PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

August 2019

Recent titles of financial articles included phrases like "About to Retire?", "Be Careful Looking for Income", and "Time for Emerging Markets?" This month, we thought it would be useful to delve a bit deeper into the thinking in these articles. The main takeaway is to be careful about taking additional risk to earn higher returns without acknowledging that this is what you are doing.

Extrapolating Past Returns into Retirement

For the ten-year period ending July 31, 2019, U.S. stocks returned 13% to 14% per year. This has helped many to recover from the 37% market decline of 2008. Some of these people feel like they can now retire. Studies consistently show two ways that investors have made or may make poor choices based on past returns.

First, if past returns have been above average (13% is above average) investors tend to **raise** their forecast of future returns. This may seem counterintuitive in the sense that if past returns have been above average, you'd think folks would expect lower future returns. However, studies consistently suggest otherwise. By having an expectation that could be too rosy, individuals might believe that they can retire on less money and/or they can spend more than they otherwise thought. However, investors may be taking additional risk in their retirement without acknowledging it.

Second, there is the potential for an error in asset allocation. Past returns may have resulted in a portfolio with 65% stocks and 35% bonds, when an individual's risk tolerance may suggest a less risky portfolio. Individuals may become comfortable with more risk going forward because stocks appear to be much more advantageous than bonds. The increased risk tolerance may not have the desired results during the next market downturn if the investor sells stocks because they believe their portfolio is too risky for them.

The best way to address the above is two-fold. First, establish some level of confidence that your beginning value is not inflated from recent returns. For example, in early 2019, the S&P 500 traded at a valuation level that appeared fairly valued. This meant you could have more confidence using the current value of your portfolio in planning for both future returns and future withdrawals. Second, be sure you review your asset allocation so you start retirement with the proper risk profile.

Be Careful Looking for Income

With interest rates on bonds and dividend yields on stocks "low", investors tend to search for ways to earn more income. This can be a valid strategy, but investors need to acknowledge that they are likely taking on more risk to achieve more income. Let's look at two examples.

First, we use both high-yield bonds and foreign bonds in most portfolios. These count as bonds when saying a portfolio is 60% stocks and 40% bonds. However, we make it clear that a portfolio with 30% standard U.S. bond funds and 10% high-yield and foreign bonds is riskier than one with 40% standard U.S. bond funds. The added risk can lead to higher returns but be mindful of what you are doing.

A "new" approach also takes added risk in the bond portion of your portfolio. The thinking in these articles is to consider of part of your portfolio as "income producing". This allows one to hold higher yielding stocks or a mutual fund that focuses on higher yielding stocks. They may recommend only 5% in this type of investment, but one is adding risk if a portion of the "bond" allocation is, effectively, invested in stocks.

One way to acknowledge the risks in either example is to reduce the stock exposure by 5%. This results in a portfolio that is 55% stock and 45% "bonds", where the bonds are riskier than a standard U.S. bond fund.

Emerging Market Stocks

Some articles urge adding emerging market stocks to your portfolio as they may produce higher returns than developed market stocks over the next one or two decades. Most articles that favor this addition acknowledge that you need to hold such securities for a minimum of 10 years and to expect years of plus or minus 50% returns. Such a security is a stock like the S&P 500 index fund, but with more risk. Acknowledge the added risk.

Be careful about adding risk to increase returns without acknowledging that this is what you are doing. If you don't do this, we believe you are increasing your chances of making some poor investment decisions in the future.

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