

Note

RE: Time to Cash Out of the Market?

I recently spent an afternoon with my best friend from high school, who is a Delta pilot and lifelong investor. Chris was sorely tested by the 2008-09 Market Panic, stuck it out (fortunately) and has now fully recovered. He plans to retire in about five years, and now that he's "back to even" was contemplating cashing out of the market, as he can't bear the thought of going through that ordeal again. His problem is that he's 50 years old, so from an actuarial standpoint, he has 30+ more years to go. Money market and CDs won't forever earn the near zero returns they do today, but even in normal times, he might be lucky to get one double out of cash assets over the next 30 years. By contrast, assets left in the market will likely double four or five times, albeit with nasty panic sell-offs occurring every few years. That's a really big sacrifice with enormous retirement lifestyle consequences to make: \$1M growing to only \$2M instead of \$16-32M (four to five doubles means \$1M growing to \$2M, to \$4M, to \$8M, to \$16M, to perhaps \$32M). So we discussed Barbell Diversification as an alternative, which involves investing at the extreme ends of the investment spectrum (ultra-safe/low returning reserve assets and volatile/maximum returning equity growth assets).

THE most reliable aspect of the market is the fact panics WILL occur, and sometimes they will morph into really big, once-in-a-lifetime scale panics like we just endured. And to try to avoid them leads to the market timers bane, which is being out of the market when it's about to perform best (think three years ago) and in the market when it's the most comfortable, and therefore most vulnerable to its next crash. The only sure way to capture the market's appreciation over time is to stick it out through thick and thin, and that means exposing ourselves to EVERY market panic that occurs.

For investors in the growth and accumulation stage, this may be an uncomfortable, but necessary evil. For retired investors who are taking appreciable income from their accounts, defined as in excess of dividends and current income, this is more problematic. Assume an all equity portfolio produces a yield of 2% and a client draws 4% per annum to fund their retirement, which means 2% must come from capital appreciation. If inflation expectations are 3%, this creates a required rate of return of 7% (4% income plus 3% inflation) to maintain real purchasing power over time. But if the market drops 50% with the same dollar amount withdrawn, suddenly a possibly unsustainable 8% must come out of the account, as the required rate of return jumps to 11% (8% income plus 3% inflation). Few retired investor want to face this situation, hence the need for reserve assets (money market/CDs) for when, not if, the next panic occurs. The duration of a typical major panic is 2-3 years, so that plus a margin of safety buffer means reserving 4-5 years of required income (12-25% if income drawn is in the 3-5% range). When (again not if) the next market panic occurs, retirement income is drawn from reserves, allowing equities to recover. Once they do, reserves are replenished and income is again drawn from equities. While the reserve portion diminishes some of the growth potential, worry over the inevitability of panics has been addressed and most of the assets remain postured for growth.

The rub of this approach is that no matter what, an investor MUST stick with this plan when tested. If an investor doubts his resolve, a more traditional 60/40 Stocks/Bonds allocation is more appropriate. However, for seasoned equity investors like my buddy Chris, Barbell Diversification is a viable option.

Lowell