



# Park Piedmont Advisors LLC

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## APRIL 2007 COMMENTS

### **IMPORTANT NEW BOOK:**

Nassim Nicholas Taleb, author of “Fooled By Randomness,” a book we have cited numerous times in our Monthly Comments, has written a new book, “The Black Swan.” The WSJ review of the book (4/24/07, D8), explains the title as Taleb’s focus on “the rare but pivotal events that characterize life... Only a single black swan is required to falsify the theory that all swans are white even when there are thousands of white swans in evidence.” The reviewer says Taleb’s book tries to deal with the following “troubling question: how do you function in a world where accurate prediction is rarely possible, where history isn’t a reliable guide to the future and the most important events cannot be anticipated?” We will be reporting on this book in depth in a subsequent edition of these Comments, and you should see its relevance to this month’s discussion of Retirement Planning.

### **FOLLOW-UP to HOUSING Section of Last Month’s Comments:**

The WSJ (4/25/07, D1) reported, in an article headlined “Housing Prices Slide as Property Glut Grows,” that “tighter credit and a growing glut of properties are depressing an already weak US housing market, wrecking the industry’s hopes for an early rebound. That leaves buyers in a strong position to negotiate for bargains during the spring home shopping season, the busiest time of the year for housing sales.”

### **LONG-TERM CARE INSURANCE (LTCI):**

For those of you who do not have LTCI, we suggest you review this subject with us. We believe LTCI is an important part of planning for the conservation of accumulated assets, and deserves your attention.

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*Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.*

**COMMENTS: INDEX RESULTS for period ending APRIL 2007**

<u>STOCKS</u>	<u>YEAR</u> <u>1999</u>	<u>YEARS</u> <u>2000-02</u>	<u>YEARS</u> <u>2003-05</u>	<u>YEAR</u> <u>2006</u>	<u>YTD</u> <u>2007</u>	<u>APR</u> <u>2007</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.4%	4.1%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	4.5%	4.3%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	5.6%	4.4%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	5.1%	4.2%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	4.8%	5.7%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	4.5%	4.0%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	8.4%	3.9%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	6.3%	2.8%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	7.9%	4.1%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	6.5%	4.3%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	3.4%	0.0%
 <u>BONDS</u>						
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	1.9%	0.5%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	1.0%	0.3%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	1.9%	0.4%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	1.1%	0.2%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	3.5%	1.3%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	3.2%	0.8%

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

- 1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
- 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
<b>S&amp;P 500</b>	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
<b>NASDAQ</b>	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
<b>BONDS</b>	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
Interm. Tax.															
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
<b>S&amp;P 500</b>	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
<b>NASDAQ</b>	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
<b>BONDS</b>	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
Interm. Tax.															
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
<b>S&amp;P 500</b>	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2%						
<b>NASDAQ</b>	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3%						
<b>BONDS</b>	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4%						
Interm. Tax.															

## APRIL 2007 COMMENTS

**STOCK** index prices posted strong gains in April, following a modest first quarter gain. Monthly gains for the three major US indexes (Dow Industrials, S&P 500 and NASDAQ) ranged from 4.0% to 5.7%. See the third paragraph below on this page for additional discussion, and see page 2 above for all figures for the month, YTD, and since 1999.

**BOND** returns (price change plus interest) were virtually unchanged in April. The benchmark 10-year US Treasury yield closed at 4.63%, which was 2 bps lower than March's close, and much closer to the 12-month low of 4.47% (November 2006) than the current 5.25% short-term overnight rate set by the Federal Reserve. This situation of short-term yields being higher than longer-term yields, referred to as an "inverted yield curve", has persisted for almost a full year. It is highly unusual, since the normal relationship of 10-year yields to short-term yields is positive 200 bps, not negative (62) bps. At some point, it is likely that either longer-term rates will rise, or shorter-term rates will decline. Bond returns for the month, YTD, and since 1999 are set out on page 2 above.

The economic news for the month provided decidedly mixed signals; alongside a slowing economy, with Q1 GDP growth at 1.3% ("the slowest rate of growth since Q1 2003"), there were reported improvements in consumer spending and business investment, and stronger than expected corporate earnings (WSJ, 4/28-29/07, front page). There was also the continuing disconnect between the economy and stock prices; economic growth over the most recent four quarters gained "little more than 2%, while the Dow Jones index has leapt 18% during that same period" (WSJ, 4/26/07, C1). In addition to stronger corporate earnings, which has kept the stock market's P/E at reasonable levels, other reasons for strength in the stock market range from large numbers of company buyouts and stock buybacks, to hopes that the Federal Reserve will reduce interest rates later this year based on the slower economic growth, assuming inflation stays under control (NY Times, 4/26/07, C1).

From a longer-term standpoint, the stock market rally that began decisively in March 2003 now exceeds four years. But the declines of the preceding three years (2000-02) have resulted in price changes (since the highs of 2000), excluding dividends, far below their long term historical averages, with the Dow Jones up 11%, the S&P 500 down (3)%, and the NASDAQ down a stunning (50)%. In a fascinating observation, the mutual fund company Vanguard notes that from 1926 through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of plus 10.4%.

Since the spectacular 1994-99 bull market began, all three major indexes have remarkably similar average annual returns (ranging from 10.0% to 10.4%) that are almost identical to the 10.4% average annual return of the stock market dating back to 1926. As these returns converge, the idea of "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), comes clearly into focus. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the returns from 2000-YTD 2007 were far lower.

**The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, in the context of a fairly stable very-long-term average return. The key question for you: What is your relevant time frame?**

	<u>S&amp;P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2003	1,112	(27)%	10,454	(11)%	2,003	(60)%
Year End 2004	1,212	(21)%	10,783	(8)%	2,175	(57)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2006	1,418	(7)%	12,463	+6%	2,415	(52)%
Year-to-date 2007	1,482	(3)%	13,063	+11%	2,525	(50)%

**Context: Prior Five-Year Gains in Bull Market of 1995 - 1999**

	<u>S&amp;P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
APRIL 2007	1,482	13,063	2,525
Gain	1,023	9,229	1,773
Avg. Ann. % Gain: '95-4/07; 12.33 yrs	10.0%	10.4 %	10.3 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

## **INVESTMENT CONCEPTS**

### **I. RETIREMENT PLANNING**

With the baby boomer generation approaching retirement, the financial press has made the subject of retirement planning a major topic. The financial services industry has also made a big point of focusing the public on issues related to retirement planning. In our view, this subject is hardly new, but rather has always been a basic reason for people accumulating money during their working years. The idea of retirement planning is just another way of describing the process whereby people provide for themselves and their families after they stop working. Taking the concept one step further, estate planning is simply another way of describing what people do in planning for their money after they are no longer living.

Since so much is being written on the subject, however, we want to provide information to our clients that we believe is pertinent and useful. As many of you know, we have developed our own methodology to quantify and discuss how long money is likely to last, based on the following critical variables:

- 1) Amount of accumulated assets in an investment portfolio, along with other assets;
- 2) Amount of additional income unrelated to the investment portfolio (e.g., social security and pension);
- 3) Projected investment return on the investment portfolio, which is dependent on asset allocation decisions;
- 4) Amount of after-tax spending, with adjustments for future inflation; and
- 5) Length of time money is needed, both for lifetime needs and goals beyond each individual's lifetime.

The number of unknowns in this planning is significant, including life expectancy, inflation's impact on spending, and the likely investment return. It is in the context of all this significant uncertainty that Taleb's observations about the difficulty of functioning in a world "where accurate prediction is rarely possible, where history isn't a reliable guide to the future and where the most important events cannot be anticipated" (from WSJ review, 4/24/07, D8) takes on major meaning. However much we agree with Taleb, we also know, and advocate to clients, that effort invested in planning is far better than no planning.

We have recently reviewed a study prepared by the investment firm Alliance Bernstein (February 2007) that we think contains a number of ideas worth reporting (all cites are from this report, unless otherwise indicated). The study begins with a discussion of unknowns, and items within (at least to some extent) an individual's person's control. The unknowns include life span, the impact of future inflation and taxation rates on how much money is needed, and the future returns from capital markets. Matters over which people have some control include when they retire, how much they spend, and how the investment portfolio is allocated, in both after-tax (AT) and tax-deferred retirement (TDR) accounts (pg. 4).

In discussing the uncertainty of investment returns and rates of inflation, a chart is presented (pg. 6) showing the nominal annual returns from stocks and bonds, adjusted for taxation and inflation to reach a “real” return, over the two most recent 20-year periods, 1967-1986 and then 1987-2006. In the earlier period, bonds’ nominal return was 8.4%, but after taxes of 2.7% and inflation of 6.2%, the return was a negative (0.5%). For stocks, a nominal 10.2% was reduced by 1.9% in taxes and the same 6.2% inflation, for a real return of 2.1%. However, in the 1987-2006 period, a different picture unfolded: Bonds, even with a lower nominal return of 6.9%, had a real return of 2.3% after taxes of 1.5% and lower of inflation of 3.1%; whereas stocks, with an 11.8% nominal return, had a real return of 7.4% after taxes of 1.3% and inflation of 3.1%.

The report notes that with an annualized real return of 7.4%, a person could spend 7.5% of his/her initial assets each year, after inflation and taxation, “without touching principal,” and even an all-bond portfolio would have “generated enough return to fund a spending rate of close to 2.5%.” By contrast, the 1967-1986 period saw “inflation and taxation erode most of the stock returns, while bond investors were forced to draw down their principal to fund their spending because the headwinds of taxes and inflation overwhelmed ALL of their return and then some. For that reason, someone who retired in 1967 and spent only moderately would have had a good chance of running out of money if he/she lived an average life span.”

The report (pg. 7) continues: “historical analysis goes only so far. While it can be useful in understanding the risks to an investment plan, it doesn’t help the prospective retiree decide what to do, because any particular historical experience is only an indication of how the future might unfold.” (We enthusiastically agree with this observation, which could have been written by Nick Taleb himself).

The next section (pg. 7) begins the discussion of the controllable factors, starting with spending, which the report states is the “critical driver of a successful retirement.” In an effort to compress the various factors that affect how long money will last, and at the same time emphasize the importance of spending, the material indicates that annual spending of 3% of capital (after inflation and taxation) provides a 90% chance of money lasting more than 40 years, but with spending increased to 6%, there is a real chance of money running out between 15 and 25 years.

The next section (pg. 8) discusses asset allocation, another decision that can be controlled. Note that while market results cannot be controlled, the allocation to stocks and bonds in a portfolio is within the individual's control. The discussion here draws extensively on the historical results of these asset classes, and depends greatly on a person's ability to live with the volatility that comes with market price changes. A chart on pg. 11 combines the factors of a person's attained age, desired annual spending rates (adjusted for inflation and taxation) using a 60-40 stock to bond allocation, and provides an amount of starting capital needed to provide a 90% likelihood of not running out of money. For every \$100,000 of annual spending from the investment portfolio (adjusted for inflation and taxation), a 65 year old needs \$2.6 million of starting capital (the spending rate is 3.9% annually, adjusted for inflation and taxation), whereas a 70 year old needs \$2.3 million of starting capital (spending rate of 4.3%). So the capital needed for \$200,000 of spending would be double the figures for \$100,000. Note that these figures cover spending from the investment portfolio only, and do not include social security and other outside income. If available, these other sources would reduce the amount of spending needed from the portfolio, or, in the alternative, increase the amount of overall spending that could be maintained.

The balance of the Report discusses tax deferred and taxable portfolios, and provides additional information on historical investment returns, which we will discuss in future Comments.



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