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HOW SAVINGS BEAT RETURNS

We're constantly hearing about investment returns and market movements in the consumer press—where yesterday's returns are reported as news, even though history has conclusively shown that short-term market movements are nothing more than meaningless white noise.

You hear virtually nothing about savings rates in the press. So which is more important to a person's long-term financial health?

There's a secret that financial planners and investment advisors understand all too well: investors (like you) have a lot more control than the professionals (like them) over how much money you will ultimately have in your retirement portfolio. Seemingly small changes in savings rates can have far more impact on the growth of an investment portfolio than market returns.

Let's take a simple example. Suppose Jonathan has an income of $100,000 per year and manages to save 1% of his total income each year for 20 years--which would actually be above-average for many people in our society. Let's assume Jonathan's salary goes go up 2% a year with the cost of living. Finally, we'll assume that he's able to earn a very generous 8% yearly return on his portfolio. (Important caveat: all return assumptions you read here are purely hypothetical and for illustration purposes only, and should not be regarded as an indication of what we or any other advisor might achieve in the unknowable years ahead. For all we know, the markets may be more or less generous, and they will be so in unpredictable ways.)

The result? In 20 years, Jonathan's portfolio would be worth $93,741.65. Not bad, you say? That's almost one year's worth of Jonathan's original income.

Now let's suppose that a second person, Joanna, sets aside 7% of her income each year. Alas, Joanna experiences a less favorable investment time period, and her portfolio goes up just 4% a year--half of what Jonathan was earning.

Even so, after 20 years, Joanna's portfolio is worth $373,183.84--more than three times more more in retirement wealth than Jonathan's, even though Jonathan had a much higher rate of return on his portfolio.

If Joanna were to save 10% of her income--which is the minimum that most financial advisors normally recommend--and if she were to get the same rate of return as the less thrifty person with a 1% savings rate, her terminal wealth would be almost exactly TEN TIMES as much as Jonathan's.

As you know, the numbers are never this tidy; you would never earn the same return each and every year, and most of us don't receive the same salary increase from one year to the next. But the point, which can be made with much more complicated illustrations, is that, in general, savings rates matter more than rates of return, and seemingly small changes in savings habits can add up dramatically over time.

No matter what you read in the press, savings rates are more important than investment returns—and they have the added benefit of being more or less under our control.

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ROTHS ON SALE

Every year around this time, financial planners talk to clients about Roth conversions. But this year, there are a few extra reasons to consider moving money from a traditional IRA into a Roth.

Roth IRAs are attractive for several reasons. With traditional IRAs (and qualified plans like 401(k)s), the money one contributes is not taxed, but you have to pay ordinary income taxes whenever you take money out of the account--which might be years in the future. The Roth reverses this; your contribution is made with after-tax dollars, but then there's no tax whenever the money is distributed during retirement.

If you believe, as many financial professionals do, that tax rates are going to go up in the future, then paying taxes now and eliminating future taxes provides a net gain.

Another interesting thing about Roths is that, unlike traditional IRAs, they don't have any minimum distribution requirements once you turn age 72. So long as the money remains in the account, both Roths and traditional IRAs give you the benefits of tax deferral, which eliminates a significant drag on the growth of your money. If you can afford to keep your money in the Roth account, and take retirement income from other sources, then the deferral can go on longer.

Finally, having money in a Roth account gives you a lot more control over your tax bracket in retirement. For instance, you might take out just enough from your traditional IRA distributions to fill the 15% bracket, and then take the rest of your living expenses out of your taxable accounts and Roth. This kind of planning might help higher-income retirees reduce taxes on their Social Security income and avoid higher Medicare premiums. If a married couple can keep traditional IRA distributions low enough that their the taxable retirement income is below $44,000, then they would pay taxes on just 50% of their Social Security income; otherwise, they pay taxes (at a potentially higher tax bracket) on 85% of those benefits. The higher Medicare premiums start at $200,000 of joint tax return income.

The Roth account will still be subject to estate taxes, and your heirs (not your spouse) will have to take the money out of the account over the ten years after the inheritance. But if they inherit a Roth account, they won't have to pay taxes on the distributions they receive--a nice additional gift for your children or grandchildren.

So why is this an especially good year to consider Roth conversions? Remember that you are paying taxes today on the amount that is moved from a traditional IRA to a Roth. Now that the markets have declined by more than 20%, people can transfer more stock shares today than they could have last year for the same tax payment.

Put another way, Roth conversions are more than 20% cheaper, taxwise, today than they were at this time last year. Still another way: Roth conversions are on sale—but this may be only temporary.

Every situation is different, and so there should be an individual assessment of your situation before you pull the conversion trigger. Fortunately, the law allows for partial Roth conversions--moving some of the money over, rather than all of it—so that each conversion can be tax-managed to avoid putting you into a higher tax bracket.

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WHAT DOES IT MEAN TO GET WHIPSAWED?

Whenever financial writers start believing that we may be at or near the bottom of a long bear market, they start warning their readers about the dangers of getting 'whipsawed.' But they seldom explain what, exactly, they're talking about, and they may actually be understating the danger it poses.

The term comes from a type of two-person handsaw used to cut down trees back before we had chainsaws to handle that difficult task. The saws required one person on one side of the tree to push, the other, on the other side, to pull, and then back again over and over until hopefully the tree fell somewhere other than on their heads. In the investment world, this concept has been stretched to mean situations where the price of a security (stock or bond) moves suddenly in the opposite direction the traders were expecting, often leading to a loss.

But that bare-bones description hardly explains the danger that these well-meaning reporters are warning about. For a better explanation, imagine an investor who is watching a long-term market decline, at first hoping the market will recover, then giving up hope and finally selling his or her investment positions, locking in the recent losses.

That person will get whipsawed if the market reverses direction and goes up in the next day, or week, or month, and moves back up past the price he or she sold at. The saddest situation comes if/when that investor decides not to buy back in until the market has dropped back down again to that value where the original sale took place, and waits as the market moves up, and waits, and then at some point realizes that he or she just missed a bull market recovery. All pain, no gain.

Short-term traders often get whipsawed; it's an occupational hazard of trying to predict the fundamentally unknowable future. Long-term investors avoid the trap by understanding that the markets move unpredictably, that a bear market can turn on a dime. Ask anyone who was trying to predict what the markets were going to do in March, 2009, after one of the greatest downturns in market history. The subsequent recovery also belongs in the record books, and rewarded investors who were able to endure the pain in order to enjoy the gain.

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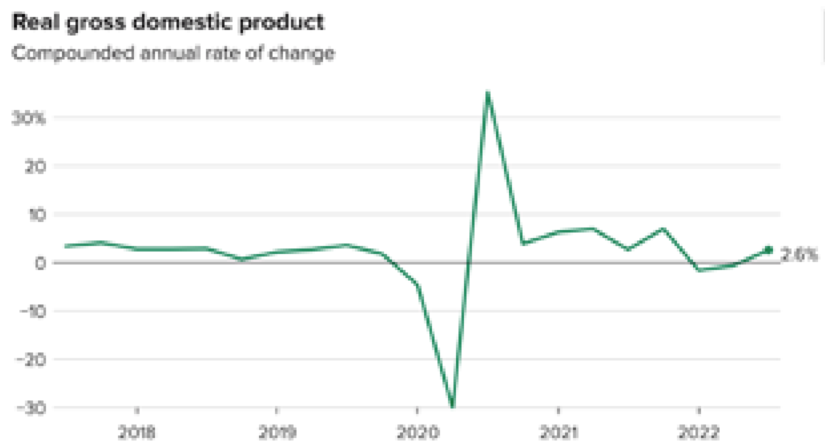
RECESSION OR NOT?

When people talk about an economic recession, it's hard to know who to believe. The U.S. economy experienced negative growth for two consecutive quarters, Q1 and Q2, according to the U.S. Bureau of Economic Analysis. That means we have already managed to survive a recession, right?

Except that employment and consumer spending were high during that period, and prices were going up. Those are not indicators of an economic pause.

Now we learn that the American economy's gross domestic product (GDP) gained 2.6% in the third quarter, according to a recent release from the Bureau of Economic Analysis. This was higher than the consensus forecast of 2.3%—and since forecasters were expecting economic growth, they clearly didn't think we were mired in a recession.



If you look at the chart of GDP going back to the Great Depression, the Covid-induced economic standstill jumps off the page, but so too does the rapid recovery, induced by the fiscal stimulus provided by the U.S. Central Bank. After that, the picture that emerges is growth much as it was before, albeit a bit bumpier.

None of this means that the economy won't experience a recessionary decline at some point in the near—or far—future. There is nothing wrong with periodic declines in growth; the role of a recession is to clear out the economy by exposing unprofitable investments and forcing companies to tighten their belts and make more productive investments with their retained capital. But for now, the U.S. economy is experiencing increases in consumer spending, job and wage growth—and there is nothing wrong with that, either.

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THE BEAR IN CHINA

While U.S. investors are coping with bear market returns, Chinese stock investors are experiencing a fire sale. The Hang Seng China Enterprises Index lost a total of 9% of its value last week, falling to its lowest level since 2008. Chinese companies listed on U.S. exchanges fared even worse, dropping 21% on Friday.

Ordinarily, these huge dips represent an overreaction and a big buying opportunity, but among funds that are investing in China, there is little appetite to move back into the market. The market drop represents a negative response among business leaders to the events at China's twice-a-decade party congress, where President Xi Jinping stacked the country's leadership ranks with allies, clearing away opposition to Xi and opening the door for the the party to exert greater state control over Chinese markets and the Chinese economy overall.

Government interference in which companies succeed and fail, and the Chinese habit of propping up unprofitable enterprises run by government cronies, has made it hard to predict future earnings and growth—which are the drivers of building stock value. Adding to the negative outlook is an initiative by the U.S. and its global allies (Europe, Canada, Japan, South Korea and Australia) to limit shipments of chip production equipment to China, cutting semiconductor technology out of China.

Piling on to the gloomy expectations about China's future is the huge debt crisis in the country's real estate sector, most prominently led by the huge Chinese development company Evergrande, whose finances are a few rungs below bankruptcy at this point, even though the company is too big a part of the Chinese economy to be allowed to fail. People who have bought homes from the real estate giant are now refusing to pay their mortgages, due to chronic construction delays. In the U.S., structural problems like these would be easily handled, but real estate and property sectors account for a quarter of China's total gross domestic product. Evergrande and the Kaisa and Shimao development companies collectively are carrying liabilities in excess of $300 billion, and no bailout is in sight.

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YOUR OTHER PORTFOLIO

Your home is your most valuable asset, right? Or maybe it's your retirement portfolio. Chances are, if you're under the age of 55, there is another part of your personal balance sheet that trumps both of them.

Most of our investment conversations, professionally and informally, are about portfolio returns and asset allocation. But the truth is, every working person actually has two portfolios which generate returns. That second portfolio is what has been called your career asset.

Broadly speaking, people who enter the workforce start out with a very large career asset—which can be defined as the (unknown but probably considerable) future value of all the earnings they'll receive over a 30-50 year workalife. In general, college graduates have larger career assets--that is, their potential earnings are greater than people without a college degree--and any specialized training will increase the value of a person's career asset.

Over time, as people move through their careers, their career asset is incrementally monetized--that is, they're paid for the work they do. As they monetize their career asset, some of that is transformed into capital assets—their savings, which is invested in a retirement portfolio, which (theoretically, at least) will grow over the course of their career.

One of the fundamental jobs of a financial planner is to make sure that each of us keeps enough of the money generated by that career asset, each year, to eventually support us in retirement (to make work optional rather than necessary) and to pay for our other goals and objectives. Ideally, the annual returns on the monetary assets will eventually exceed the yearly salary income, making work optional and retirement affordable.

We call this savings and investing, but it's really a process of gradually, with discipline, turning your career asset into capital assets, so that when you decide to retire, and your career asset has been consumed, it's replaced by the ever-growing capital assets in your investment portfolio. Tragically, millions of people never retain enough of the money generated by their career asset (never save enough) to make work optional later in life.

This career asset is usually far more stable than the stock market; when the markets go down, you still go to work; when the markets go up, you're still earning the same income. But as millions found out in the last economic downturn, your career, too, can be affected by upheavals in the economy. When somebody is laid off, it interrupts the cash flow from the career asset, and raises a lot of "career asset management issues" that probably should have been considered all along:

Are you working in a stable, growing industry or profession?

Shouldn't you, every year, reevaluate your skills and value in the marketplace?

When does it make sense to change jobs or careers, or get retraining?

How much of a return will you get on the cost of taking time out from work and paying for college courses or specialized training?

Are there free training opportunities that you should be taking advantage of?

Other seemingly-complicated financial issues make much more sense once you understand the career asset concept. Life insurance, for instance, can be seen as a way to protect the future value of your career asset. The same is true for disability insurance. Theoretically (unless you have estate planning issues, which is another discussion), the amount of life and disability insurance coverage you need will be reduced as you "monetize" your career asset over time.

Financial planners are beginning to take a closer look at those clients who walk in their door and can't wait to retire early, because they're miserable in their present job. What we're learning is that the solution may not be an early retirement, but either a renegotiation of the current job (less responsibility, less stress, maybe less travel, and also less income) or a career change to something more satisfying. As more of your career asset is monetized, as work becomes more and more optional, some workers are looking for a more fun way to generate income and prolong their worklife. One advisor recently talked about "helping people shift from a great-paying crappy job to a crappy-paying great job"--something they would enjoy doing for many years.

Suddenly, their work-life has been extended by a decade or more, putting less stress on the retirement portfolio, putting more fun in their lives, adding new value and life to their career asset. This is the holy grail of financial planning: a win-win-win.

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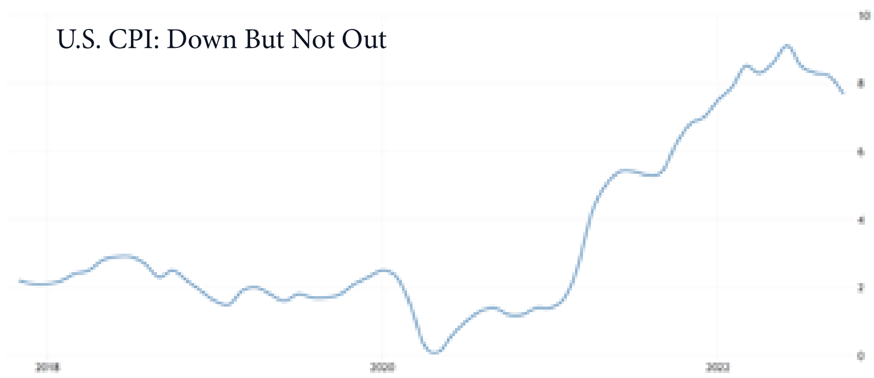
INFLATION IMPACTS

The inflation rate soap opera currently playing out in the world economy matters for your investments in several ways. First, high inflation has a surprisingly large impact on the value of your assets. By one calculation, if you were to have put $10,000 under your mattress in 1980 (you know, to keep it safe), and pulled it back out in 2021, it would only be worth the equivalent of $2,679.

Of course, current inflation is much higher than in the recent past (8.3% as of the most recent report), so the value erosion is greater now than it has been over the last 40 years. Five years of inflation at that rate would reduce the value of a $10,000 account to an equivalent value of $6,800. (You can explore a variety of these inflation-eroding calculations here: https://www.rl360.com/row/tools/inflation-calculator.htm?.)



Inflation also matters because the Federal Reserve is watching current rates, and taking steps to bring the rate down to roughly 2%. The policy instrument, as you know, is raising short-term interest rates, which increases the chances of a recession and makes bonds more competitive with stocks. Every rate hike seems to bring with it another decline in the markets.

That introduces one other way that inflation impacts our lives: if the Fed does trigger an economic recession, companies will cut costs and lay off workers. More people will be out of work, the unemployment rate will go up, and wage increases will stall. Overall, the working public will not be better off.

It's not easy to measure inflation in aggregate. Since all of us buy different things in our monthly budget, these price changes impact all of us differently. Some believe that 'core inflation' is a better measure than the consumer price index, because it excludes volatile food and energy prices. Core inflation, over the last three months, is running around 5.8% a year, having fallen a bit, in part, due to the re-normalization of formerly sky-high used car prices. That's still higher than the Fed target, and not much comfort for those of us who still insist on buying food and driving our cars.

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