WOODSIDE ASSET MANAGEMENT

Focus

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A trillion dollar time bomb?

In our last issue, we examined the potentially over-optimistic expectations for investment returns used by some financial planners when performing retirement planning for their clients. Using "historic" returns of 10-15%, when actual returns going forward may be closer to 6% for stocks and 5% for bonds, could derail an individual's retirement plans. Robert D. Arnott, CFA, is the Managing Partner of First Quadrant, an institutional money management firm, and a highly respected observer of the investment scene. In his recent letter to clients entitled "A Trillion Dollar Time Bomb?," Arnott examines the potential impact of reduced investment expectations on corporate pension plans.

According to Arnott, the average U.S. pension fund currently assumes a 9% return. If the actual returns are only 6%, the 3% shortfall for the 1,000 largest U.S. plans amounts to $100 billion annually. With a $100 billion plan deficit, contributions are too low by $100 billion and reported earnings are too high by roughly $50 billion. Stretch these calculations over the average duration of pension liabilities, 15 years, and you have a deficit of $1.5 trillion. This deficit is significant not only for the pension plans themselves (and their beneficiaries) but also for the sponsoring companies' earnings and valuation.

To drive his point home, Arnott includes a quote from Warren Buffet: "...Anyone choosing not to lower assumptions—CEOs, auditors and actuaries—is risking litigation for misleading investors. And directors who don't question the optimism thus displayed simply won't be doing their job." Besides issues of corporate governance, Arnott also warns investment managers to take account of pension assumptions

in gauging the quality of the earnings of companies they hold. We have taken this admonition to heart and are careful to examine a company's pension liabilities when considering any stock for purchase.

Home sweet home

Are we in a real estate bubble? Victor Canto of La Jolla Economics researched this question in his paper entitled "Home Sweet Home." His conclusion is that the American dream is alive and well.

His first finding seems obvious. "Temporary fluctuations in current income (as in a recession) do not have as large an impact on consumer spending as do permanent changes in income." If you lose your job, but expect to find another soon, you will keep your house. If that outlook changes or finances are completely depleted, then you sell or walk away. While Silicon Valley and other pockets of the country are experiencing job losses, the majority of the nation is recovering. Any decline in housing prices should be selective.

The bearish case for home ownership argues that the ratio of home prices to income is high relative to historical norms. Canto counters with evidence showing how the decline or rise in home prices depends on the economic environment. "Real declines in home prices tend to occur during periods of tax rate increases, a phase-in of tax rate cuts, or oil shocks." We do not expect any changes in tax rates this year with an upcoming election nor while we are still coming out of a recession. Therefore, unless oil prices spike up, home prices should be relatively stable.

The final concern that Canto addresses is the specter of increasing mortgage rates. If rates rise, which is likely, the housing bears worry that the debt-burdened consumer will stop buying, thus drying up demand. That could be true if Greenspan raises rates and we are not in an economic recovery. However, if the consumer still has a job and can afford the mortgage, then homes will still be purchased.

We would add to the bullish case the fact that demographic trends also support continued growth in housing: the 96 million children of the baby boomers, now entering their prime earning years, outnumber their parents by 20 million or so. With parents living longer and tending to stay in their homes longer, household formations among the younger group will constitute a large and fairly stable source of demand for some time to come.

Following the herd over the cliff

The institutional research group at William O'Neil & Company, publisher of *Investor's Business Daily*, recently distributed a study of mutual fund holdings of selected, widely-held tech stocks at the top of the market in 2000, a year later, and then as of April of this year. The data is summarized in the following table; it shows the company and, in each cell to the right, the number of funds holding it and the number of shares held, in millions, as of the dates shown:

ISSUE	AT THE TOP	1 YEAR LATER	4/2002
AOL	846/358	1,000+/946	1,000+/911
BROADCOM	457/21	N/A	463/47
CHECKPOINT	485/75	N/A	577/64
BROCADE	431/80	N/A	505/92
EMULEX	187/34	N/A	237/30
AMAZON	164/40	129/68	165/72
JDS UNIPHASE	734/189	897/280	612/156
NOKIA	645/544	N/A	714/402
QUALCOMM	555/109	752/138	879/123

To quote the study (with minor editing for readability):

"What these data show is that most of Wall Street is late to the party, and the continuing, mindless Buy, Buy, Buy drumbeat of Wall Street analysts sucks in everyone who is foolish enough to believe that a topped-out, former big leader becomes a value as it collapses.

"This phenomenon is also a factor in our observation that big leaders in one cycle rarely lead in the next, for the simple reason that everyone is now loaded up with these former big leaders well after the fact, well after they have had their incredible runs, and well after the fundamentals have started to deteriorate. There is nobody left to buy them, and these stocks languish for a substantial period of time, often sitting out the next bull cycle altogether. This phenomenon is central to our current thesis regarding the technology sector: it will under-perform for a period of time from here."

The market certainly seems to be confirming O'Neil's thesis!

Russia: The collapse of an empire

Back in 1991, we published some statistics about how bad things were in the then Soviet Union. Although much has changed in 11 years, and some areas such as communications have improved, one area has not: public health. *Fortune* magazine recently published an article about the plight facing the country's 145 million inhabitants.

According to one long-time demographer who specializes in Russia, the combination of a low birth rate among women and the high death rate among men could result in the population declining to as few as 100 million by the year 2050. The cause of the high death rate: accidents and cardiovascular disease, in turn the result of alcoholism, and the spread of infectious disease like TB and AIDS.

The average Russian male consumes 15 times as much alcohol as the average Frenchman, and consumption is actually growing. It is estimated that 10% of Russia's prisoners are infected with TB, and a third of them are released every year. (The average TB carrier infects about 15 to 20 people a year.) Finally, there are now over 1 million people infected with HIV, and the top AIDS official at the Ministry of Health predicts that the death rate from AIDS could top a half million annually by 2005. Like TB, the AIDS problem is

especially acute in prisons. In the Kresty prison alone, more than 1,000 of the 7,800 inmates are infected, up from only 10 in 1997.

Nicholas Eberstadt of the American Enterprise Institute summarized the state of affairs in Russia very succinctly: "No industrialized country has ever seen this kind of demographic meltdown in peacetime." *Fortune* goes on to state that "Russia is really no longer a developed country... [Its] demographic problems are the clearest sign it's no longer a great power: It is, at best, Mexico with nukes."

We're sure there are lots of people in Mexico who would take issue with this comparison. However, it serves as a reminder that the situation in Russia poses two very real threats, one nuclear and the other medical. The nuclear threat has been well publicized. We won't be surprised if the health threat comes to the fore over the next several years because of the danger it poses to our collective well being, nor will we be surprised if the U.S. taxpayer ends up helping pay for efforts to deal with it.

From our Financial Planning Department: The 65-year retirement

Bob Veres, a well-respected columnist covering the financial planning profession and publisher of *Inside Information*, an "e-zine" for planners and advisors, wrote an article recently entitled "Planning the 65-year Retirement." Essentially, the article turns on its head a commonly held perspective regarding retirement planning. Traditionally, financial planners have assumed that the typical retirement begins somewhere between ages 60 and 65 and lasts until death at age 90 or 95. This equates to a 25- to 35-year retirement. In Veres' article, the reader is invited to imagine what retirement might look like in the future for those who retire at 55 and live to be 120 or more, a likely scenario given the advances being made in medical technology.

According to Veres, the concept of a 65-year retirement represents a new frontier in financial planning. Until now,

most planners and advisors have focused on “accumulation” strategies. This is another way of saying that the focus has been on asset allocation issues and risk tolerance considerations. As important as these are, Veres argues that now we must look at the other side of the same coin and consider “distribution” strategies as well. Distribution strategies seek to determine the amount that can be withdrawn from a portfolio year after year, the goal being to ensure that in the 65th year of retirement the investor still has a portfolio from which to draw.

With this in mind, what if an investor were to draw down his or her portfolio at roughly the same rate as the investment return the portfolio is expected to generate over the long term? Probably not a good idea: simulations show that all it would take to throw this strategy off course is several years of back-to-back negative returns.

What about a strategy of taking out no more than 4% of the portfolio during the first year, converting this figure to a fixed dollar amount, and thereafter increasing the amount based on inflation? Generally speaking, this kind of approach is more likely to increase one’s chances of success.

A variation of the not-more-than 4% strategy is to withdraw 6% of the portfolio the first year and base subsequent distributions on the previous year’s investment performance. If the portfolio grows so that the 6% is replenished, the following year’s distribution stays at the 6% level. As long as the portfolio continues to grow, so will the distribution in actual dollars. In years when the portfolio’s returns are negative, withdrawals are frozen at the current level. As a safeguard during an extended bear market, the withdrawal is limited to some maximum percentage of the portfolio, say 10% for example. The implication of this is that withdrawals may even have to be reduced during lean periods.

To quote Veres, “the state of the art looks a bit primitive” with respect to distribution strategies. Financial advisors are

devoting more time and energy to this topic, and we expect to be reading much more on it, both in the near term and for some time to come. Fortunately, some very powerful tools are being developed to facilitate the analysis of different approaches and varying the assumptions. We stand ready to assist our clients with any retirement planning issues they would like to address.

Groaners

[Sorry. It's been a slow quarter for humor.—ed.]

A good pun is its own reword.

A man's home is his castle, in a manor of speaking.

My wife really likes to make pottery, but to me it's just kiln time.

I fired my masseuse today. She just rubbed me the wrong way.

I used to work in a blanket factory, but it folded.

I used to be a lumberjack, but I just couldn't hack it, so they gave me the ax.

If electricity comes from electrons, does that mean that morality comes from morons?

A hangover is the wrath of grapes.

Does the name Pavlov ring a bell?

Without geometry, life is pointless.

When you dream in color, it's a pigment of your imagination.

Inside Woodside

As a reminder, our offices will be closed on Friday, August 30 and Monday, September 2 in observance of the Labor Day holiday.

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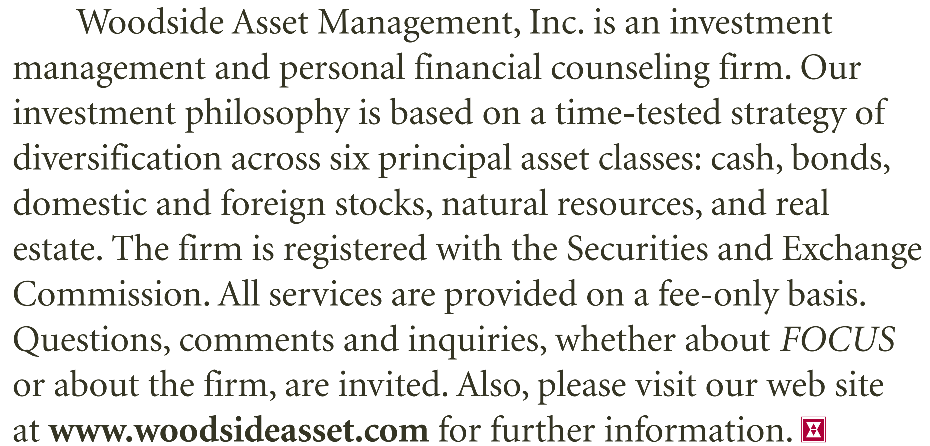

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