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"What, me worry?"

Alfred E. Neuman: fictitious mascot and cover boy
MAD Magazine, June 1955

Dear Friends,

Younger readers may not know of Alfred or, for that matter, MAD Magazine. Those of you born in the mid-'50s or earlier will likely remember Neuman's smiling teenage cover-boy likeness distinguished by jug ears, a freckled face and an inexplicably missing front tooth. The June 1955 cover for the first time carried the iconic quote attributed to Alfred, "*What, me worry?*" The editors reported they instructed the artist to portray Alfred as being "loveable, having intelligence behind his eyes but having a 'devil-may-care' attitude, someone who can maintain a sense of humor while the world is collapsing around him." Remembering that the fifties were characterized by the Korean War, the Cold War with its drop and cover exercises in schools in the event of nuclear attack and the dawn of the beat generation, there was plenty to *worry* about. Just not for Alfred. We early teens ate up Alfred's comic book irreverence like candy. (Remember the classic Mad Magazine cold war parody, Spy vs. Spy?)

Given that our Client Letters for the past two years have put a lot of energy into things we are worried about, we have alternatively decided to follow Alfred's counsel, "What, us worry?" and talk about some constructive developments. At least for this edition.

Global Interest Rate Warming?

After many years in the deep freeze, recently interest rates have begun to show signs of an approaching spring. But before we get too carried away, the move up from the low of 0.625% last year to 1.36% currently on the two-year Treasury is the functional equivalent of the first half an inch of a daffodil cautiously appearing in February. But every reversal in trend has to begin somewhere. The move last week by the Fed to raise the discount rate for the third time in seven months is a pretty clear indication the journey to the new normal in rates has begun. In a sociological sense, this change is long overdue. Risk averse savers have been forced by Fed policy to scavenge the couch seat cushions for lost change to enhance the .25% their savings have been receiving. That leaves the obvious question, what is the new normal in rates? Followed by, how long will it take? Since our Red Phone to the Fed is currently out of service, we admit our views are more based on guessing than anything else. (What else is new?) The current economic recovery is already the third longest in history. As a result, it stands to reason the next economic climate change will be in the direction of a slowdown as opposed to a pick-up. Retailers have been reporting weaker quarter-to-quarter sales, car purchases have decelerated from their feverish 0% interest rate pace, wage growth is anemic and capital spending to meet surging demand is notably absent. Stubborn economies accompanied by low inflation are not your classical pre-conditions for higher interest rates. As a result, it is our view that any rise in rates is likely to be painfully slow. Reinforcing this hypothesis is the fact that market-set (as opposed to Fed-set) interest rates have done very little to follow the lead of the Fed. We are currently getting a bit over 1% for 6-month CDs and 1.5% for corporate notes of about the same duration on funds not invested in equities. It would not surprise us to see those figures go to 1.5% and 2.0% respectively over the next year. That would be especially true if the current recovery has legs and demand picks up a bit. Go Economy!!!

Your Cash Is Trash

Or so it has seemed for years now. But we are here to argue that returns on cash exist which are not measured by interest rates. The first and most obvious function of cash in a portfolio is moderation of risk. The common term to describe this concept is a "balanced portfolio." Clearly in a bear market when stocks are down 25% and a 10-month corporate note has returned +2%, an investor is well rewarded for having held "cash" whether that trove amounted to 20% or 40% of the total portfolio. Avoided losses are equally as handsome as a capital gain when it comes to calculating returns.

A related concept in determining returns on cash is purchasing power. Over a year ago we sold a widely held stock, Verizon, at about $54 a share. For the most part the cash went into short-term bonds and CDs. At the time of the sale another stock we hold widely today, Fifth Third Bancorp, was selling at $19. Not long afterward Fifth Third sold off, along with most banks, down to $16. The proceeds from Verizon amounted to roughly $5400 which would have purchased *284* shares of Fifth Third at $19. But at $16, the $5400 which hypothetically sat in a short-term CD would have purchased *337* shares of Fifth Third. In other words, the "total return" on the funds which were "parked" while waiting for a bargain such as Fifth Third was clearly far in excess of the interest earned on the CD alone. We hope the concept makes sense to you if for no other reason than it does to us and it is a part of our investment process. Said alternatively, you do not pay us to hold cash. You pay us to know when it is advisable to hold cash. Buffett puts it this way: "Investing is worthwhile only when value exceeds price by an amount great enough to create a margin of safety." When he cannot find such vehicles fitting this description, Warren is content to hold cash; today that total at Berkshire Hathaway approaches $100 billion. When asked about this sum at the most recent annual shareholders' meeting he replied that he "loved cash" because of what it enables him to accomplish when the right situation comes along. Yet something else to feel *good about* when stocks, bonds and real estate are priced to near perfection.

The IRA Era

It is with sadness that your writer reports he has reached age 70 and is now held hostage to the dreaded annual RMD (required minimum distribution). It has been so much fun accumulating these assets over the years, it almost feels like being the orphanage house mother who is forced to set her children out on the street just because they turned eighteen. With the benefit of having 45 years experience as a retirement saver (and one as an RMDer), we thought it would be interesting to share what we believe are best practices for retirement savers. If you are already on the proverbial beach, you may enjoy the nostalgia of looking back on your career as a saver. If you are working, perhaps some of these concepts will incent you to step it up! Possibly there are children in your life who are entering the workforce and could benefit from your savings experience given the sorry state of Social Security and pensions.

- When many of our clients began saving for retirement, IRAs did not exist. Larger employers had either a profit sharing or pension plan that typically had a matching provision for savings by employees. In later years these plans came under IRS scrutiny and became known as a 401-k. The two aspects of these plans that were key to their success were the matching incentive and the ability to save small amounts out of *every* paycheck. The message: start early and never miss out on $1 of a match.
- While the amount of money which can be put into these plans changes from year to year, the contribution limits for 2017 are $18,000 for a 401-k (or $24,000 if you are over 50) and $5,500 into either a standard or Roth IRA (or $6,500 if you are over 50). The 401-k figure does not include an employer match. If the latter was, for example, $3,000, a worker under 50 could accumulate a total of up to $26,500 for their retirement.

- Remember, all of the above contributions go into qualified accounts on a pre-tax basis. The message: it is a whale of a lot easier to save $2,000 in a month on a pre-tax basis than after tax which counting federal, state, Social Security and Medicare would cost most people over $3,000 to set aside $2,000.
- Fine, you say, but who can afford to put that kind of money away when they are just starting out? You are right. But for those who have been working for twenty years, let's assume they have reached the point where they have $100,000 in qualified plans and could set aside $2,000 monthly. Partner Marcia Hull built a model that assumes at age 45 a couple pulls $24,000 together plus an employer match of $2,500 for a total of $26,500. As the IRS adjusts the limits annually for inflation, also assume that the limit goes up $500 a year. At a return of 5%, what would be there for our diligent savers at age sixty-five, 20 years later? Drumroll please… $1.37 million! Message: hopefully this paragraph demonstrates what people can do for themselves, even if they get a late start.
- Loans? Over 20% of plan participants whose plans permit loans have loan balances. The message: don't. First of all, over half of loan balances are paid off by liquidating assets in the plan, paying taxes *and* penalties for early withdrawal as the form of repayment. If participants do make payments on the plan out of their paychecks, this is money which should be going into contributions. It's unlikely a borrower could afford to do both.
- It has been our experience that many people have more than one 401-k or IRA rollover. Message: don't. It unnecessarily complicates the process. If an employer plan permits funds from prior employer(s) to be rolled over, just do it! Or call us!
- Investments? Follow Warren's advice. Be greedy when others are scared and scared when others are greedy. That formula would have had you mostly in stocks in 2009 and disproportionately in a shorter term bond fund today.
- Withdrawals? The goal here is to not outlive your capital. In the same way a disciplined approach got you to the $1.37 million, a mirror image disciplined approach can carry you through retirement. Starting at age 70 the government will tell you how much you must take out of your plan (the RMD). Up to that point, it's up to you. Assuming interest rates normalize and that bonds are a major component of your plan assets, a 4.5% annual withdrawal rate starting at 67 (to coincide with starting Social Security) on $1.37 million would produce $58,500 per annum. At 5% the figure grows to $65,000. We strongly advise that people withdraw retirement savings on a level monthly installment basis. This amount plus Social Security becomes your monthly budget in the same way that paychecks did in your working years.
- Some amount of after tax savings in retirement is also essential. You don't want to start taking unplanned distributions from your IRA rollover to make a down payment on a car or repair a leaky roof. Such invasions will impair the principal of your primary nest egg and runs the risk of compromising your retirement plan. So, in addition to saving in the 401-k as above, at age 50 our retirement savers are going to have to start saving another $300 a month in an after tax investment account. After 16 years at a 5% compound return this account should have over $85,000 in after tax funds available to meet unbudgeted expenses in retirement. While it is not a ton of money, it is a rainy day fund for unforeseen costs.

Clearly this is not a formula for living life large in retirement. What we have hoped to demonstrate is what is possible through regular savings and the wonder that is compound returns. Please remember all of the figures cited above are simplistic and do not take into consideration changes in the law/taxation, actual returns on investment which are certain to be different than a flat 5%, inflation, job losses, divorces and the myriad of other messy parts of life. But with discipline and insight it is truly amazing what can be accomplished, even by late starters.

Nearly A Wrap

As the clients who partner Kip Acheson covers already know, Kip will be retiring late this summer after a distinguished career as a senior banker at First Interstate Bank and twenty years as an investment advisor with Spence Partners at RBC and our previous employer. Kip has contributed to our clients' success in more ways than we can count. His career began in San Francisco followed by nine years in Asia in four different countries. In Portland he managed the International and Cash Management Divisions of the bank before moving on to a career in working with people one-on-one in an endeavor to secure their financial well being. Shortly Kip and his wife, Dr. Lizzie, will become grandparents and will be splitting their time between their homes in Portland and Charlottesville, Virginia. This will be a sad day for those of us remaining behind. While we know Kip will not miss the 50+ hour work weeks, it is certain he will miss his contact with all of you who were blessed to have his professional skills and friendship as a part of your life.

We have a couple of additions to the team which we are excited to share with you in an effort to fill the large shoes that Kip will be leaving behind. Joining us after 18 years at RBC in a Senior Client Associate role is Shana Heyden who will be serving clients in the same capacity as miracle worker and Senior Client Associate Kathy Crocker. Also new to the team is Sam Manafi who is registered and comes to us having just sat for his Level One Chartered Financial Analyst exam. As an Investment Associate, Sam will be helping the partners with the day-to-day tasks associated with managing money with emphasis on trading, research, retirement planning model building and client communications. Welcome Shana and Sam!

OK. Now it's a wrap. Please give us credit for remaining on an even keel amidst the craziness. We worried only Alfred E. Neuman could keep smiling and remain worry free under current conditions. This being summer, it's time for vacation planning. Last year was an easy call with the collapse of European currencies following Brexit. This year's recommendation? Victoria BC. The Loonie is still depressed against the dollar, Vancouver Island is a treasure and the outlying islands on the Sunshine Coast are ferry served: consider Saltspring Island/Ganges Harbour. The Hastings House resort there is a national treasure. Best of all you will be nearby the San Juan Islands and can swing by for lunch and a meeting with Steve.

Cheers!

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