



The Best of Both Worlds — A Time-Weighted Income Strategy For Educated Investors

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Growth or Safety?

As we've met with hundreds of individual investors over the past decade, a common question we've asked is "What would you like your money to accomplish for you?" The vast majority of the responses are very similar: "If the stock market is doing well, I'd like to earn a really nice return, but I'd also like to not lose much (if any) when the stock market drops." At first we really struggled with this response. It seemed like "I'd like to have my cake and eat it too, thank you kindly." However, if the client can answer one simple question, we can likely provide what they're hoping for. That one question is, "When do you plan to spend the money?"

If the funds in question are earmarked for a Caribbean cruise next year, you really don't have any business investing those monies into long-term stock portfolios. Historically, the Dow has experienced negative returns about three out of every ten years. The one obvious conclusion that we can take away from these past two years is, even the "Wizards of Wall Street" didn't know what was going to happen. If you agree that there really are no gurus out there with a crystal ball, it's really just speculation whether this year will be an up or down year. The lesson that 2008 taught us is that the stock market can and will have some big down years from time to time. If your short-term goal anticipates the need for cash next year, investing in a short-term conservative portfolio is a sensible, prudent approach. Should your plans also require income in 10, 15, 20 or more years, a short-term conservative portfolio may not keep pace with the cost of living.

“Over the long haul, inflation is potentially the greatest destructive force we must face.”

A typical retirement period can easily extend out 20 to 30+ years. Short-term conservative investments don't have a good track record of beating the rate of inflation. Inflation is the silent monster hiding in everyone's closet. A real danger—steadily eroding your purchasing power. To understand the full impact of this nasty beast, all one has to

do is converse with an 85 year old widow on a fixed income of \$782 per month. What once provided a comfortable living at age 65 is now barely enough for basic food and shelter. Many aging elderly or fixed income families must

make difficult decisions on what necessities they will go without every month. Too often it is prescribed medical needs that get cut. This is the impact of inflation.

Portfolios with greater exposure to equity or stock allocations have historically beaten inflation over time, even when accompanied with significant and unpredictable downturns. Our problem is that in the short term, we're (appropriately) concerned about market swings reducing what we can spend today. Over the long haul, inflation is potentially the greatest destructive force we must face. The effect of inflation on our future income should be treated with the same aggressiveness used to fight a pandemic outbreak. Inflation affects everyone and there isn't much that can be done to prevent it from spreading. What's an investor to do? There is a way to protect your investments from the full destructive power of inflation, an "inflation inoculation," so to speak. With some sound planning and a good understanding of your short-, mid- and long-term investing goals and income needs, you can effectively reduce the ravages of inflation on your ability to sustain your chosen lifestyle.



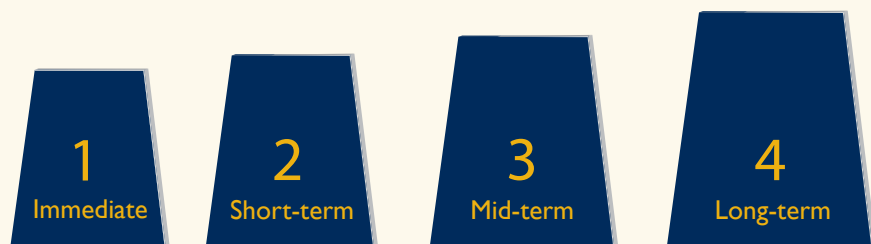
The Best of Both Worlds

We all have short-term income needs: groceries, utility bills, or a weekend getaway, that must be met today. We also mustn't forget our long-term goals that may take many years to achieve, such as education or retirement. Rarely do all of our goals need to be met by week's end. Yet when it comes to investing, we find too often that people have an "all or nothing" concept to their investing approach. During the discovery process it is all too common for us to discover that individuals have all their eggs in one basket. Everything they have is either in aggressive funds with their 401k or in CDs at the bank. This isn't a very productive philosophy, it isn't the right approach, and can lead to financial frustration and too much risk taking. It is possible to have your short and long-term needs met with one approach. If you will allow us to adjust your financial perspective from "all or nothing" or short-term versus long-term needs, we will introduce you to the best of both worlds, the educated path to investing.

With a little planning effort, together we can estimate the expected withdrawals from your portfolio for years 1, 2, 3 through years 25 or 30.

The actual investing piece of the educated path can best be explained as dividing your money into four (4) time segments. Imagine four baskets sitting in front of you. Each basket is labelled with a number 1-4, under each number is a specified period of time, as follows:

- #1 (Immediate 1-2 years)
- #2 (Short-term 3-5 years)
- #3 (Mid-term 6-10 years)
- #4 (Long-term 11+ years)

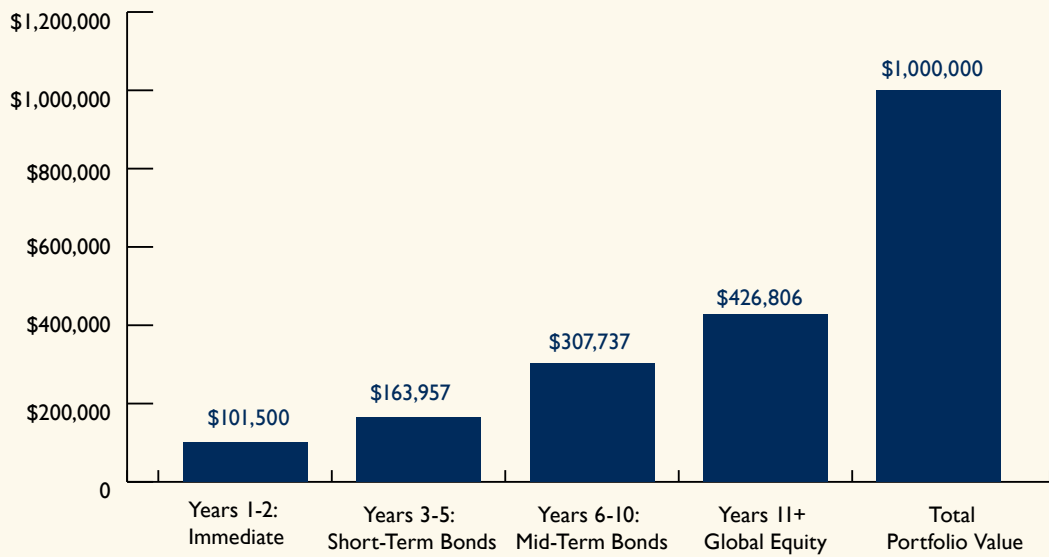


1. In the first, we'll place the money you plan to spend in the coming two years. This basket invests in a one year bond fund, treasury or money market account. A portion (up to one year of income) could be held at your local bank or credit union. This money needs to be liquid and readily available. ¹
2. In the second, we'll invest the funds for years 3-5. The goal of basket #2 is to provide a better return than can be provided by basket #1 while maintaining the ability to easily access those funds. A short-term bond fund is appropriate for these monies. ²
3. In the third, we'll invest the funds for years 6-10. With a longer timeframe, we can begin to allocate funds towards better yielding bonds. This basket will contain mid-term bond funds, these funds have a longer duration before they mature, typically 6 or more years, thus providing better rates of return. ³
4. In the fourth, we are now investing for at least 11 years. With this longer time horizon we can comfortably allocate for your long-term needs in our globally-diversified equity portfolio. ⁴

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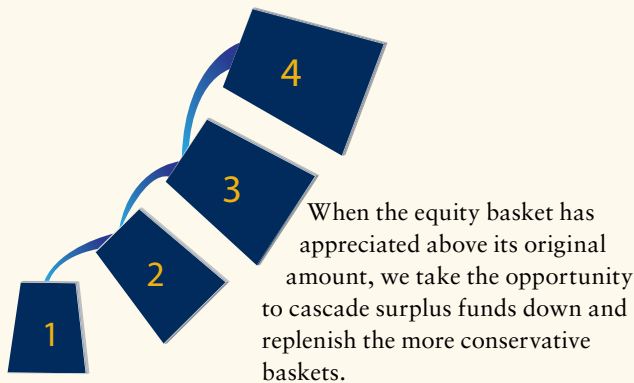


Value of Portfolio Segments: Beginning of 2000

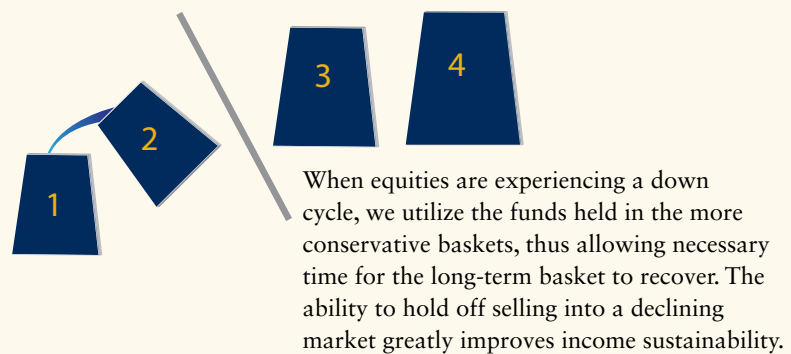


1. Together we run retirement income plan projections and identify spending shortfalls not covered by income from Social Security, rental income, pensions, or other available resources.
2. We calculate the required withdrawals from the portfolio year by year, adjusting for inflation.
3. We allocate funds for the first two years in one year treasuries or money market type accounts, years 3-5 in short-term bonds, years 6-10 in mid-term bonds, and the remainder in a globally-diversified equity portfolio.

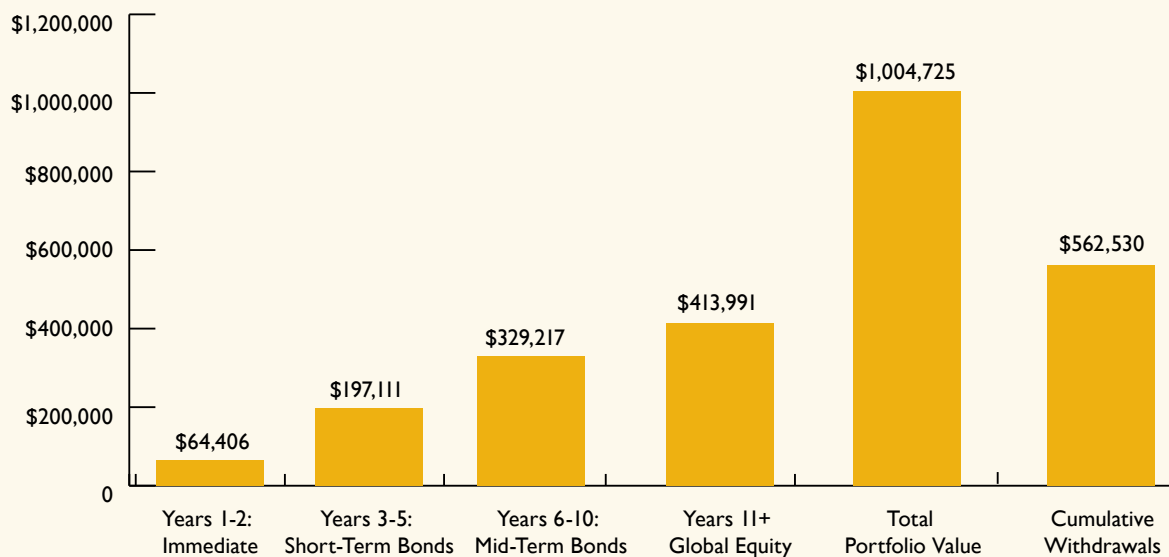
When the market is up...



When the market is down...



Value of Portfolio Segments: Beginning of 2010

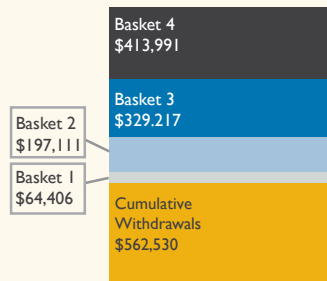


Time-Weighted Income Strategy — Decade-by-Decade Results

- Each decade begins with a \$1,000,000 portfolio
- Withdrawals are adjusted based on the actual annual inflation rate, so cumulative withdrawals vary by decade.

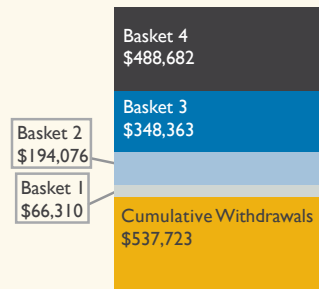
2000-2009

Ending Portfolio Value + Withdrawals
\$1,567,255



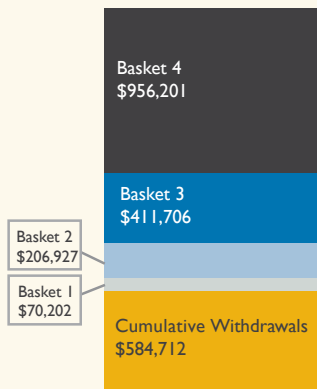
1960-1969

Ending Portfolio Value + Withdrawals
\$1,635,153



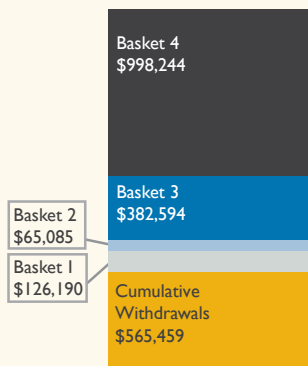
1990-1999

Ending Portfolio Value + Withdrawals
\$2,229,748



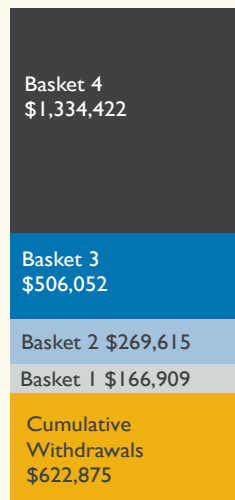
1950-1959

Ending Portfolio Value + Withdrawals
\$2,137,571



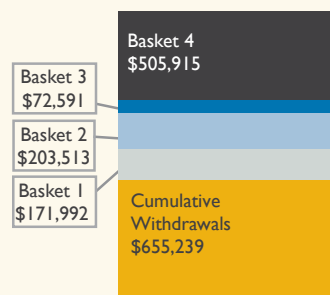
1980-1989

Ending Portfolio Value + Withdrawals
\$2,939,874



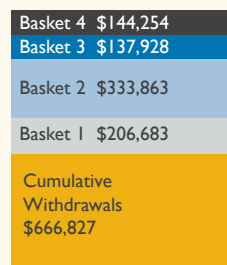
1940-1949

Ending Portfolio Value + Withdrawals
\$1,609,250



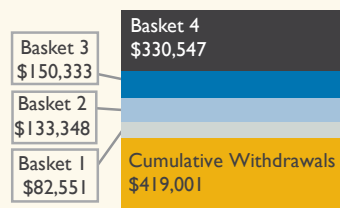
1970-1979

Ending Portfolio Value + Withdrawals
\$1,489,555



1930-1939

Ending Portfolio Value + Withdrawals
\$1,115,780



Let's take a step back and see what we've accomplished by setting up what we describe as the time-weighted income strategy:

1. We've followed grandma's advice, "don't put all your eggs in one basket."
2. We've met the need for short-term funds in a portfolio that historically has maintained its value and in good years earns a tidy return.
3. Long-term needs are satisfied with a portfolio that should easily outpace inflation.
4. All baskets are invested in a manner that maximizes the probability of solid returns while greatly reducing the chance of a loss over the expected holding period.
5. Despite the uncertainty of the markets, whenever you need money, for whatever reason, there will always be a smart place to go get it.

A few years ago, I published an article that profiled a fellow named Nervous Ned who was a typical, emotional investor and contrasted him with his opposite – an abnormally unemotional fellow named Steady Eddy. In that article, the two investors struggled through the market turmoil of the 1970s. For this article we focus on the recently concluded decade of the 2000s.

As you may recall, this was a decade frequently referred to in the press as “the worst decade in a gen-

eration” or a “lost decade” for the stock market. The reason for these negative titles describing the last ten years, in part, can be illustrated in the following performance data, the S&P 500 averaged (-0.95)% returns over this period (no, the negative sign isn't a typo). That means a dollar invested in the S&P 500 at the beginning of 2000 was worth 91 cents at the end of 2009. By almost any measure, this was not a great decade for the stock market. But it was by no means a lost decade for the investor who had the advantage of the previously described time-weighted income strategy.

Starting with a \$1 million portfolio, Steady Eddy decides to take withdrawals on the high range of the 4-5% withdrawal rate suggested by his financial advisor, so \$50,000 is required for year one. For year two, we assume inflation of 3% will increase the required withdrawal to \$51,500. So the sum of years one and two equals \$101,500, which is allocated to the immediate basket. The amounts placed in baskets two to four (accounting for inflation) can be viewed in the chart “Setting up the Portfolio.”

The next year, we look back and find actual inflation was 3.38%, so Eddy needs \$51,690 to enjoy the same standard of living in the coming year. In the meantime we've entered into the “Dot-com” induced bear market of the early 2000s. Equities are struggling, so we'd prefer to leave that basket alone until it can recover and since we've allocated funds to the more conservative baskets holding funds for years 3-5 and 6-10, we can. The short-term bond basket #2 had a great year going UP 11.2% in 2000. So we replenish the immediate income basket #1 with basket #2's allocated funds.

A year later, inflation comes in at 1.55%, so \$52,491 is now required to maintain purchasing power. The



“Despite the uncertainty of the markets, whenever you need money...there will always be a smart place to go get it.”

market is in a prolonged downturn. We'd still prefer not to touch our equity

basket and we don't need to. The short-term bond basket #2 went UP 6.2% in 2001. So we replenish the basket #1 again with monies from basket #2.

2002 is another down year (will this ever end!?) and now we're running low on short-term bond funds, but still don't want to touch our equities since they've fallen -18.3% this year. What to do? Generally speaking, the average investor has already raided their portfolio, selling into a declining market and locking in losses that may never be recovered. Investors on the educated path can simply take advantage of the next planned option – moving up to the next most conservative basket, basket #3. Contained within our mid-term bond (basket #3) we find that we've got plenty of money. How has our 6-10 year basket performed during this downturn? It was UP 15.3% in 2000, 4.2% in 2001, and 13.7% in 2002 (yes, those really are all positive returns). Cash is systematically cycled down from basket #3 to basket #1 to replenish your immediate income needs without having to risk basket #4 assets.

In 2003, the prolonged bear market comes to an end and equities rebound sharply with a 48% gain. Suddenly the equity basket is well above its original amount, we now can happily, safely and effectively take the opportunity to cascade funds down and replenish all of the more conservative baskets. In addition, by utilizing this process we effectively reduce the risk of having to sell our equity basket into a declining market.

Eddy continues on the educated path throughout the 2000s. Despite the bad timing of retiring and

starting his portfolio withdrawals at the beginning of a bear market in 2000, and experiencing a second major and worse bear market in the same decade, he never once has to lock in a loss in long-term basket #4. Why? Because of the funds available in the more conservative baskets #1-3. The educated path to investing and the time-weighted income strategy has provided something of great value to Eddy - options. He's developed a confidence about his financial future that stands in stark contrast to the sleepless nights his neighbors are complaining about.

What about his income for the past decade? How much did his portfolio really provide? Due to inflation, he's on track to spend \$64,406 during 2010 (just to maintain his \$50,000 lifestyle of a decade earlier). His cumulative withdrawals for the past decade total \$562,530. And this all occurred during “the lost decade.” You're probably wondering about now how much of the initial \$1,000,000 he has left. He's probably lucky if he has half of his original portfolio left, right? Eddy is in a cheery mood as his latest portfolio statement shows his portfolio value after 10 years of withdrawals at \$1,004,725 (see the chart “Ending Portfolio Value”).

Eddy notes that 2008 was a tough year, with a -40.3% drop in his equity basket #4, and his short-term bond basket #2 (which went UP 11.7% that same year) is mostly used up due to the recent bear market, but the mid-term bond portfolio in basket #3 is well funded and will provide years of income to allow the equities in basket #4 to fully recover from the downturn. After a 36.8% gain in 2009, it's well on its way. ▶



Eddy smiles as he realizes that he's been able to experience the best of both worlds. The time weighted income strategy has provided him a comfortable living in the short term and confidence in his plan to beat inflation over the long term. As he puts down his account statement, he feels a sensation strangely akin to having his cake and eating it too.

After withdrawing the same \$562,530, the ending portfolio value was \$728,276. That's a \$276,449 penalty (vs. the time-weighted income strategy) for the "safety" of CDs. Once again, we're reminded that market volatility is not the only or most important type of risk. For a retirement portfolio, the loss of purchasing power and potential to run out of funds is the bigger concern. From this standpoint the time-weighted income strategy comes out the clear winner. •

Regarding the time-weighted withdrawal strategy, one final question remains to be asked, "What about the alternative of simply buying bank CDs – in a difficult decade, doesn't the bank approach outperform having some of the funds invested in equities?" Using historical data supplied by the Federal Home Loan Bank of Des Moines⁵, we ran the same withdrawal scenario, reinvesting the portfolio each year in one year CDs.

Short-term safety
Long-term inflation-beating potential
The Best of Both Worlds!

Initially, this approach pays off with a 6.0% yield in 2000 (while the equity markets stumble). Unfortunately, CD rates vary significantly over time. During this decade half of the years had yields under 3%.

Disclosures

Past performance is not a guarantee of future results. As with any investment strategy, there is potential for profit as well as the possibility of loss. LJCooper does not guarantee any minimum level of investment performance or the success of any investment strategy. All investments involve risk (the amount of which may vary significantly) and investment recommendations will not always be profitable. This is not a solicitation or an offer to sell securities or investment advisory services except where applicable, in states where LJCooper is registered, or where an exemption for such registration exists. Returns data are sourced from DFA Returns Program, are net of DFA's management fees, and assume monthly rebalancing. Returns are net of LJCooper's management fees for a \$1,000,000 portfolio. Returns do not include custodial transaction fees. Performance information presented in the charts or tables in this brochure represents back tested performance for the indexes or asset class funds indicated and not the experience of any one individual client. Actual performance of client accounts may differ from the asset class portfolios. Direct investment cannot be made into an index.

1. Immediate proxy is the One Month Treasury Bill index.

2. Short-term bond proxy is the 5 year US Treasury note.

3. Mid-term bond proxy is the 10 year US Treasury bond.

4. Diversified equity proxy is the Dimensional US Adjusted Market Value Index, comprised of all the securities of US companies traded on the NYSE, NYSE Amex, Nasdaq NMS, Nasdaq Global, and Nasdaq Global Select Market. Rather than weighting by market capitalization, the index over-weights securities of small and value companies.

5. One year CD yields for 2000 - 2009 sourced from Federal Home Loan Bank of Des Moines: <http://www.fhlbdm.com/www/RatesDb>

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