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White Paper:

*How Traditional Investing
Can Fail Baby-Boomers*

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How Traditional Investing Can Fail Baby Baby-Boomers

Executive Summary

The majority of “Baby Boomers” (those born between 1946 and 1964) will be transitioning from their wealth accumulation phase to their wealth distribution (retirement income) phase within the next 15 years.

With the changing landscape of retirement, Baby-Boomer investors now have to assume the majority of the investment and longevity risk, while trying to create a ***predictable, sustainable, increasing, lifetime*** retirement income (making sure they don’t run out of money). As someone nears retirement, the strategy should be to become more conservative in their portfolio and reduce the risk of large portfolio losses.

Unfortunately, investors often make one of three classic mistakes: (a) they over-concentrate their holdings; (b) they lack the discipline to systematically rebalance their portfolio; and (c) they make emotionally-driven decisions during interim periods of market uncertainty.

A traditional “buy-and-hold” investing approach, based on Modern Portfolio Theory, has two pitfalls during the wealth distribution phase: (1) over-dependence on average returns and (2) failure to recognize how the randomness or sequence of returns can dramatically affect income, if one retires during an unfavorable period of time in the market.

Baby Boomers approaching retirement need to understand how to overcome some of the traditional investing weaknesses and mistakes during the wealth distribution years.

Wealth distribution requires a comprehensive financial plan using a combination of different approaches or strategies. Baby Boomers need to work with an unbiased advisor who is experienced with multiple strategies, so they can better understand the merits and trade-offs of the different strategies and how they may best be integrated and used in their particular situation.

Multiple strategies that are integrated could help an investor get back into the market now (or stay in the market going forward) to capture any potential positive market gains, while protecting a portion of their portfolio and/or having the protection of a lifetime ***income*** stream, regardless of market performance.

If the goal of a lifetime retirement savings portfolio is to produce a predictable, sustainable, increasing, lifetime retirement income, this information should be a wake up call. It will challenge the overall effectiveness of traditional investing approaches being used today and question how successful they will be throughout the wealth distribution “retirement” years going forward.

Background on Traditional Investment Strategies

In 1952, Harry Markowitz's published an article that is regarded as the first development of "Modern Portfolio Theory" (MPT). His portfolio model showed how to derive the expected return and risk for a portfolio and how to achieve an effective diversification effect.

The model assumes that investors are risk adverse, meaning that given two assets that offer the same expected return, investors will prefer the less risky one. Thus, an investor will take on increased risk only if compensated by higher expected returns. Conversely, an investor who wants higher returns must accept more risk. The exact trade-off will differ by investor based on individual risk aversion characteristics.

Two of MPT's basic approaches are to: (1) reduce risk through diversification and (2) reduce risk through periodic rebalancing.

Diversification

Theoretically, using the traditional asset allocation approach, an investor can reduce their exposure to individual asset risk by holding a diversified portfolio of assets (e.g. stocks, bonds, real estate investment trusts (REITs), etc.). Diversification is designed to allow for the same portfolio return with reduced risk. Since investors' objectives, risk tolerance and time horizons are different, the structure of each investor's portfolio should also differ.

Unfortunately, investors often make one of three classic mistakes: (a) they over-concentrate their holdings; (b) they lack the discipline to systematically rebalance their portfolio; and (c) they make emotionally-driven decisions during interim periods of market uncertainty. These actions help explain why so many investors consistently under perform the market

Asset Allocation and Periodic Rebalancing

The traditional "strategic" asset allocation is closely related to the traditions of MPT and widely used by most investors and investment advisors. Its focus is the identification of the asset mix that will provide the optimal balance between expected risk and return for a long term horizon. Some people would refer to this type of asset allocation as a passive "buy-and-hold" strategy. With fluctuating asset prices, some asset classes will naturally do better than others, which will unbalance the portfolio relative to the weights originally assigned to each asset class.

Without periodically rebalancing a portfolio, this shift may, in fact, position the portfolio at a much higher risk level than the investor intended. Recognition of the importance of rebalancing occurred by early 2003 after investors suffered over three years of large stock market losses – a period during which bonds appreciated in price. Too often, investors make the common mistake of chasing returns, which can cause portfolio allocations – and risks to shift in ways they never intended. Strategic asset allocation and periodic rebalancing can be effective for investors with a long time horizon; but, a static asset allocation may suffer during periods of significant market uncertainty.

Traditional Investing Weaknesses with Regard to Wealth Distribution

Dealing with the Changing Retirement Landscape

The traditional “buy-and-hold” investing approach fails to recognize and deal with the structural shift in the retirement landscape and the added risk it imposes on Baby Boomers. ***Personal savings are becoming the primary source of income for many current and future retirees.*** It’s no secret that Americans are living longer than before. Whatever the reason (healthier lifestyles, more advanced medical care), life expectancies are on the rise. With this structural change of responsibility and longer life expectancies, comes the transfer of two critical risks from institutions to individuals: ***investment risk and longevity risk***, or the risk that retirement withdrawals, investment volatility, and inflation could cause a retiree’s portfolio to run out of money during their retirement period.

Creating sustainable retirement income portfolios is both an art and a science. Multiple uncertainties and assumptions complicate the task, as individual investors must balance portfolio stability and growth in order to meet future liabilities. Furthermore, portfolio withdrawals amplify the impact of market declines in the distribution phase. The shift from the accumulation to the distribution phase of investing requires new thinking about risk and risk metrics.

A constant concern for investors, both before and after retirement, is investment risk. But a number of other variables add to the uncertainty of the distribution phase. Advisors must make multiple assumptions — about time horizon, investment returns, withdrawal rates, inflation and taxes — each of which can have significant ramifications if oversimplified or underestimated.

Average returns, which are useful in accumulation-phase planning, are less meaningful when cash outflows become a key model assumption.

Asset diversification is an integral part of successful investment planning for both the accumulation and distribution phases. In the accumulation phase, a well-diversified portfolio can help reduce volatility, enhance compounding effects and build wealth. With patience, discipline and the luxury of time, investors can generally withstand shorter term declines and meet their accumulation goals. The difference in the distribution phase is that regular portfolio withdrawals compound losses. The slow-and-steady approach of the accumulation phase suddenly gives way to more complex calculations based on the compounding effects of negative cash flow.

There are two pitfalls with traditional investment approaches: (1) overdependence on average returns and (2) failure to recognize the randomness or sequence of returns.

Pitfall # 1: Over-Dependence on Average Returns

The market volatility that has occurred over the last decade has exposed a weakness in the general investors’ approach. If asked how the average investor determines which stock, mutual fund or other investment to add to their portfolio, they would generally discuss the reported one, three,

five, ten and lifetime annual average returns. The term “standard deviation” seldom comes up, unless you are talking to a financial advisor.

Standard deviation is the variability of the average rate of return. A lower standard deviation means that there is less variability in the average rate of return. A higher standard deviation means that there is more variability in the average rate of return.

TABLE 1		
Year	Annual Returns	Annual Returns
	Portfolio A	Portfolio B
	S&P Actual	Sample Portfolio
1989	31.49%	10.45%
1990	-3.17%	8.45%
1991	30.55%	10.45%
1992	7.67%	8.45%
1993	9.99%	10.45%
1994	1.31%	8.45%
1995	37.43%	10.45%
1996	23.07%	8.45%
1997	33.36%	10.45%
1998	28.58%	8.45%
1999	21.04%	10.45%
2000	-9.11%	8.45%
2001	-11.88%	10.45%
2002	-22.1%	8.45%
2003	28.68%	10.45%
2004	10.88%	8.45%
2005	4.91%	10.45%
2006	15.79%	8.45%
2007	5.49%	10.45%
2008	-37%	8.45%
Average Annual Return	10.35%	9.45%
Standard Deviation	19.98	1.03

Why is “standard deviation” so important in the world of investing? Considering average annual returns AND the standard deviation (variability) in a portfolio can dramatically improve long term investment results. The illustration below (Table 1) can help highlight the importance.

Portfolio “A” has the actual S&P returns¹ from 1989 – 2008. The 20 years of returns have an average annual return of 10.35% and a standard deviation of 19.98. Portfolio “B” is a sample set of returns created to help illustrate the importance of standard deviation. The average annual return for Portfolio “B” is 9.45%, with only a 1.03 standard deviation.

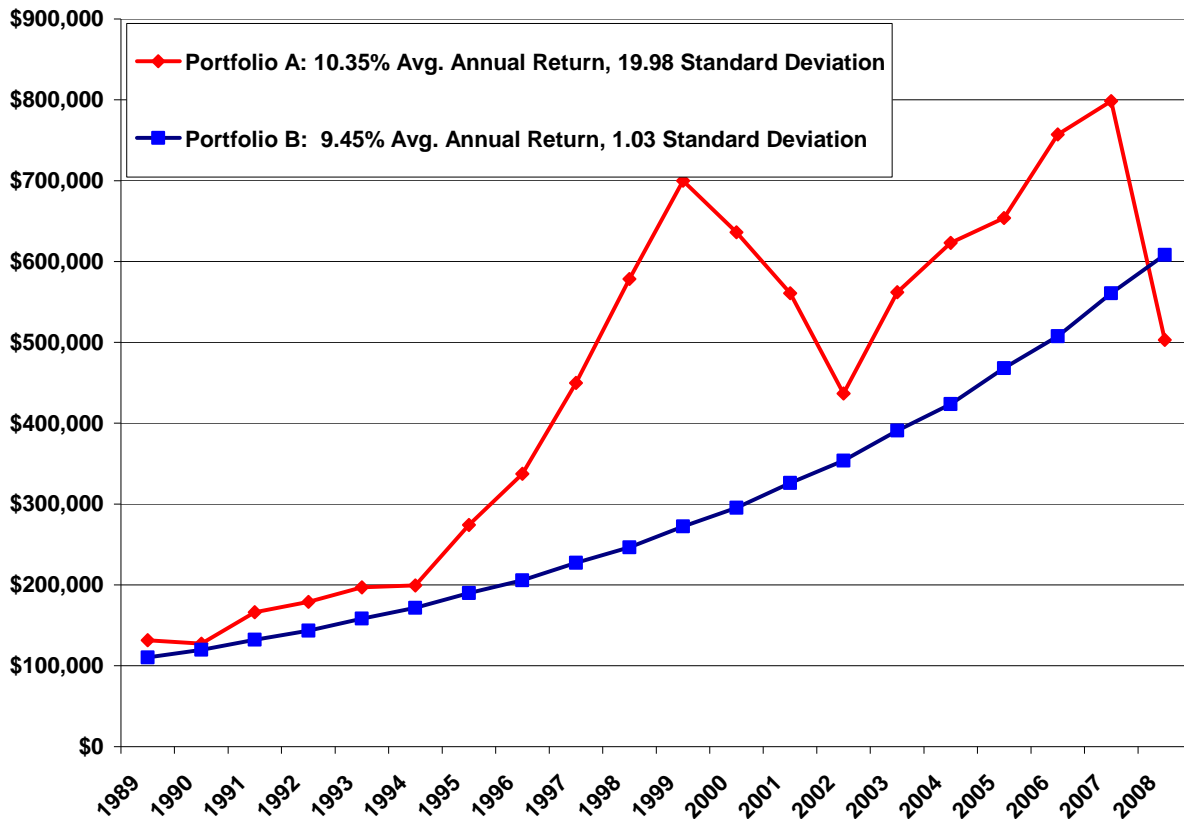
If an investor had \$100,000 to invest for 20 years and were told that they could have the set of returns from either Portfolio “A” or Portfolio “B”, which would be better?

If the traditional approach of emphasizing average returns was used, one might choose A over B, since A has a greater average annual total return.

However, Portfolio B actually produces 20% more growth than Portfolio A (see Chart 1 on the next page). Why? Portfolio B has less variation in the average annual return (lower standard deviation). If one was to consider standard deviation (variability) of the average return over the 20 years, one would choose Portfolio B over Portfolio A.

¹ The S&P 500 Index comprises 500 U.S. stocks and is a common measure of the performance of the overall U.S. stock market.

Chart 1
Pitfall # 1: Over-Dependence on Average Returns



Pitfall # 2: Failure to Recognize the Randomness or Sequence of Returns

Wealth distribution can be dramatically affected by unfortunate timing and a poor sequence of returns. Even if standard deviation is taken into consideration when developing an asset allocation, a critical flaw in a traditional “buy-and-hold” approach is its failure to recognize how the randomness or *sequence of investment returns* can dramatically affect the **distribution years**. Table 2 & Chart 2 below and on the next page can help highlight the importance.

Table 2 on the next page shows two portfolios: Portfolio C reflects actual returns for the S&P 500 Index from 1984 through 2008. The hypothetical Portfolio D earns the same returns in inverse order. This example illustrates the impact of the **return sequence**. Both Portfolio C and Portfolio D have the same average annual total returns of 11.44% and standard deviation of 18.46. But that’s where the similarity ends.

Taking annual withdrawals makes a significant difference. This example illustrates the impact of return sequence when taking annual withdrawals, as is done during the wealth distribution phase.

TABLE 2

	Annual Total Returns	Annual Total Returns	
	Portfolio C	Portfolio D	
Year	S&P Actual	S&P Inverted	Year
1984	6.27%	-37%	2008
1985	32.16%	5.49%	2007
1986	18.47%	15.79%	2006
1987	5.23%	4.91%	2005
1988	16.81%	10.88%	2004
1989	31.49%	28.68%	2003
1990	-3.17%	-22.1%	2002
1991	30.55%	-11.88%	2001
1992	7.67%	-9.11%	2000
1993	9.99%	21.04%	1999
1994	1.31%	28.58%	1998
1995	37.43%	33.36%	1997
1996	23.07%	23.07%	1996
1997	33.36%	37.43%	1995
1998	28.58%	1.31%	1994
1999	21.04%	9.99%	1993
2000	-9.11%	7.67%	1992
2001	-11.88%	30.55%	1991
2002	-22.1%	-3.17%	1990
2003	28.68%	31.49%	1989
2004	10.88%	16.81%	1988
2005	4.91%	5.23%	1987
2006	15.79%	18.47%	1986
2007	5.49%	32.16%	1985
2008	-37%	6.27%	1984
Average Annual Total Return	11.44%	11.44%	Average Annual Total Return
Standard Deviation	18.46	18.46	Standard Deviation

Returns are Inverted

Assume that a Baby-Boomer couple has done a good job accumulating their retirement portfolio, which has grown to \$2,000,000. They want to generate a *sustainable and increasing* retirement income for a projected 25 year retirement period. They have determined that they need \$100,000/year (in today's dollars) to support their current lifestyle throughout retirement.

A \$100,000 annual payout is 5% of their \$2,000,000 portfolio, which seems to be possible over the 25 year period. Since they don't want to lose purchasing power, they want the first annual payout of \$100,000 to increase 3%/year to keep up with inflation (e.g. \$100,000, \$103,000, \$106,090, \$109,273, etc.).

With so many positive years at the beginning of the 25 year retirement period, Portfolio C was able to build a large base, weather the four down years during the last decade, and generate an inflation adjusted income throughout the 25 year retirement, while still having \$11,365,140 left in the portfolio. In this case, the sequence of returns didn't negatively impact generating the required inflation-adjusted retirement income. (see Chart 2 on next page).

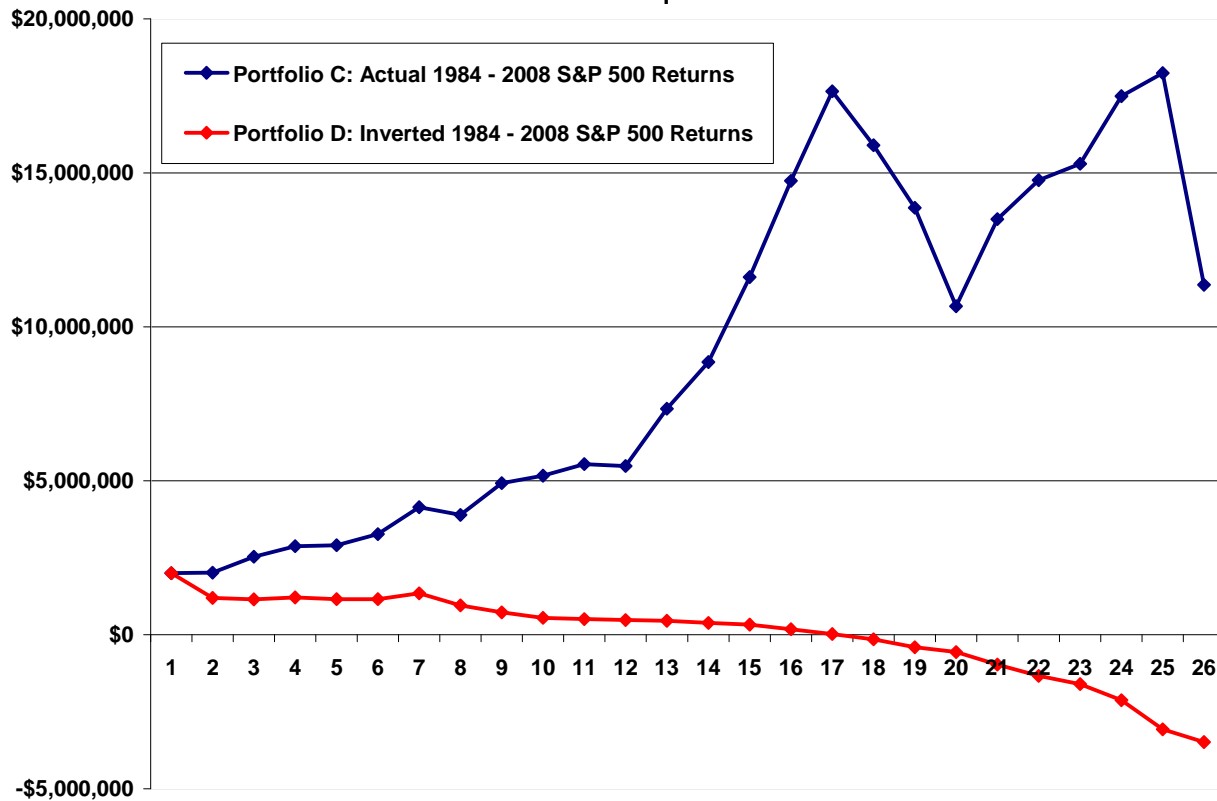
With so much decline in Portfolio D during the early years of the 25 year retirement period and trying to maintain an inflation-adjusted 5% withdrawal rate, Portfolio D runs out of money in the 16th year, a full

nine years before the projected end of retirement. If the calculations continue to the end of the 25 year period (even though in real life, the portfolio would be out of money), Portfolio D would ultimate end up with -\$3,481,485 after the end of the same 25 year period.

Over different periods of time or with different withdrawal rates, the sequence of returns has a variable effect — there may be a dramatic difference, or very little. The point of this illustration is that, **despite having identical average annual returns and standard deviations, results in these periods are dramatically different.**

Investors in any phase are vulnerable to the market's random gyrations, but investors in the distribution phase are even more sensitive to unfortunate timing of the market. Someone may retire at a favorable time in the market or during a highly unfavorable period. While there is no way to control the sequence of returns, advisers can add value by focusing on what they can control: trying to insulate portfolios from downside risk.

Chart 2
Pitfall # 2 - Sequence of Returns



Summary

If wealth accumulation is like climbing Mt. Everest, then wealth distribution is analogous to getting safely back down. But, just as most climbing accidents occur while descending, creating a sustainable lifetime income is more challenging, involves more uncertainties, and requires more advanced planning than wealth accumulation.

Hopefully, you can now understand how average returns, which are useful in accumulation-phase planning, are less meaningful when cash outflows become a key model assumption. Planning for the distribution phase must reflect this shift from simple math to models based on multiple assumptions. While risk in the accumulation phase is often summed up by volatility, the central focus in the distribution phase becomes shortfall risk, or the risk of outliving one's money.

Wealth Management is more than just portfolio management. It encompasses a disciplined professional approach to growing, protecting, preserving, utilizing, and transferring your wealth, using a broad range of services and an experienced team of advisors.

Dave Jones holds the CERTIFIED FINANCIAL PLANNER™ certification and is an Investment Advisor Representative for Select Portfolio Management, Inc (SPM). He is also a Registered Representative (Series 7, 63, and 66) with Securities Equity Group, member FINRA, SIPC, MSRB.

Dave specializes in retirement planning and specifically, how to successfully transition from the wealth accumulation phase to the wealth distribution phase of someone's life.

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