HOW TO MARKET TIME THE FISCAL CLIFF

"If you don't have time to do it right, when will you have time to do it over?"
- John Wooden

Market timing has become fairly well known among academics, advisors and investors to be a risky strategy when dealing with serious money designated to fund future lifestyles. I'm not going to go into the plethora of pitfalls of market timing in this article, as there is an abundance of evidence freely available to argue against it. Despite this, with the known uncertainty of the fiscal cliff looming imminently on our near term horizon, what is the real cost of taking your money off the capital market table and waiting it out to see what happens? Even though market timing is generally known to be a risky and costly endeavor, might it be different this time with the looming fiscal cliff?

The answer is that the cost is not small. I created a simple scenario of a 64 year old single client with $1 million in taxable assets and no unrealized gains, no estate goal, and a desire to maximize an after-tax inflation adjusted income yield of $44,000 (4.4%) a year to age 93, his 80th percentile life expectancy. Our simple balanced income allocation (45% stocks, 50% Treasuries, 5% cash) had historically exceeded his goal in 571 of 673 historical 30 year periods going back to 1926, or 85% of the time. **Going to cash for just the next year lowered the confidence level by 9% to 76%, with only 512 of 673 historical periods exceeding his goal.**

Another way to look at this is to calculate how much one would have to reduce retirement spending in order to have the same historical chances of exceeding the goal without the "one time" move to cash. In essence, how much would one have to decrease the retirement spending to make up for the gamble of moving to cash for one year? Going to cash for one year would cause a $1,900 drop in inflation adjusted lifetime retirement income down to $42,100 versus $44,000. That is not insignificant. It might mean one or two fewer trips to visit the grand kids, or ten to twenty nice nights out on the town.

All of this assumes that the fiscal cliff is an outlier event that makes us think "this time it is different." It also assumes that the rational long term allocation will be used for the rest of the investor's life, and we are completely certain that there will never be another "this time it is different" event causing the same emotional move to cash at any time in the future. But how does one know whether they will perceive another "this time it is different" event in the future? Will the investor again be tempted to move to cash the next time the media heralds the latest financial scare? Is the fiscal cliff materially different than the Russian currency crisis and failure of Long Term Capital, the dot com bomb of 2000, 2008's panic, the 2010 flash crash, or the third quarter of 2011 with the Treasury credit downgrade by S&P and debt ceiling gridlock?

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What Do We Fear?

Fear is an emotion, and emotions can cause us to make some decisions that objectively we wouldn't otherwise make. Wealthcare is different than the rest of the industry in that we actually embrace the emotions of our clients to help us discover what people are passionate about, as well as what they fear. Unlike many advisors who implore clients to ignore emotion altogether, we are actually able to provide rational and objective advice that has meaning, purpose, and provides comfort for each client.

We do not coerce or judge, but we do objectively expose the consequences of choices. When we model choices, we want to make sure the assumptions we are making are reasonable. In the example of going to cash for a year, we would want to also consider the possibility that this might not be the only event that would cause the client to go to cash so we would want to see the impact for more than just one year.

It is not always the client that is the driver of potentially poor and uninformed emotional choices. Many advisors fall victim to emotions that end up harming their clients. A good example is annuities, which are generally sold based on fear. I think advisors in general care about their clients and have a sincere desire to do what is in a client's best interest, but even if an insurance company designed their product to have no advantage for the insurance carrier (in essence making it a fair coin flip), half of all the buyers of an annuity would be harmed by buying it (half would die by normal life expectancy). Insurance companies normally fail to remind advisors of this inherent consequence of their product. (See: How Much Is That Guarantee In The Window?)

Another example is the "Buckets of Money" approach that is used in numerous forms by many different advisors. The concept is easy for advisors to sell because it has a great deal of emotional appeal. Conceptually, the idea is that some amount of cash is set aside for planned cash withdrawals for some period of time, while other "buckets" are set aside to fund other goals later on in life. There is emotional appeal because clients are less likely to need to sell an asset at a loss to fund a goal. But it carries with it a huge price to the client's lifestyle. For example, consider the aforementioned client with which we modeled the impact of going to cash for one year. If we instead merely changed the allocation to plan on always keeping about two years of extra cash (increase the cash allocation from 5% to 14%), **the historical odds of exceeding the spending goal drop from 85% to 63%.** That two years of extra cash on hand may be emotionally "comforting" just like the guarantees of annuities, but it comes at a huge price (also like annuities). To get to the same historical odds as not having all that extra cash lying around, the client would have to reduce their retirement spending from $44,000 to $40,500, a $3,500 annual lifestyle inflation adjusted price to that "comfort."

Normally advisors and the industry leaders that are promoting these emotional sales tactics do not disclose this price to their approach --they only focus on the "benefits." Often, they don't even realize that their approach comes at a cost, and they think that what they are doing is "helping" their clients. And, while for some people or in some markets there may be cases in which a benefit is realized, the facts remain that these odds are unlikely and it comes at a large price to a majority of their clients that end up being harmed.

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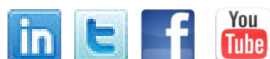
What is truly ironic to me is that the emotion advisors are afraid to face (occasionally selling an asset at a loss to meet a spending goal) is infrequent anyway when you tax efficiently manage retirement distributions like we do for hundreds of clients every day. We use retirement spending goals to get the portfolio closer to the targeted allocation by recognizing long term gains in assets that generally are over weighted anyway, and we have no problems generating highly tax efficient retirement distributions that equate to a 4-5% yield in dollar terms.

There is a lot to fear about the fiscal cliff. The risk of trying to market time it, though, does not objectively appear to be worth the price. Simply put, the best way to market time the fiscal cliff is to not market time it at all.



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