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Practice Management

Tactical portfolio helps ease retirement in today's market

Q After watching more than 30% of my retirement funds disappear since March 2000, I am wondering if I should stay in the stock market or get out. I am close to retirement and am concerned about my future. Is there any advice you might have for planning for retirement in today's markets?

By John J. and Traudy F. Grande, CFPs

It may not be any consolation to you, but many investors have become concerned about, or are now discouraged with, the performance of their investments. Standing by and watching years of savings and past gains slip away over a 2-year period has many people wondering what to do next. According to the September issue of the *AARP Bulletin*, more than $7 trillion has evaporated since this bear market started. Of this, about $700 billion disappeared in value within retirement savings. To give you another perspective, a dollar invested in the broad-based S&P 500 in March 2000 is now worth about 55 cents.

The source of the current market trouble stems not only from the cyclical nature of our economy, but from many other areas: Sept. 11, Enron, WorldCom, Arthur Andersen and, not so unexpected, a resulting lack in consumer confidence. Even after 11 interest rate cuts, the economy is still struggling, as are company profits.

The question you asked us is one that is being asked of our top financial gurus each day on every financial radio and television station in America. What adds to the confusion are the compelling, yet constantly opposing, points of view that these economists, financial advisors, and analysts are giving. As an example, here are two monumental names in the financial industry giving their most recent advice.

Two views

According to a telephone interview with Peter Lynch, in the same *AARP Bulletin* that we quoted above, he is a tad impatient with the gloom and doom talk over the economy. He says, "We've had nine other recessions since World War II and we have gotten out of every one of them." The advice that Lynch is offering to investors is to keep things in perspective. After every bear market (defined as a 20% decline) in the last 60 years, he says, "a year later the market was higher."

Or, we can give you a less optimistic forecast according to an interview with PIMCO's Bill Gross, in the March 4, 2002 issue of *Fortune Magazine*. Gross oversees investments of more than $350 billion in bonds and is the highest-paid money manager in the world. According to Gross' September investment outlook (*www.pimco.com*), his message is as follows: stocks stink and will continue to do so until they're priced appropriately, probably somewhere around Dow 5,000, S&P 650, and the NASDAQ "God knows where." His article is interesting and worth viewing at the above-mentioned Web site. Keep in mind, however, that Bill is a bond trader.

So, here we go again, two viewpoints from two of America's top managers. Both are brilliant and respected, both can offer compelling evidence to back their opinions, and yet they are giving conflicting predictions.

Alternative strategies

We believe that the question is not which analyst, financial advisor, or economist you should believe, but rather, why should you have to believe anyone?

After all, this is your money, your retirement, and your security. We think that guessing who is right and who is wrong is taking

too much of a gamble with your retirement funds. How can you attempt to lessen your risk, while still attempting to achieve a decent return on your investments?

We believe that the answer lies in constructing a tactical portfolio, and adding to your existing portfolio some of the newest state-of-the-art investment vehicles. Especially, if you are close to retirement or just entering retirement, you should learn about new ways that allow you to take monthly income while participating in the possible future growth of the stock market, and at the same time having a safety net in place to protect against declining markets. This can be achieved through the use of what we refer to as "defensively aggressive" investment vehicles.

The basics

First, going back to basics, diversification between asset classes is still prudent and strongly recommended, but, as we have seen over the last two and one-half years, asset allocation was not enough to protect profits or principal. Whether you were invested in large cap value, large cap growth, international, or any one of many other asset classes, your portfolio most likely saw a decline in value over the last 30 months.

Besides diversifying between equities, traditional fixed-income investments, and real estate, there are other ways to reduce risk further in a portfolio by investing in asset classes that are either negatively correlated or noncorrelated to traditional equity investments (See "Alternative investment strategies can offer significant ROI," May 15, 2002 issue, Page 59). We strongly believe that in many cases this sophisticated approach to investing should be considered for 5% to 10% of an investment portfolio. Among the various management styles within alternative investments there exist hedge managers, who utilize low leverage and are permitted to apply strategies and techniques that provide them the opportunity to achieve positive rates of return in down, sideways, and up markets.

There are many different types of alternative investments and, although they are not a panacea for all investors, we recommend that you read this article. A reprint can be found at *www.grandenewsletters. com*, or we will be happy to send you a hard copy.

Some new approaches

Besides alternative investments there are now products available that have been specifically developed for the purpose of protecting profits and principal during periods of crisis or economic turndown. Some of these newer types of investment vehicles were not available even 1 year ago. There are so many variations of these products that it is impractical to cover them fully in our response to your question. However, we will introduce you to some of the more popular benefits that these investments can offer you. Please keep in mind that these investments are offered by prospectus only.

Table 1 Allocation of assets matrix 1926 to 2001

S&P 500	Inter. Gov't Bonds	76 Years (1926 to 2001) Average annual return	Std. Dev.	Years with negative return	40 years (1962 to 2001) Average annual return	Std. Dev.	Years with negative return	20 Years (1982 to 2001) Average annual return	Std. Dev.	Years with negative return	10 yea Average annual return
100%	0%	12.7%	20.24	22	12.1%	16.24	10	16.2%	14.68	3	14.1%
90%	10%	11.9%	18.27	21	11.7%	14.81	10	15.6%	13.47	3	13.4%
80%	20%	11.2%	16.32	20	11.2%	13.41	10	15.0%	12.32	3	12.7%
70%	30%	10.5%	14.41	19	10.8%	12.06	10	14.4%	11.22	3	12.0%
60%	40%	9.8%	12.54	18	10.4%	10.77	9	13.7%	10.21	3	11.3%
50$	50%	9.1%	10.73	16	9.9%	9.57	8	13.1%	9.30	2	10.5%
40%	60%	8.4%	9.04	14	9.5%	8.49	8	12.5%	8.54	2	9.8%
30%	70%	7.6%	7.54	11	9.0%	7.58	5	11.9%	7.97	1	9.1%
20%	80%	6.9%	6.36	8	8.6%	6.92	4	11.3%	7.62	1	8.4%
10%	90%	6.2%	5.70	5	8.2%	6.58	2	10.7%	7.53	1	7.6%
0%	100%	5.5%	5.74	8	7.7%	6.60	3	10.1%	7.70	2	6.9%

Ophthalmology Times / Source: Ibbotson's 2002 Yearbook and Ir

The table above presents the arithmetic mean (average) and the annual standard deviation (variation from the mean) of the annual returns f period stated. The data presented above are based on annual figures taken from Ibbotson's 2002 Yearbook. Equity returns are based on the S&P 500, an unmanaged index of 500 widely held stocks. Bond returns are based on the historic performance of Ibbotson's Intermediate G government bonds are issued and guaranteed as to the timely payment of principal and interest by the federal government. Also shown for number of calendar years that produced a negative return. Past performance does not guarantee future results. There is no assurance this tre value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs and tax considerations.

The first area we would like to introduce you to that provides protection of principal, while being invested in equities, can be found in some mutual funds. There are a few funds available that offer a return of your principal after a specific number of years in the event that your original investment has dropped below the initial investment at the end of that specified period. Some of these mutual funds also allow you to "ratchet up" each year and, in effect lock in the then existing higher value for a new period. Extra fees apply for this benefit. Also, principal will fluctuate and you can lose principal if you withdraw your funds before the end of the guaranteed period.

The next area you may want to investigate is the new hybrid variable annuity. We believe this area deserves serious attention from investors. How you may have viewed annuities in the past may not be an appropriate way to view them today.

There have been numerous enhancements in the basic contracts and available riders. There are many companies that not only offer enhanced death benefits, but now also offer valuable living benefits. The death benefits have been around for a long time, but the living benefits are new and have been getting a lot of attention lately by top financial advisors. Many of these new products are designed in such a way that they allow you to mix and match benefit riders to meet your own specific needs. As an example, some riders offer a return of principal after a certain period in the event the underlying balance of your stock account is less than the original investment. Some offer a minimum rate of return, such as 6% per year, or the amount of the equity account balance, whichever turns out to be the greater of the two.

There are also ratchet or "high-water mark" riders, which can be combined with other living benefits and provide an extra degree of safety for your account. Some riders guarantee minimum lifetime monthly payments. Again, each of these products has a prospectus you should request and read carefully before purchasing an annuity.

There are additional expenses connected with these benefit riders and the guarantees that are offered are based on the claims-paying ability of the insurer. Some contracts allow for the immediate withdrawal of a certain percentage of the original investment, and, if the amount of the original investment is lower than the then current value (in some cases the company gives you until age 85 to make this decision), the contract will give you income based on the original investment amount for the remainder of your and your spouse's life, regardless of how the stock market has affected the underlying investments. There are extra costs associated with the purchase of annuities and these riders.

ars (1992 to 2001)

Std. Dev.	Years with negative return
17.29	2
15.69	2
14.13	2
12.62	3
11.17	3
9.82	2
8.61	2
7.60	1
6.89	1
6.58	1
6.72	2

ntermediate Government Bond Index

for each allocation during the e historic performance of the Government Bond Index. U.S. r the same time period is the end will continue. The market

Costs and benefits

When weighing the costs of these new products versus the benefits, the first consideration should be whether the annuity contract is placed within or outside of a qualified retirement account. Even though annuities are tax-deferred contracts, holding them in a tax-deferred retirement account may still be justified because of the death benefit and living benefit features. If the assets are outside of a qualified retirement plan, the savings in taxes may offset the extra costs of the annuity. Also, if your annuity contract has a rider that guarantees return of principal or a minimum growth rate regardless of market performance, you could consider placing most of your equity exposure within this type of an investment, and reduce the amount of exposure in equities that you have outside of the contract by repositioning these holdings into fixed income.

Also, since some of these products can offer you guaranteed future income as well as high-water mark features (annual ratcheting up), this strategy allows you to have a greater amount of your investments in equities, rather than lower-paying fixed income accounts.

You can see from Table 1 on Page 40 that, over time, the higher the percentage invested into equities, the higher the return has been. Although past results are never a guarantee of future performance, we could assume that by being able to increase the exposure to equities, because of the added guarantees, we would also increase expected return.

The question, then, is at what level the difference between the asset mix of stocks and bonds, and the increased expected rate of return, would cover the added costs, which can range from 0.25% to 1% per year for the benefit rider?

In retrospect, most investors or pension fund trustees, when looking back at account values from March 2000 and comparing them with current values, would have locked in their values, if they had been allowed to ratchet up, and they would be sleeping a lot better today with those guarantees in place.

Finding a balance

To paraphrase, Will Rogers said many years ago, "it isn't the return on my money that I'm worried about, it is the return of my money." Today, this seems to be a familiar theme that we keep hearing. The question, however, is now, "how do I participate in the higher expected returns of the stock market and not risk losing everything I have worked for?"

The answer is not easy but may be found in diversification between equities and fixed income, asset classes and styles, alternative investments for those who qualify, and newly developed investment vehicles that are structured to allow investors to be defensively aggressive. Placing a safety net under some of your portfolio should offer you more peace of mind.

We do not have a crystal ball, nor can we pretend to know which economist or money manager is right or wrong about the future of the stock market. We believe that things will get back to normal and America will prevail as the leading economic power in the

world. Stock markets will more than likely rebound until the next economic contraction occurs and then the cycle will start all over again.

We do not know what the future holds, and since Sept. 11, we all sense, sadly enough, that for a long time into the future we will live in a world of uncertainty. It is because of this uncertainty that we suggest that you research and consider placing a safety net under a portion of your portfolio. Without hesitation you insure your home, car, boat, and anything else you have of value. Now you can insure a portion of your money.

Having a portfolio that includes equity investments whose performance is not solely tied into the stock markets and/or vehicles that provide minimum guaranteed rates of return, or guaranteed return of principal, while being invested in the stock market, will allow you to participate in the future of America's industrial and technological growth while reducing your downside exposure. There is a small cost for this benefit, but we believe it is worth it. **OT**

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