

January 1996

New Year's Resolutions

1. I will finally get serious about saving for retirement. This year, the 76 million baby-boomers begin to turn 50, at a rate of 10,000 a day. Some observers suggest the mutual fund industry exploded because baby-boomers began to worry about retirement. In fact, sales of individual securities have offset the flow into mutual funds. Savings rates overall are near all time lows. Even those saving for retirement tend to dump money into retirement accounts without sufficient analysis of how much they need to save for a comfortable retirement.

2. I will not learn too well the lessons of 1995. Just as military strategists tend to fight the last war, investors are too influenced by recent market history. Thus many invest with the winner of last year's mutual fund performance sweepstakes, only to lose money as the "laggards" outperform. 1995 was a year in which unwise actions were rewarded. It is rash to concentrate your portfolio in glamorous technology stocks, and yet this produced dramatic returns in 1995. It is reckless to ignore diversification and concentrate solely on the U.S. market, and yet foreign stock markets severely lagged the U.S. stock market in 1995. It is shortsighted to ignore the long term superior returns of small company stocks, and yet big company stocks dominated the performance tables in 1995. It is rash to be fully invested at high market valuations, but anybody who had cash reserves in 1995 now wishes they hadn't. Not that we're bitter...!

The accompanying table shows just how unusual 1995 was. For only the second time in the last 30 years, large company U.S. stocks were the best performing asset. In contrast, small company U.S. stocks and international stocks, which both lagged in 1995, have each been the best performing asset in 10 out of the last 30 years. Even conservative intermediate government bonds have been the best performing asset in eight out of the last 30 years, four times as often as large company U.S. stocks. The table also shows the benefits of diversification -- portfolios that mix different asset classes tend to have quite good returns with less risk than you get from just holding a single type of asset. Chasing 1995's winners can be hazardous to your long term financial health.

3. I will save money outside of my tax-free retirement account. Foolish you -- you thought the government set up tax-deferred retirement plans (such as Keoghs, SEP-IRAs and 401(k) plans) to encourage you to save a lot for your own retirement. As a higher-income professional or business person, all you had to do for retirement was to stuff the maximum contribution each year into your tax-deferred retirement plan, right? Maybe not. A little known tax may prove to be a nasty surprise for investors with substantial accumulations in tax deferred retirement plans. The IRS imposes a 15 percent excise tax on retirement plan distributions that exceed certain limits based upon life expectancy tables.

Dying doesn't get you out of this, either -- there is a similar 15 percent excess retirement accumulations tax if you were too successful at saving before you died. Baby-boomers retiring threaten the solvency of the Social Security system. There is likely to be a hunt for extra tax revenues, and well-funded retirement plans will make an inviting target. It does not take too much imagination to suspect that the levels at which the "excess retirement savings" taxes are applied may be lowered and the 15 percent tax rate may be increased. If so, you are going to wish that you had also invested substantial sums outside of a tax-deferred account. We will write more about this little-known time bomb later in the year.

4. I will not ignore stock market valuation levels. Investors make a mistake if they extrapolate recent stock and bond market history into the future, ignoring current valuation levels. While the last few years have certainly been stimulating (and confidence-building), consider that we have gone for the longest period (since 1990) in this century without a 10 percent correction in the major stock market averages. In addition, the dividend yield on the major averages is the lowest in this century. Forget the great returns in 1995 -- the average inflation-adjusted return for stocks in the last 70 years is around 7 percent. Superior returns tend to follow periods when the stock market is at low valuation levels, while inferior returns tend to follow periods in which the stock market is at high valuation levels. Given the current market valuation, returns in the next decade could well be below the long-term average. Investors counting on a 20 percent annual return on invested funds until their retirement are ignoring history.

Sigma's primary mission is to help its clients develop rational, long-term investment strategies that do not depend on short term market movements. Sigma also helps its clients with the discipline to stick with their investment plans through the occasional inevitable adversity resulting from market cycles. If you would like help in preparing for your retirement or if you have questions on any of the items discussed above, contact us.