adjustments” to the CPI. Stay with us....

Since 1990, the government has adjusted prices in the CPI for *quality*. According to the CPI, for instance, the quality of a television set has improved so much that a set that cost \$1,000 in 1996 now costs only \$22. So, according to the CPI, prices for TV’s have plummeted because we get so much more TV now than we did in 1996. This is true, but you will still pay \$1,000 (not \$22) for a television set.



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From a cash flow perspective, everyone is forced to buy the quality improvements since the \$22 sets aren't available. After the hedonic adjustment for quality, the cost of a car has only risen 2% since 2009. You can imagine the calculation for a computer or a cell phone! From a cash flow perspective (which one could argue reflects "reality"), the price of a TV hasn't really declined at all. While cars, computers, and cell phones have a wider variety of price and quality points than do TV's, most models incorporate quality features that weren't available ten years ago and even if we step down in price points, we tend to pay for at least some of those features, thus experiencing higher prices.

To frame this more specifically, consider ShadowStats's results from using the pre-1990 method to calculate CPI. They show inflation running about four percentage points per year higher than the post-1990 calculation. Another alternative measure is the Chapwood Index. Twice a year, Chapwood checks the price of 500 common consumer items in the 50 largest cities. As of mid-2019, by this measure the five-year average annual cost of living rose anywhere from 6.6% to 13.1%. Even the government's CPI calculation could heat up over the next decade; many economists think that today's loose fiscal and monetary policy will eventually result in an acceleration of inflation.

Returns: Perhaps the biggest uncertainty in the computer's forecast of a retiree's success surrounds the projection of how much a new retiree's assets will earn on average over the next 25 to 30 years. The financial planning software assumes historical rates of return. This may be a reasonable assumption for such a long time frame, but we think it's probably too optimistic for the next 7 to 10 years. Vanguard, for instance, is predicting that over the next 10 years large U.S. company stocks will provide nominal annual returns of 3.5% to 5.5% and U.S. bonds will return 1.5% to 2.5%. GMO (Grantham Mayo and Otterloo), a firm that built a highly successful business on the basis of surprisingly accurate 7-year forecasts, currently expects large-cap U.S. stocks to *lose* 2.7% per year over the next 7 years and bonds to return just 0.4%. If GMO's forecasts proves out, after incorporating a projection of 2.2% inflation, the real return to large-cap U.S. stocks would be decidedly negative and bonds would be modestly in the red.

While the computer's answers will be a function of mathematical assumptions and forecasts, our answers will be nuanced by our understanding of each client's individual and unique situation. We're generally likely to be more conservative than the computer, and to plan carefully for the negative surprises rather than assuming we'll experience anything close to "average."

As we wrote this piece, we thought it would be an interesting exercise to explore what clients have in reality been doing with their investments. The good news is that over the last five years, on balance our clients have added to their accounts. For those drawing from their accounts, the top decile of negative draw was -15.9%. Most of the portfolios in this category experience a significant one-time withdrawal for an extraordinary circumstance. (This level of draw on a continued basis would not be sustainable even in a very favorable market environment!) Of those clients that are withdrawing funds regularly, the average account draw down has been 4.4% per year. This would probably be too high for someone just retired, but the average includes our older clients, many of whom are drawing 5%-6% of assets. Given their age and that their *required* draw from tax-deferred accounts is higher than for a younger client, this is reasonable.

The tradeoffs between "Now versus Later" and "Secure versus Risky" lie at the very heart of investing. Helping clients understand these tradeoffs and exploring where they'd like to be on the continuum is always an interesting, and many times an illuminating, conversation.

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