Comprehensive
FINANCIAL PLANNING
INC.

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Here is our newsletter for the 1st Quarter of 2014.

The Markets: Looking Back and Looking Ahead

The 4th quarter saw markets, especially in the U.S. continue their strong run. The chart shows returns of major asset classes for the quarter and the full year. 2013 saw a huge divergence in returns among asset classes. U.S. equities saw their biggest gains since 1997 at 32% while the U.S. Core Bond market saw its largest loss since 1994 at over 2%, its first decline in 14 years. All the fixed income markets saw losses with emerging market local currency bonds losing the most with a 9% loss. Even the emerging market stock market saw a loss of almost 5% for the year. Commercial real estate (REITs) had a small 2% gain and most commodities declined with the index dropping almost 10%.

Asset Class	Q4	2013
U.S. Large-cap Stock	10.5%	32.2%
U.S. Small-cap Stock	8.6%	38.7%
Foreign Stock-Developed	5.9%	21.8%
Foreign Stock-Emerging	3.1%	-4.9%
Core U.S. Bonds	-0.2%	-2.3%
High-Yield Bonds	3.5%	7.4%
Tax-free Muni Bonds	-0.2%	-2.6%
World Gov. Bonds	-1.1%	-4.0%
Emerging Market Bonds	-1.5%	-9.0%
Real Estate, REITS	-0.7%	2.3%
Commodities	-1.1%	-9.5%

The U.S. stock market has gone up 139% since the lows of March 2009. This had occurred under an environment where economic growth has been sluggish yet corporate earnings have gone from depressed to record levels. But over the last year net earnings of the S&P 500 companies have only grown 6.3% while prices have risen 32%, making most of the stock market rise simply a price increase. The bulls are clearly on the run as the Investors Intelligence survey of newsletters bull to bear ratio is over 4 to 1, the highest reading since 1987.

The economy is slowly but surely recovering from the financial crises of 2008. Most economic indicators are showing improvement over the last year in the U.S. and other developed economies. Individuals have done a good job of reducing their debt and the housing markets are improving. However, the deleveraging cycle is not over as the U.S. and other developed nations national debts are high and still rising. What happens when the Federal Reserve stops their asset purchases and actually begins to sell them is unknown. We should expect economic growth to continue to be moderate at best going forward and for corporate earnings growth to continue to slowdown or reverse.

For 2013 our portfolios all had positive returns yet well below our benchmarks as we are underweight U.S. stocks, overweight emerging markets stocks and bonds and have a significant allocation to alternatives. We will continue to invest in our alternatives allocation which is intended to generate long-term returns that are better than core bonds with much lower downside risk and volatility than equities and relatively low correlation to traditional stocks and bonds. Why we continue to emphasize diversification and downside protection for our clients is explained further below.

Robert Shiller Wins the Nobel Prize in Economics

I mentioned the work of Yale professor Robert Shiller in our newsletter a year ago. He was awarded the Nobel Prize in Economics in October for his work over many years concerning asset prices. In 2000 his book "Irrational Exuberance" evoked Alan Greenspan's infamous late 1996 use of that phrase concerning the 1990s bull market in stocks and accurately predicted the upcoming dot.com stock market bust. An addition of his book in 2006 added a chapter about house prices and warned about the exuberance in the housing markets.

Below is a graph illustrating his U.S. stock market valuation method called the Cyclically Adjusted Price/Earnings Ratio or CAPE. Robert believes there is a big flaw in the PE ratios used commonly because current or even forecasted earnings are used over a one year period. The problem is earnings are extremely cyclical, rising and falling with the ups and downs of the economic cycle of expansion followed by slowdowns or recessions. The CAPE ratio addresses this by using average earnings over the past 10 years, adjusted for inflation. Using a 10 year average should smooth out the ups and downs of the economic cycle and present a better measure of PE over the long term.

You can easily see the record peak of around 44 in the ratio in the year 2000 and a value of 30 in the year 1929. Both peaks were followed by drops corresponding to stock market losses of 50% and 80% respectively. The current value of 26 has only been exceeded by these two peaks and the time period from 1995 to 2007. The long term average has been about 16 (40% below current level) and has spent most of the time between 10 and 20.

The CAPE is <u>not</u> a good short term market timing indicator. At the beginning of 2013 the CAPE was at 23 but that did not prevent a 30% rise in the U.S. stock market. However, it is a very good indicator of future returns over the next 5 to 10 years. Thus we use this measure and other measures of which most are indicating that equities are richly priced, especially in the U.S. and offer returns probably not higher than inflation over the next 7 years. For those that are patient enough the markets will provide us a better opportunity over the next few years to increase our equity allocation at better prices.

How Your Equity Exposure Should Change Over Time

One of the biggest questions for investors and their advisors has always been to determine the best asset allocation. In other words, how much of a portfolio should be in stocks vs. bonds and other major asset classes and how should your asset allocation change as you age. Your father's or grandfather's advisor often used the "age in bonds" rule of thumb. So a 50 year old should have 50% in bonds with the remaining in stocks and increase the bond allocations 1% per year going forward. By the early 1990s this practice was modified by most advisors recommending a steady asset allocation once retirement arrives at somewhere around 50-60% equities, thus the classic 60/40 equity/fixed income balanced portfolio for those close to or in retirement. Research by Bill Bengen and others on how to optimize asset allocation and sustainable withdrawals in retirement found that the constant 60/40 allocation maximized the chances that your nest egg would not be depleted and would sustain you throughout your retirement.

More recent research promises to turn the old "age in bonds" rule on its head. The paper "Reducing Retirement Risk with a Rising Equity Glidepath" suggests that retirees' portfolios that start out conservative and become more aggressive over time can "reduce both the probability of failure and the magnitude of failure for client portfolios". While this research is new, the authors Wade Pfau and Michael Kitces are well known and reputable in the industry. Their bottom line suggests an allocation of 30% equity at the start and a 70% equity allocation at the end of a 30 year retirement.

Others have suggested similar strategies by keeping a separate bucket of safe investments early in retirement (cash and bonds) to fund spending for a few years out. The main advantage of the strategy is to reduce the exposure to big losses when most vulnerable in early retirement when you have the most to lose. The authors looked at many scenarios ranging from a strong stock market in the early years followed by subpar returns in the later years and the opposite where stock returns are negative in the early years followed by strong returns in the later years. They found that the rising equity glidepath becomes a "heads you win, tails you don't lose" situation. If equity returns are bad in the early years a rising equity glidepath ensures that clients will dollar cost average into markets at cheaper and cheaper valuations. If equity markets are good in the early years then there is not much to worry about and you might even be able to change your glidepath to a not so aggressive increase in equities in the later years.

All the above only considers the investment portfolio and many other factors determine the best allocation plan for each of my clients. Understanding the client's income needs, other sources of income and other factors also helps to determine your best plan.

Thanks for reading and let me know if I can be of further service.

Sincerely,

Stan Johnson, CFP(R)
Comprehensive Financial Planning, Inc.
Registered Investment Advisor