

WJM FINANCIAL, LLC

Fee-only financial planning and investment management

Bill Moeckel, CFA, CFP™
President

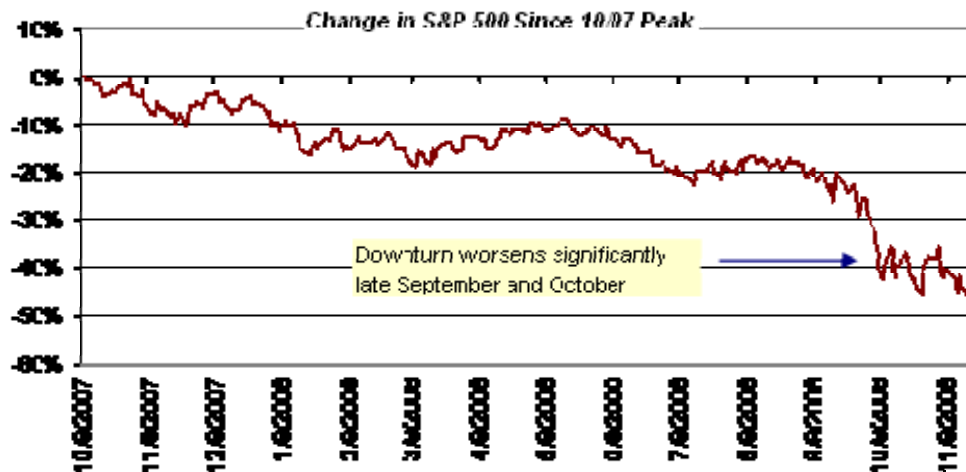
MARKET DOWNTURN Q&A

How bad has this market downturn been relative to other downturns?

The current market downturn has been severe by historical standards and extraordinarily difficult for investors of all sorts. Since reaching a record high in October 2007, the S&P 500 has declined by 51% as of this writing. In terms of severity, this is the worst market decline since the downturn in 1929-1932. The following table summarizes the severity of other notable market declines:

Time period	Total peak-to-valley decline	Duration
1929 – 1932	-83.4%	34 months
2007 – 2008	-51.5%	13 months
2000 - 2002	-44.7%	25 months
1973 - 1974	-42.6%	21 months
1987	-29.5%	3 months
1968 – 1970	-29.3%	19 months
1962	-22.3%	6 months
1946	-21.8%	6 months

By the middle of September of this year, the stock market had declined approximately 20% below its peak value, and the downturn appeared to be painful but not extraordinary. Unfortunately, what had been a steady decline through the first three quarters of the year, turned into a panic driven sell-off in October when the stock market registered one of its worst months in history. The S&P 500 fell by as much as 25% in October, and has retested those lows in November.



Has diversification helped to lessen the impact of the downturn?

The benefits of diversification have been less than in prior downturns. As the following table illustrates, this has been an indiscriminate downturn that has taken a bite out of just about every investment style, including the traditionally “Armageddon safe harbors” of gold and silver.

	1 month	3 months	YTD	1-Year
US Stocks (iShares S&P 500)	-23%	-40%	-47%	-46%
Foreign stocks (iShares MSCI EAFE)	-25%	-43%	-54%	-54%
Bonds (iShares Lehman Aggregate Bond)	2%	-2%	0%	1%
Real Estate (iShares DJ REIT)	-42%	-59%	-60%	-60%
Gold (iShare Comex Gold Trust)	-6%	-8%	-11%	-7%
Silver (iShares Silver Trust)	-9%	-33%	-40%	-40%
Return data through 11-20-08				

Bonds have certainly helped to balance a portfolio and reduce the downside, but the extraordinary level of risk aversion has even resulted in declines for all but the very highest quality bond funds (i.e. US Treasury Bonds).

Do our current investment strategies continue to make sense?

As difficult as the past year has been, and it is certainly testing our resolve, I do believe that our core investment strategies – asset allocation and broad diversification, passively managed asset class funds, low costs, and disciplined rebalancing – remain appropriate.

- Asset allocation and diversification have not helped as much as they have in the past, and they have certainly not helped as much as we expected. We believe that this is partly systematic (global markets are increasingly intertwined), but we also believe that long-term diversification benefits remain even if they are not as great as they once were.
- While passive investment styles are often derided as “fine during a bull market, but sure to underperform when the markets get ugly,” the fact is that passively managed funds have performed better than most actively managed funds during this downturn. We believe that this is almost entirely a result of the much lower expenses associated with the funds that we use.
- Low investment expenses help in every type of market, but they are especially important in downturns and during low return periods when higher investment costs eat into a larger percentage of total return. In most cases, we have maintained average portfolio expenses that are approximately 0.30% to 0.40%, which is more than 1% lower than the average mutual fund.
- While we continue to believe in the value of disciplined rebalancing, it has not added value during this downturn as virtually all major asset classes (other than fixed income) have experienced significant declines. As a result, we are rebalancing in a more selective manner.
- We believe that our philosophy of holding at least 5+ years worth of projected portfolio withdrawals in cash and high quality fixed income has provided some cushion for current retirees and enhanced their ability to weather this storm.

It is important to note, however, that while we believe our philosophy and long-term strategies continue to make sense, we are very cautious about becoming complacent or finding ourselves confined to an outdated paradigm by assuming that past relationships apply into the future.

Consequently, we seek input from economists, investment managers (including those whose opinions differ from our own), and many colleagues. We expect that our strategy will evolve over time as investment markets and our economy evolve.

What has WJM Financial done in response to this downturn?

From an investment standpoint, we have made a few changes to our strategies over the past year, which have been modestly beneficial.

Our changes have included reductions to large value stocks, small/mid company stocks, commercial real estate, and commodities. We also increased our exposure to “alternative assets” in order to provide additional diversification from traditional stock markets. These changes have added value, but the adjustments were incremental, and the benefits were small.

We also slightly increased our exposure to international equity earlier in the year. This adjustment initially proved beneficial, but has recently been a drag on portfolio performance as international markets have performed worse than domestic markets. Overall, our changes have added some value, but not as much as we would have liked.

From a planning perspective, we are actively seeking opportunities to reduce tax liabilities by harvesting unrealized losses in order to reduce current (and possibly future) taxable income. We are also reviewing opportunities to convert depressed IRA values into Roth IRA accounts in order to minimize future tax costs.

We encourage you to contact us if you have questions about how this downturn has affected your financial situation.

Is WJM Financial considering future changes in response to this downturn?

In light of the past year’s downturn, we are considering additional changes to our investment strategies, as well as our planning. Some of the changes being considered include the following:

- Additional increases in exposure to non-correlated asset classes in our portfolio models. We increased this target from 10% of equity to 15% of equity earlier this year, and we are considering additional increases in order to further enhance diversification from traditional equity markets (domestic and international).
- Inclusion of additional asset classes. We have selectively added market neutral funds to the portfolio mix of certain accounts, and we are considering a broader inclusion across accounts. We are also considering additional asset classes that are not currently included in our portfolios.
- Flexible asset allocation targets. We are considering the inclusion of more flexible asset class target ranges that allow for additional valuation-based adjustments. This might take the form of high and low targets for each asset class that more easily allows for risk management and/or opportunistic planning.
- Enhanced portfolio and retirement plan stress testing. We have previously used 95% confidence ranges for stress testing, but this recent downturn has exceeded those “worst case” scenarios. We are likely to include stress testing at the 99% confidence ranges going forward.

As a recent/soon-to-be retiree, what impact might this downturn have on my retirement?

Retirees, and those soon to retire, are certainly the most directly impacted by this downturn. And it would be unreasonable and misleading to conclude that there is no adverse effect from what has been a historic downturn in the market...even a conservatively allocated portfolio of 50% stocks and 50% bonds may have lost more than 20% over the past year.

The actual impact will depend on many factors, but one of the most important factors is the projected withdrawal rate, which is calculated as *annual withdrawal ÷ portfolio value*. For example, a client with a \$1 million portfolio who expects to withdraw \$5,000 per month (\$60,000 per year), has a withdrawal rate of 6% ($\$60,000 \div \$1,000,000 = 0.06$, or 6%).

Assuming that the actual dollar amount withdrawn is increased annually by the rate of inflation, the following table approximates reasonably safe withdrawal rates based on historical results and current market valuation levels:

Projected retirement duration	Reasonably safe withdrawal rate
20 years	5.5% to 6.0%
25 years	5.3% to 5.8%
30 years	5.0% to 5.5%
35 years	4.8% to 5.3%

Please note that these are only approximates and should only be used as an initial benchmark. A significant flaw to this “rule of thumb” is that it assumes equal growth rate for income sources, expenses, and taxes. This is often unrealistic since many expenses grow at rates above or below inflation, and certain income streams (particularly defined benefit pensions) may not grow at all. Consequently, a retiree’s withdrawal rate often grows at a rate that is above or below inflation.

Note: please feel free to contact us if you would like to update your retirement analysis at any time. We are happy to update the analysis, and to include any alternative scenarios that you would like to consider.

As a recent/soon-to-be retiree, what can I do to improve my retirement if my withdrawal rate is projected to be at an unsustainable level?

There are a number of strategies that might be used to shore up your retirement, but the ultimate objective is to slow withdrawals in order to take pressure of your portfolio's ability to sustain withdrawals, and to allow time for it to recover. Some strategies include:

- Delaying retirement for a year or two, or earning a part-time income for a few years to reduce the amount of required withdrawals.
- Freeze or cap inflationary increases in withdrawals (i.e. never increase annual withdrawals by more than 3%). While this has a relatively minor short-term impact, it can have a very dramatic long-term impact if maintained throughout the planning horizon.
- Identify opportunities to reduce discretionary spending in order to reduce withdrawals. It is very important to realize that relatively small percentage reductions in spending can result in disproportionately large decreases in required withdrawals, particularly for retirees whose social security and/or pension incomes account for a large portion of their income needs. For example:

	Current	Reduce spending by 5%	Reduce spending by 10%
Portfolio value	650,000		
Living expenses	70,000	66,500	63,000
Income sources	30,000	30,000	30,000
Portfolio withdrawal	30,000	36,500	33,000
Withdrawal rate reduction (%)	-	-8.75%	-17.50%
Adjusted withdrawal rate	6.2%	5.6%	5.1%

The impact of these changes may be even greater than illustrated because the smaller withdrawal associated with reduced spending typically reduces income taxes, which further reduces the required withdrawal (this is one of the reasons that many rules of thumb are unrealistic...they cannot accurately account for the dynamic nature of cash flows).

- Consider an immediate annuity, which provides a guaranteed stream of income for life. Since an insurance company can combine the mortality risk of very large numbers of people, they are able to use shorter projected time periods than a single person can use. As a result of this, annuities are often able to provide payout rates that are about 1% higher than those listed above.

Given the severity of this downturn, wouldn't I have been better off not contributing to my investments and simply spending the money on other things instead?

Probably not. With the benefit of hindsight, it clearly would have been beneficial to delay contributions as investment markets have declined in value...a contribution today would buy much more than the same dollar amount purchased 12 months ago.

While it's tempting to think that you would be better off had you just spent the money, the reality is that your contributions have been used to purchasing investments in hundreds of companies. When the market recovers, and it will, the value of these investments will grow and you will be better off than you would have otherwise been had you spent the money.

This is especially true when the investment have been applied to tax-advantaged accounts since the tax savings often offset what the market has taken, and employer contribution (if they apply) provide additional "earnings" that are not accounted for in traditional rates of return.

Given the severity of this downturn, are the return assumptions used for planning purposes still reasonable, or will they need to be changed?

While it might seem counterintuitive, such a severe downturn is likely to result in slightly higher assumed returns going forward. Consequently, we may modestly increase our expected returns for projections, although that will depend on each client's situation, time horizon, and current risk tolerance and portfolio target.