

IAP FINANCIAL ADVISOR

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Points of interest:

- Inflation inflicts permanent damage on a retirement portfolio.
- Inflation has devalued the U.S. dollar in every one of the last 52 years.
- Retiring on a fixed income can be disastrous: someone who retired with \$50,000 in income in 1986 would need \$91,500 a year to buy the same goods and services today.

THE REAL FINANCIAL THREAT IN RETIREMENT COMES FROM INFLATION

Ask the average person who is planning to retire and will have to depend on an investment portfolio for part of his income and he will tell you one of his biggest concerns: losing his principal. Then he'll often add that perhaps it is time to get more conservative with his investments in order to avoid volatility that could destroy his retirement nest egg.

The first concern is legitimate: it is very hard to rebuild a damaged investment portfolio once someone retires and no longer earns income that can be added to the portfolio.

The second concern, however, misses the biggest threat to retirement success: It's not short-term swings in market prices that damage a retirement portfolio but inflation that is the destroyer of long-term wealth.

Pernicious effects

Year in and year out inflation eats away at the value of your capital. And there is no "make-up" period: disinflation, that is, periods when inflation falls, are almost as rare as sightings of Bigfoot.

The last calendar year consumer prices fell in this country was 1954. Before that one had to go back to the low point of the Great Depression to find prices falling.

Investment market swings, by contrast, can be brutal but are also relatively short, usually lasting just months or at worst two or



Retirees can't let their financial assets sit back and relax. Instead, they need growth at or above the rate of inflation.

three years. And they are usually followed by market recoveries that help to rebuild wealth in a portfolio.

Long-term effects

As we live longer on average inflation becomes a bigger concern in retirement. It is becoming common for workers to live 20, 25, or even 30 or more years after they receive their gold watches.

That means a retiree must plan on having a growing income stream over retirement. A retiree can't begin with a fixed income and expect it to carry her through the years.

For example, suppose you retire today on a \$50,000 fixed pension. What if you experience the same rates of inflation that occurred over the last 20 years? The latest figures, for October 1986 through October 2006, show that consumer prices increased by 83%.

That means your pension would have to grow to \$91,500 in 20 years just so that you can maintain your standard of living.

And that's for an average annual inflation rate of just 3%. There have been 20-year

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INCOME-PRODUCING INVESTMENTS AREN'T ENOUGH FOR RETIREMENT

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periods in the past when inflation has been higher than that.

The first lesson, then, is don't retire if you are going to stretch your income to its limits. If you need \$50,000 a year and the income from your portfolio, your pension, and Social Security will provide just that amount, you may be heading for trouble in the future. While Social Security is currently indexed for inflation, it is likely that your pension is not.

In that case, you can't take an unreasonable income stream from your portfolio. If you keep everything in a fixed interest account at 5% and you spend all the interest each year, your inflation-adjusted income will fall.

The second lesson is that keeping everything in income-producing investments is a recipe for failure. You will have to expose some of your portfolio to assets that have the potential to grow with inflation, such as stocks, commodities, and inflation-linked bonds. If you



Multiple assets boost a retirement stash.

do that, and keep your portfolio withdrawal rate to a reasonable level, you will have a better chance of succeeding.

BULL MARKET AT AGE 4: NOT SO SPECTACULAR

The bull market that started in October 2002 recently passed its fourth birthday, and the resurgence in U.S. stocks has some investors feeling good.

Indeed, the Dow Jones Industrial Average, which declined by 38% during the 2000-02 bear market, finally surpassed its early 2000 high and has moved up into the 12,600 range.

However, the broader and more representative Standard & Poor's 500 Index, in the mid 1,400s, needs to gain another 5% or so just to regain its all-time high of 1,527.

According to Standard & Poor's, the investment research firm that maintains the S&P 500 and other popular indexes, the average bull market extends for about five years.

That does not guarantee that 2007 will be a positive year or that the S&P 500 will go on to new records. In other average bull markets the S&P 500 has regained its highs in just 3.3 years; by that stan-

dard the market recovery that began in late 2002 is already below-average.

Average gain of 80%

The S&P has gained about 80% since its low on Oct. 9, 2002. But InvestTech Research says the average bull market recovery in the S&P 500 since 1932 has been almost twice that.

And there have been other bull markets where stocks did not gain enough ground to

regain previous highs.

Instead, they fell back in a new bear market and had to wait for the next bull market to break higher ground.

Consider the long stretch from 1966 to 1982. Although there were several bull markets within that period, stocks

as a whole pretty much went nowhere, because bear markets kept dragging stocks down again.

It is impossible to know until well after the fact whether the market is in a long-term bull market or bear market. It seems pretty certain that the market was in a

long-term bull from 1982 through 1999.

Don't predict

All in all, trying to predict market outcomes is fruitless. Past patterns may not be repeated, or won't occur to the same extent.

At best an investor should hedge his bets by staying diversified. Commit money to the stock market but also hold other investments, such as bonds, cash, and perhaps hard assets like commodities. That way you will be covered no matter the outcome.



Despite going for four years the current bull market has yet to push stocks back up to their previous highs.

"In other average bull markets the S&P 500 has regained its highs in just 3.3 years."

REGULAR REBALANCING IS THE BEST WAY TO PROTECT A PORTFOLIO

It's a simple fact: investors abhor losses. They engage in all sorts of strategies and practices in order to avoid or minimize losses.

At the same time, investors are often also excitable and greedy. When a segment of the investment market goes through a prolonged upswing, they throw money at it as they chase recent returns.

Many academic studies, as well as the real world experience of honest investors who admit their own mistakes, show that these practices are often ruinous.

Attempts to avert loss by a wholesale shifting of money in and out of markets usually go awry, because it is difficult to predict the right times to make such moves. Investors can also miss potential large returns when they avoid markets perceived to be risky.

Chasing recent hot returns periodically backfires. The multitude of investors who in early 2000 poured money into U.S. technology

stocks after a four-year bull market were soundly whipped over the next three years.

A better way

Regular portfolio rebalancing is a simple but proven way to take emotions and the need for impossible predictive powers out of the process.

It requires an investor to commit to holding a specific allocation of stocks, bonds, cash and other assets and then to periodically trade among those assets in order to maintain the original balance.

Suppose an investor decides to hold 50% of his money in stocks and 50% in bonds. Then suppose the stock market rises over the next year while the bond market holds steady. Stocks will now make up more than 50% of the portfolio and bonds less than 50%. Rather than sitting still, or throwing extra money into stocks because they have gone up, the inves-



You can use periodic rebalancing to force yourself to buy low and sell high.

tor should sell enough stocks to reduce them to 50% of the portfolio, and reinvest the proceeds in bonds.

Such rebalancing forces the investor to sell something that has gone up and buy something that has become cheaper.

It keeps the portfolio's risk in balance with the investor's original objectives, provides an objective standard for investment decisions, and eliminates the need for guesswork about the future of the markets.

"Regular portfolio rebalancing is a simple but proven way to take emotions and the need for impossible predictive powers out of the process."

BIG SALARIES, EARLY RETIREMENT, & MORE

Want to know how to make money on Wall Street? You might do better working there rather than investing through the street's brokers.

The average weekly pay for a Wall Street job soared to \$8,300 in 2006, says the federal Bureau of Labor Statistics. Yes, that is a weekly, not monthly, salary.

In fact, the estimated 280,000 workers in Manhattan's finance industry collect more than half of all wages paid there.

At one large investment

house, Goldman Sachs, the average compensation per employee was \$500,000 last year.

Forced out early

Workers planning their retirements are being blindsided by forced early retirements, a survey by Sun Life Financial found.

About 22% of those surveyed said they were forced to retire an average of seven years early.

"It appears that unanticipated, forced retirement is occurring at an alarming rate,

leaving the impacted retirees unprepared," said Sun Life executive Mary Fay.

Index emerging markets

Despite claims in the investment community that risky emerging markets are best exploited by stock pickers, a new study by two Pace University professors found that indexed emerging markets funds outperform actively managed funds.

Aron Gottesman and Mathew Morey also found that lower cost funds did better than higher cost funds from 1997 through 2005.



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INDEXED INVESTING BEATS ACTIVE STOCK MANAGEMENT ONCE AGAIN

Some investors never stop searching for the Holy Grail of investing—a stock picking, market timing investment manager who can consistently beat the market.

The performance of the mutual fund industry in 2006 added more evidence on the difficulty of that quest.

Statistics compiled by the Vanguard Group, one of the nation's largest mutual fund companies, show the majority of domestic funds of all sizes and styles were beaten by simple stock indexes.

Of course, Vanguard has an ax to grind because it started the first large stock retail index fund 30 years ago and now offers a variety of bond and stock index funds.

But the statistics are hard to argue with. For in-



Active stock fund managers found it hard to keep up with the indexes in 2006.

stance, three-quarters of 1,033 large-cap blend funds—meaning funds that held value and growth stocks—failed to match their appropriate index in 2006.

Blended funds with smaller stocks did a little better, but the relevant index still beat 60% of the 329 small blend funds tracked by Morningstar Inc., an independent fund rating service.

Value stock managers found it particularly hard to beat their indexes: 94% of large value stock funds under performed their indexes, Vanguard said.

Growth stock managers did a little better, yet 72% of them failed to beat their growth stock index.

Vanguard said similar results were found in 5- and 10-year track records for actively managed funds.

This is disturbing since the fund industry attracts many of the best and brightest portfolio managers.

Other studies have shown that those funds which beat indexes fail to do so consistently—winners over the past few years tend to under perform in subsequent years.

Vanguard's conclusion is that simple index investing will bring better returns to most investors.