Perspective

November 2012 *By Davis Riemer*

DHR Investment Counsel, Ltd.
The Fine Art of Wealth Management

In my life, I have felt what I believe the theologian Paul Tillich meant when he referred to an "ontological experience." I remember the moment, four years ago this month, in November 2008. As I listened to the terrifying financial report I was being given, I felt like I was staring into the void – a completely black, limitless void. As my thoughts recovered, I wondered: "What will happen to our clients? To our firm? To my family? To me?" There was no answer.

Four years have passed - and so has the crisis. Not only has it passed, but we have also recovered almost all that we lost – ***except our confidence***. When hoping that we can now return to "normal" ways of financial thinking and acting, it seems as though we now doubt our beliefs and believe our doubts. What a list can counter our optimism! The challenges to our economic health look daunting. But – ***we have been here before!***

Next time you visit our office, ask to see our chart of 20th century American financial history. Our country has faced daunting obstacles in the past. Our nation has had disastrously bad politics in the past. We have lost our economic footing before. True, today's threats differ from those of the past, but strong similarities exist, also. Our economic growth is quite slow, in part because we have been deeply wounded. As with our bodies, economic wounds differ, but are similar in that we recover. Are we recovering slowly? Yes. "What wound ever healed but by degree?" (Shakespeare)

As you should expect, DHR does a lot of research into investment matters, including historical data on the markets. In addition to the data itself, this research includes study of the processing of that data into information, the delivery of the resulting information to the public and the way in which both individuals and the public interpret and make decisions about that information. This research is especially interesting around times of economic or national stress. We can certainly describe today as one of those times, in part due to the approaching "fiscal cliff" and the looming national debt.

Most of our readers know what the term "fiscal cliff" means, but here's a brief explanation. "The fiscal cliff" describes a 10% decrease in federal budget expenses and a simultaneous increase in taxes, to begin January 1. This expense reduction will be accomplished with "sequestration," which simply means that the reductions are automatic and based on a broad formula (in this case, 10% across the board reduction) and not left to the decisions of management. These changes will occur on January 1, 2013 and are therefore abrupt. Like a cliff, they are steep, deep and, for most of us, un-nerving to look over. As all our readers know, the federal government has been wrestling for years with a large and growing debt. Congress and the White House have attempted work out a method of debt reduction, but unable to agree, they simply extended the existing tax law, which has been in place for the last decade. The extension expires this December 31. Upon expiry, sequestration determines the budget policy for expenses. The tax rules revert to those in force prior to the Bush Era tax cuts. Therefore, if there is no long term plan by January 1, we can assume that, faced with the consequences of an economy that "went over the cliff" elected officials will make changes. Perhaps in 2013. Perhaps after. That would be two major changes in a short period of time. Long term planning, essential to the long term health of our private sector, is made very difficult by inconsistent or uncertain changes in government fiscal policy. Under prevailing conditions, individual investors and corporations cannot formulate sound long-term plans for the deployment of capital because, among other reasons, they cannot predict the taxes due for any of a large variety of transactions and investments.

Many reputable thinkers believe that the abruptness and nature of these changes will stymie the economy's current growth, turn the country back in the opposite direction, and push us into recession. When is "zero hour?" The Chief Economist for the Vanguard Funds Group believes that date is December 14. Few voices advocate ***for*** the acceptance of the results of going over "the cliff."

All this is known to Congress and the White House. So what will Washington do? They have several basic options:

1. **Continue to disagree, let the event occur, blame the other guy, then attempt to remediate.**

2. **Agree to postpone the sequestration and tax change date by some period of time – say, six to nine months. Buy time to figure it out.**

3. **Agree on a different short-term approach before year-end.**

4. **Agree on a different formulation of long-term budget and tax policy before year-end.**

Most people want the same thing--number 4, except that the 54 days from election date to January 1 is not long enough to do the job properly, let alone the shorter time available before December 14. More time would make it more likely. Consequently, I bet on number 2. However, number 2 is an ***extension*** -- not a ***solution***.

By fault of that fact, future policy remains unpredictable, just as it has been for the last several years. This uncertainty about policy affects all financial decisions in an undesirable yet avoidable way. Whether a corporation is considering a commitment of millions, a family of thousands, or an individual person the choice of employment or education, both the tale and the tail of risk grow longer.

As individual investors, we cannot affect the economic environment in which we work. But, we can control what lies within our power. We can decide about the benefits we seek and the costs or risks we assume. Specifically, we can determine the allocation of our portfolios.

Before addressing allocation directly, let's look at the problem again. You, the stock and bond market investor, might perceive significant risk of recession, market turmoil, share price fluctuation, uncertainty and anxiety over future outcomes. Why suffer? Why take that risk?

Two reasons persuade investors to take that risk. First, no alternative choice has "no risk." Risk is everywhere. Since one cannot avoid risk, one should assess and evaluate various risks. Second, investors take the risk of fluctuation and uncertainty because the markets reward them for doing so. The markets pay investors higher returns for being willing to being patient, holding on, and investing long-term. Those "higher returns" are the best tool one has to overcome the losses in purchasing power from long-term inflation. One might ask "What inflation? It's nothing to speak of now and quite possibly for several years more. Why worry?"

Our nation has accumulated a great deal of debt. Concern over it has woven its way into most public discussion for the last five years. Speaking in simple terms with broad generalizations, I believe we can agree on three things about this debt:

1. It constitutes a major obstacle in our nation's future. We must overcome it. We know of the turmoil induced in Europe and specifically in the countries that have accumulated substantial debt and whose economic growth is low. The problem there is the relationship between the amount of debt and the domestic product of the nation. We want to avoid those conditions in our own nation. "Overcoming it" does not mean that we must pay it down to zero. It means that we must bring our debt into a more reasonable relationship with the nation's gross domestic product so that we can afford to pay it off without adopting extreme austerity measures.

2. We can overcome it with robust economic growth, which will generate greater national revenue with which to pay taxes and reduce the debt. After all, to use a simplified comparison, if one takes out a mortgage, the payments on which are very large in comparison to earned income, then one can make it more affordable over time by significantly increasing one's earned income over time. So, if we can make our national economy grow like that, then we can overcome the debt that way.

3. Sovereign governments have the ability to use another tool in the reduction of debt - inflation management. As another simplified example, let us suppose that you borrowed $100,000 in 1970. Today, (ignoring interest for the moment) you go to pay it back. After 42 years of inflation, the impact on you of the $100,000 repayment will be far less than it would have been, had you repaid in inflation-adjusted 1970 dollars. Fixed-amount obligations become less and less burdensome over time with inflation. This same phenomenon can be used by sovereign governments. Over the course of the next several decades, the economic effect of paying off the fixed dollar value of our debt, or even paying it down, can be greatly reduced if inflation increases over those same decades. Using or avoiding various policies, the federal government can induce, allow, or promote inflation. This strategy has been used historically by a number of governments on a number of occasions and, so long as one does not look at the long-term negative consequences of inflation, it works well. For politicians, it works extremely well because it is a way that the persons making the decision can push the costs and consequences of their decision into the future. This view is not so much cynical as it is observational.

Our political leadership will, at the very least, expound on the necessity of paying down the debt and create some means by which to do that. However, I believe that the solution will implicitly involve inflation. Many years ago, upon first entering the investment business, I learned that the two principal obstacles to real long-term investment growth are inflation and taxes. Sadly, it appears that, as investors, we might see increases in both in the coming decade. What then does that mean for our portfolios?

Now, to return directly to the question of portfolio allocation, and the point at which the investor, seeing risk of market turmoil and price fluctuation, wondered about reducing the portfolio's commitment to "risky assets." Switching to "stable" assets greatly increases the risk of long term erosion of the purchasing power of those assets. The choice lies between two risks: first, fluctuation in market pricing and portfolio values through time; and second, gradual erosion of purchasing power. All of that supports what all of us already know: to manage our portfolio allocation means to balance our risks of fluctuation and erosion.

Most of us, at one time or another, have encountered the lines known as the "Serenity Poem." This poem asks that we be granted the power to do what must be done, the grace to accept what cannot be changed, and the wisdom to know the difference. When we face the unknown and the emergent consequences can be significant, we should control our position. While, in our present circumstance, we can ***not*** control the economic environment, we ***can*** control our allocation. So, how should we consider allocation in this environment? This is more than a rhetorical question. Before the November 6 election, we received questions about whether it would be advisable to move a portfolio entirely to cash. The questions reflected fears that the voters' choice might mean bad things for the economy, our international relations, and our economic stability. If we decide that we want to adopt the position that defends us against those near-term events, then certainly one should move risky portfolio assets into less risky positions. However, that illustrates that the matter of allocation cannot be adequately resolved without consideration of the circumstances that might cause the next change, the length of time to remain in a given allocation, or the reasons to move back to "long term" positions.

We believe that, to properly allocate a portfolio with long-term financial goals, one should focus on planned long term objectives, not upon near-term speculative outcomes. For most of us, the objective is retirement income sufficient to support our lifestyle to the end of our days. Some of us have an additional objective of an amount for distribution to heirs. DHR recommends to its clients that the portfolio allocation be structured to accommodate the financial life expectancy of the owner. In most cases, that is several decades. Historical patterns of long-term investment experience show clearly that there is substantially more predictability in results in two to four decades than over one, two, or four years.

We can all enumerate potential troubles and explain why they will cause stock market prices to fall or bond market prices to rise, and why they will hurt us. Less obvious - sometimes completely unknown - are the sources of positive outcomes. Yet, positive outcomes have always arrived. Every significant period of financial losses has preceded a period of growth. The growth has overwhelmed the decline in values. Every time.

A recent article posed the allocation question to three major figures in the investment profession: Larry Fink, Bill Gross and Jack Bogle. Fink has a bias to equity, Gross to bonds, and Bogle to balanced portfolios. Each spoke from the viewpoint of his own intellectual and professional framework. Interestingly, they all agreed on several things about the future:

1. Cash is an undesirable investment position for long term periods.

2. Bonds with short-term maturities will provide higher returns than cash.

3. Bonds with long maturities are currently to be avoided.

4. Stocks will provide higher returns than bonds, over time.

They also all agreed that, in the future, the investment returns in all three -- cash, bonds, and stocks --will be lower than their norms of the three decades that began in 1980. (That means a significant re-adjustment in expectations for most of us, who have spent most of our investment lifetimes in those three decades.)

The three gentlemen differ on portfolio construction. Two of them would use more exotic or unusual and riskier instruments. One of them, Jack Bogle, would stick with what he (and we at DHR) know well - stocks in diversified index fund portfolios and high quality bonds.

At DHR, we are fully aware of the attraction of recent offerings of complex investment opportunities and alternative investments. Most of them have been on the scene for many years and have lain underutilized. (Or at least "underutilized" with respect to their promoters' viewpoints.) After long dormancy, these opportunities gained much greater currency following the tech bubble collapse in 2000 and then, after 2008, they have sprouted like mushrooms after a rain. These opportunities have been created with computer "back-testing" to demonstrate their success and have been offered to the public in a vigorous way. However, DHR has chosen not to use these vehicles and has instead confined its choices for client portfolios to publicly-traded stocks held in diversified portfolios, high quality bonds held either in mutual funds or selected individually, real estate investment trusts, and cash. We understand these investment vehicles and are comfortable with the assumptions, operations, and opportunities they present.

With each of you, our clients, we seek the right balance of these asset classes for your own portfolio. With you, we work to control what we can and to put ourselves in good position to respond well as the future unfolds. There is a sobering aspect of the forecasts for what might unfold in the future. Investment returns from stocks will be lower than they have been in the past and returns from bonds will likewise be lower. That of course means that returns to portfolios will be lower than those upon which many financial plans have been based. Our financial plans and performance assumptions may well need attention.

DHR planning has anticipated this matter in several ways. Two examples: During the last several years, when projecting possible future portfolio returns, we have reduced historical performance substantially. We have pretty much refused to project historical returns into the future without discussion about probabilities. Second, when planning retirement income, in the present or in the future, we have also urged clients to consider a distribution rate of 3% rather than 4%. DHR recommends a constant commitment to equities, as you know, and in this environment, we also acknowledge the wisdom of reducing expectations. It makes sense to adopt this cautious position with respect to expectations: better to promise less and deliver more, than the opposite. We look forward to continuing our dialog about these matters with all of you in 2013.

If our economy slides over the edge of "the cliff," the tax rate on capital gains will increase and the federal tax rate on virtually all forms of income will increase. DHR will be examining all taxable portfolios during the coming weeks, to see whether we can identify beneficial transactions in the face of those possibilities.

The three simple strategies for this possibility of higher rates are:

1. **Realize capital gain this year.**
2. **Realize income this year, if it can be shifted to this year.**
3. **Defer deductions to next year, if that is possible. However, few people have sufficient control over income and deductions to move the dates.**

If you have given gifts to charity in the past and feel inclined to do so again, then please consider the timing. For smaller gifts, a check is the best method and the timing can be anytime prior to December 31. However, for larger gifts, securities are a much preferred method. If this is possible in your situation, please tell us right away. The deadlines for executing such transactions are far earlier than December 31, and the actual action can be more complex. That just requires more time. So, if it is possible for you, please do let us know as soon as possible.

In the last two years, we have lost several close, personal friends to premature death. Others have contracted serious illness. Still others have had to face other personal tragedy. None of it was predicted to occur when or as it did. All were surprises. So, my friends – count your blessings! Give hugs! Tell ‘em you love ‘em! ***Life*** is not really about the money!

DHR Investment Counsel, Ltd.
A Registered Investment Advisor

5435 College Avenue, Suite 200 • Oakland, California 94618 • 510.596.2580 • www.dhrcounsel.com