PACIFIC WEALTH MANAGEMENT®

As individuals approach retirement many begin shifting their portfolio composition into a conservative allocation, consisting of more bonds than stocks. Bonds have historically provided more security than stocks while generating enough income to sustain a retiree's lifestyle.

In the present economic environment however, bond yields are hovering at record lows. As longevity and the cost of living increases, the perceived safety of bonds can be negated by the insufficient returns they provide.

How does one mitigate the risk of outliving their assets without assuming too much investment risk in this new environment?

Low investment returns lie ahead

The expected returns over the next 10 years are 5.6% for stocks and 0.6% for bonds. A balanced portfolio return would be 3.6% per annum.[1]

Indicators Signal Low Growth for Stocks for Next Decade

- Mean Reversion of Earnings Growth: Average earnings growth over any 10-year period is 5.7%. Decades with above average earnings growth have been historically followed by decades with significantly slower earning growth. The 2010-2019 decade experienced the highest earnings growth on record, 10.58%.
- Earnings Growth is the Primary Contributor to Stock Valuations: Investment return analysis demonstrates that most of historical returns can be attributed to earnings per share (EPS) growth. As the last decade's returns have been driven by record EPS growth, it is very likely EPS in the upcoming decade will revert to its mean, therefore reducing overall return expectations.
- Current Household Allocation to Stocks is at Extreme Levels: With bond yields at record lows, investors have increased their allocation to stocks. Currently stock allocations are in the highest quintile (above 51.86%). Historically, when this occurs, returns in the following 10-year period have averaged only 4.01%.
- Buffett Metric: *Stock market capitalization as a percentage of Gross Domestic Income (GDI).* Recent growth in the stock market

[1] According to Ned Davis Research, using the current dividend yield, long-term average EPS growth and amortizing a return to fair value over time gives us a 10-year return projection of 5.6% for stocks. Bond returns are estimated using current yield. Estimates – dividends, earnings, and valuation will differ from expectations.

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has outpaced the growth of the economy. This portends lower returns in the future.

- Shiller P/E ratio: *Demonstrates the correlation between current valuation, measured using Shiller's Cyclically Adjusted Price to Earnings Ratio (CAPE) and subsequent 10-year returns.* Currently projects a 6.7% 10-year return on stocks vs. the average since 1948 of 11%.

Low Interest Rates Signal Low Returns for Bonds for the Foreseeable Future

- Future Long-Term Bond Returns Can Be Estimated Using the Current Bond Yield: According to an analysis by *Ned Davis Research*, "historically, there has been a strong positive correlation between the current yield and the buy-and-hold return for bonds–which makes intuitive sense. For example, an investor buys a 10-year U.S. Treasury bond at yield of 0.65%. The investor will earn 0.65% per annum if they hold the bond until maturity."

Retiree need for return & the risk of asset depletion

Risk of Outliving Assets

- Longevity: Average life expectancy for a 60-year-old man is 82, woman is 85.[2] However, according to the *American Society of Actuaries*, there is a 34% chance that at least one spouse aged 60 today will live beyond age 95.[3]
- Greater Inflation Rate in Core Living Expenses for Retirees: Housing and healthcare account for approximately 60% of spending by retirees. These have seen significantly higher rates of inflation: Medical CPI (Gain/Annum: 5.7%) Housing CPI (Gain/Annum: 4.2%) Core CPI (Gain/Annum: 3.9%).
- Insufficient Investment Returns to Sustain 4% Annual Withdrawal: For decades, the rule-of-thumb advice for retirees has been to withdraw 4% of portfolio value each year as retirement income. This becomes problematic when a balanced portfolio is only expected to return an average 3.6% per annum over the next decade.
- Sequencing Risk[4]: During bear markets, portfolio income may fall–triggering the sale of assets to meet minimum withdrawal requirements. This shrinks retirees' portfolios, making it harder for it to earn sufficient future income.

[2] https://www.ssa.gov/oact/STATS/table4c6.html

[3] http://www.longevityillustrator.org/, (accessed June 29, 2020)

[4] **Sequencing risk** is the danger that the timing of withdrawals from a retirement account will damage the investor's overall return. Account withdrawals during a bear market are more costly than the same withdrawals in a bull market. (Investopedia.com)

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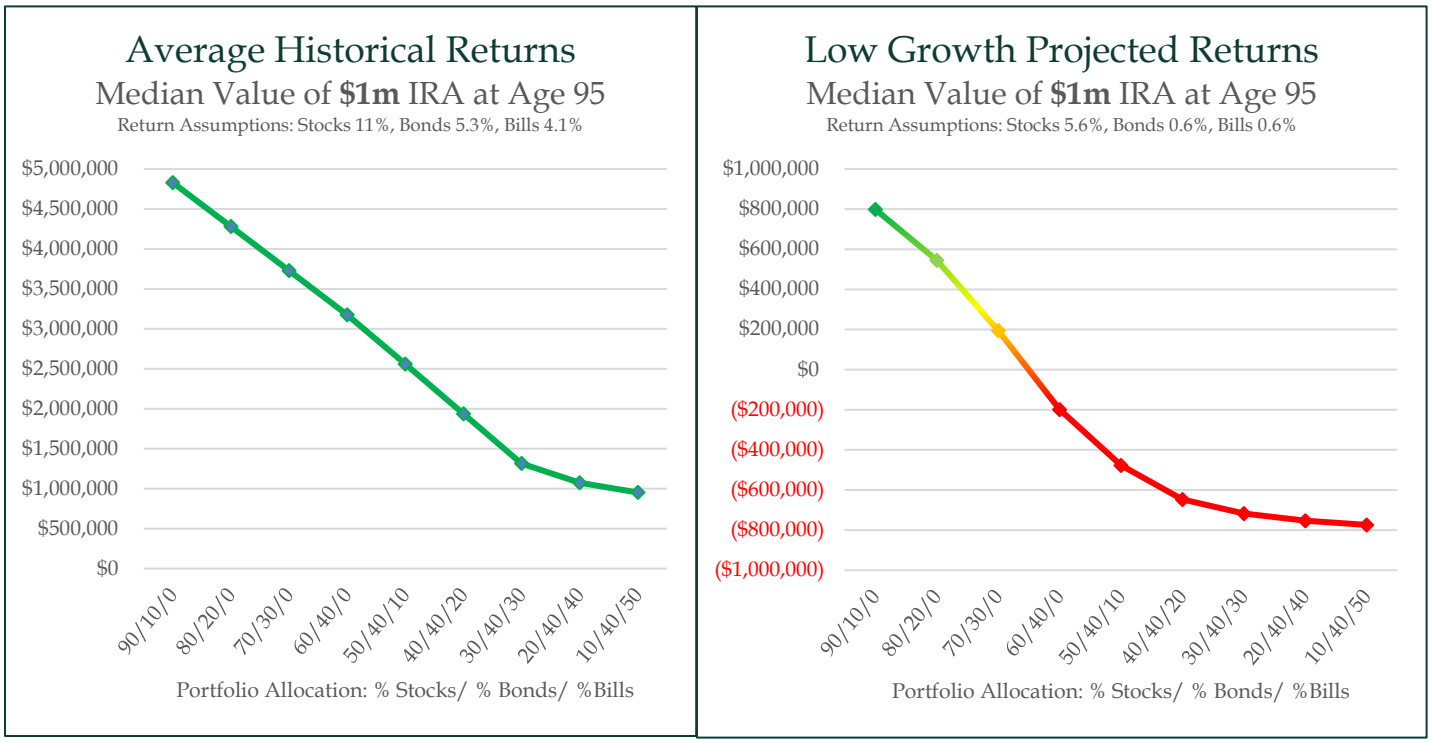
Portfolio Simulation

- The following graphs project the end value of a retirement portfolio of a retiree with the following assumptions:
    1. Retiree age 62
    2. Social Security filing age 62 with year 1 benefit of $24,000. Spouse files for spousal benefit (50% of primary benefit) at full-retirement age (67).
    3. Annual expenses of $67,145 (the average expenses of a retiree in CA[5]) in year 1 adjusted for inflation at 2.62%.
    4. Life expectancy of 95 years. According to the *American Society of Actuaries*, there is a greater than 1 in 3 chance that one spouse will live beyond age 95.



[5] https://www.usatoday.com/story/money/2020/01/10/what-it-costs-to-retire-comfortably-in-every-state/40953369/, (accessed June 29, 2020)

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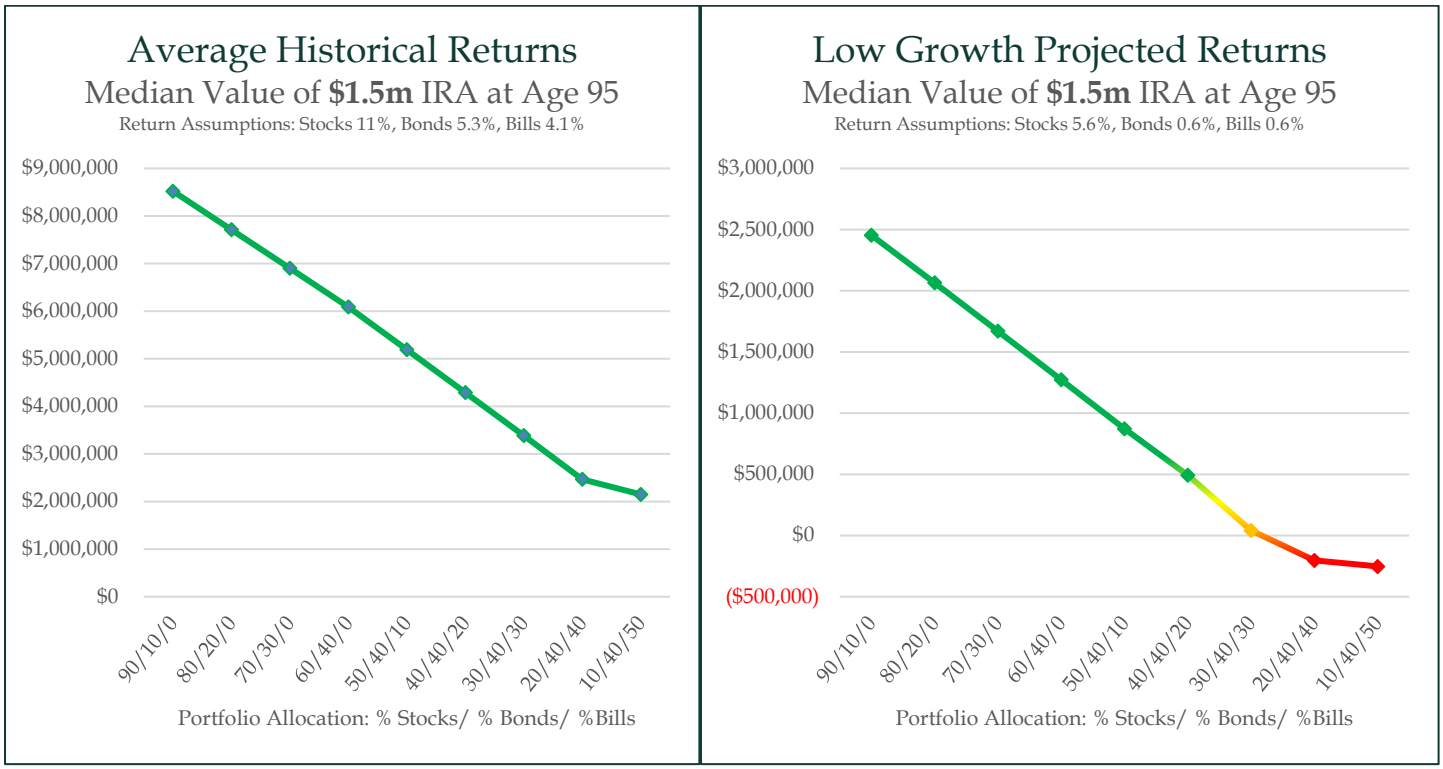

Due to reduced stock and bond return expectations, higher inflation for housing and healthcare for retirees, and increased longevity, a balanced 60/40 portfolio may not meet the needs of many individuals about to retire or already in retirement.

A pathway to secure retirement

The Case for Increased Stock Allocations

- The dividend yield for U.S. stocks is currently higher than the yields available on bonds, such as U.S. Treasuries.
- Stock Dividends have historically grown at a faster rate than inflation.
- Stocks Dividends are more stable than stock prices.
- A larger allocation to stocks reduces the risk of outliving your assets in retirement.

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Mitigating the Risk

Allocating more to stocks reduces the probability you will outlive your retirement savings yet increases the volatility of your portfolio and the potential impact of sequencing risk.

Tactical asset allocation can be used as a strategy to help manage these risks. Preserving wealth more effectively in bear markets allow portfolios to efficiently maximize participation in subsequent market rebounds.

Tactical Asset Allocation

- Effective Tactical Asset Allocation strategies reduce the impact of rare, extreme "tail risk" losses within the critical period when people are imminently transitioning into retirement and the initial 10-15 years of retirement.
- Within the last 50 years there have been 15 cyclical bear market declines (including February-March 2020). The median *bear market declines averaged -25.9% with a median duration of 304 days*. Over the same 50 years there have been 15 cyclical *bull markets with median gains of +73.1% and a median duration of 916 days.*
- The worst returns in a bear market happen in the *final* third of a typical bear market. The decline in the final third is more than the first two thirds combined. Avoiding at least part of these bear markets significantly reduces portfolio volatility and sequencing risk. When markets rebound, historically it is the first third of a bull market where the highest returns are made.
- A strategy that avoids the final third of a bear market by reducing exposure to stocks and increases its exposure at the start the second third of a bull market, historically has avoided more than half of the median loss, while capturing approximately half of the median gain.
- Successful Tactical Allocation Strategies preserve wealth effectively in bear markets so investment portfolios can effectively maximize their participation in the subsequent bull market rebounds.

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Sound Management for *your* Secure Future

Pacific Wealth Management is a fee-based, fiduciary firm offering comprehensive Retirement Planning expertise.

Our disciplined retirement planning process includes:

- Goals Based Needs Analysis
- Social Security Planning
- Long term Projections
- Monte Carlo Analysis
- 401(k), 403(b), 457 retirement plan analysis
- Retirement Distribution Strategies

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