Ep52: Asset Allocation Strategies That Work!

August 28, 2020

PATTI BRENNAN: Hi, everybody. Welcome back to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Joining me today is Sam Baez. For those of you who haven't listened to the prior podcast, boy, you got to tune into that. That was really good. It was a lot of fun. We talked about the most common mistake retirees make.

To add on to that, I'll get into the weeds a little bit more. Sam and I are going to be talking about what do people do as it relates to their money, whether it be the asset allocation, the portfolio management strategy, etc.

Speaking of which, Sam is a portfolio manager here at Key Financial. As I said before, he is just a unique planner because he really takes a holistic approach to the money management side of things. It's so important because it's not just about a portfolio.

We're talking about real people here, lives. We're talking about weddings, trips to Italy, and retirement dreams of being able to finally step back into all the things you always wanted to do and never worry about money for the rest of your life.

Sam, thank you so much again for joining us today.

SAM BAEZ: Absolutely. Thank you, Patti, for having me back. This is great.

PATTI: It's so much fun, isn't it?

SAM: It is.

PATTI: Yeah, oh yeah. I don't know about you guys. We're having fun. We're learning a lot too. Sam, let's begin where we ended the last podcast and talk about the asset allocation strategies.

When we talk about asset allocation, folks, what we're talking about is not just diversification. You can be well diversified if you have a mutual fund or an ETF. That's

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diversification, but it's all the same kind of investment. It could be stocks or bonds.

What asset allocation does is take it to another level to have different types of investments doing different things, right?

SAM: Yeah, it's true.

PATTI: I've used in the past, in order to create a really effective strategy, it's like your garden. You want something blooming all the time, so you have something to look at.

SAM: Absolutely, Patti. I wish I would have thought of that when I was landscaping my new home. I became a home owner back in 2015. I live in beautiful Lancaster County. It's about an hour from here, but I love the commute. I get to see fields, flowers, trees. The scenery is absolutely beautiful.

PATTI: Sidebar, guys. That's what I call dedication. This guy does a commute an hour each way. Truly, if you were to meet Sam, you're going to see he's got a Hollywood smile. He has a Hollywood smile when he walks in the door, got the Hollywood smile on the way home, usually seven o'clock at night, sometimes eight. This guy is incredibly dedicated.

I'm sorry, Sam. I interrupted you.

SAM: Oh, no. It's...

PATTI: Tell me more about that ride home.

SAM: I remember the first year that we had our home, we bought it in the fall, and then spring was coming around the corner. I'm seeing flowers start to bloom, and everybody else is landscaping in flowerbeds.

What's the first thing that blooms in spring? Daffodils. I'm seeing daffodils. I get very excited. Beautiful yellow, some white. I said, "Let me pick up some daffodils so I can have some blooms in my garden."

I purchased some daffodils, planted them, two to three days later, all the flowers were gone.

In hindsight, if I did a little more research, I would have known that there's a certain time when certain flowers bloom, but I just kept chasing it.

Next, tulips came up. Bought tulips, two to three days later, gone. I did that for the entire spring and summer season. I would just keep purchasing whatever was there and blooming, because it was exciting, it was beautiful. You want to buy what looks great at the

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time.

What ended up happening is I never really had flowers for a very long time. What I learned was you know what, I should go back, I should research, find out when these things bloom, and plant them ahead of time. It's not as exciting because you may not be planting something that's doing something right now.

But if you plan appropriately, then like you said, you have something blooming all the time. You have your daffodils in the spring, and you're ready for mums in the fall.

PATTI: That is a great metaphor. I love that, Sam. I don't know about you, but as I'm listening to you, I'm liking the evergreen approach, you know?

It's consistent, it's constant, etc. Unfortunately, and if we can take that one step further, maybe evergreens are like your bond portfolio.

SAM: Sure.

PATTI: You don't really have to worry about them that much, although they do get brown, and they do die, and the deer love them, but unfortunately, they don't flower. They don't create that beauty that maybe your daffodils and your roses do. You got to need.

Again, when you're planning this beautiful garden, when you're planning your portfolio and more importantly, your future, you want something blooming all the time.

SAM: Yeah. Sometimes boring is definitely beneficial. Not to call evergreens or bonds boring, but stability, there's a lot to be said about stability. You can't really hang Christmas lights on petunias.

PATTI: There you go, absolutely. Love that. Let's talk about this thing about sequence of returns and taking a look. Again, let's take that one step further as we talk about how do we plan for retirees, people who are retiring in the next couple of years.

Now that we're in this 10th year of a bull market, do you take a different approach knowing that we're in the mature phase than you did, for example, 10 years ago?

SAM: Without a doubt. We'll never claim to know exactly what's going to happen in the next 3 months, 12 months, or even three years, but we do know what has happened historically. Just based on the experience that we've got, we can have an idea of what it may look like going forward. We want to be sure to plan accordingly.

In the idea of sequence of returns, when we've had a long bull market like we've just experienced and we're currently in, we've had over a decade of stellar stock performance.

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That could continue for another year, another two years, another five years. We don't know, but the bottom line is based on what we've experienced in the past, based on what the data suggest, that will at some point turn.

This bull market is getting a little long in the tooth, and we want to prepare for the downside.

PATTI: Isn't it true, Sam, that just because it's been one of the longest bull markets, it doesn't mean that it's going to end?

SAM: Bull markets don't die of old age.

PATTI: They certainly don't. You got to look at the metrics. You got to look at things like P/E ratios, etc. When I say you've got to, not necessarily you listeners have to, but that's something that we do take into consideration.

The thing about bear markets and the thing about really bad bear markets is it always feels different. The catalyst that created the downfall is something different. It could be China. It could be what's going on with Britain and Brexit. We don't know what it is and we'll never know in advance, but we just look at a common sense for each individual situation.

If you're 10 years away from retirement and you're needing to actually pull the money, we would take a different approach with somebody like that, right?

SAM: Sure, sure. Especially going back to the idea that we've had a nice, long bull market and it could continue. The bottom line is if we know that there is a short-term cash flow need, we may maybe have a little more...maybe prepare for three to four years' worth of cash flow rather than one to two.

Typically, we look at the shorter term. We'll have one or two years earmarked for either big expenses or just ongoing cash flow that you may need.

In this case, we want to take a little extra precaution and create maybe a few additional years of cash flow. In this kind of scenario, the opposite is also true.

PATTI: Yeah, Sam. That's a really good point. Let's talk about what happened in the fourth quarter of 2018. We're not talking about market timing. We're just taking a look at what happened and responding accordingly. We know that these things can happen. What did you do during that period of time?

SAM: Sure. There's quite a difference between market timing and just realizing opportunities. I think a 20 percent correction in the market is without a doubt an opportunity.

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In that regard, where equities are now representing less of your portfolio than we originally targeted for you, why not take this opportunity to get you back in balance, pick up some stock investments at attractive valuations, and over the long term, you're going to be happy you did?

PATTI: OK, Sam. Now, I'm going to be playing devil's advocate. I'm going to be a client on the phone with you and say, "The market is down. It's going down. It's going to keep going down. We should get out of the market and wait until things are better, and then we can get back in. We can buy lower." What do you say to that?

SAM: We certainly understand that sentiment. It's never exciting to watch the portfolio values go down on paper, but the bottom line is, to make that decision, it's not really one decision. Its two. You have to decide when to sell and you also have to decide when to get back in.

PATTI: It's true. You think about how often does the market lose five percent. It typically does that three times a year. A 10 percent correction...By the way, folks, what I'm talking about is it goes down five percent, and then stops going down.

If we sell at five percent, then you're not going to recover when it recovers. That happens three times on average per year over the last hundred years.

A 10 percent correction on average has happened about once a year. We sell at 10 percent and then it stops going down, because historically, that's what it's done. A 20 percent, good, old-fashioned bear market about every three and a half years.

It's important to recognize that those things are going to happen. We're not going to react to it and sell. If anything, just as Sam said, we want to be opportunistic about it. We want to rebalance the portfolio so that we can add a little turbocharge to that car we were talking about in the previous episode.

SAM: Absolutely.

PATTI: That is an important, important aspect of things. When we think about investors, a lot of times, there is rules of thumb when you're retiring. You got to have a lot less in stocks, a lot less risk. Why is growth important during retirement?

SAM: That's a great question. You often say, when you retire, it's not like you're falling off a cliff. You're just shifting into the next journey of your life.

At the end of the day, if you really consider, especially now with longevity, individuals living longer, we have to consider the fact that you could very well be in the distribution phase, the retirement phase where you're withdrawing from your investments as you were saving for them.

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PATTI: That's really important. For those of you who listened to our podcast with the MIT AgeLab, longevity is a big deal, guys. We are living longer and we are going to be living longer than we ever thought possible.

We got to make sure that this money lasts for the rest of your lives. I got really bad news for you on that one. We're not going to be able to do that if we focus only on a preservation strategy.

I can't think of a more certain way of someone running out of money than not keeping pace with even inflation, because you're taking money out. You're not getting the rate of return that even keeps pace with inflation, and you're pulling out four percent per year.

If inflation's three and you're pulling out five, you're losing money every single year in that strategy. That's not going to be sustainable. It's important to have growth in the retirement planning, in the portfolio.

Sam, here's a question for you. When we look back at long-term data, and we look at the average annual return for stocks, call it the S&P 500, or the total stock market, we talk about the average rate of return of between 8 and 10 percent, depending on whether it's big companies, small companies, etc.

When you look back at that data, which I know you have, how many years, if you look at January to December, how many years did the market actually earn that 8 to 10 percent in a given year?

SAM: Sure. We're looking back from 1926 to the end of 2018, an average rate of return of around 10 percent. The number of times that the market has actually returned 8 to 10 percent has been zero.

PATTI: Zero?

SAM: Never.

PATTI: Never?

SAM: We've been close. In 1993 and, I believe, 1994, we were pretty close, but we have never, ever hit between 8 and 10 percent.

PATTI: That is wild.

SAM: We focus on averages so often because an average to us is what we should expect over time.

PATTI: Over time. Those two magic words, folks. Over time, not every time. Big difference. Over

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time, that part of your portfolio will hopefully average that 8 to 10 percent, but it's not going to do it every year. In fact, it never has.

SAM: Never has. To take that a step further, if you were to consider over that same time period, the number of times that the market has either gone up over 20 percent or down less than 20 percent, 41 times.

PATTI: Oh, my goodness. There you have it right there. That is the issue that we have with averages. In terms of managing expectations and helping you to understand how your money will perform, which to be honest with you, I cannot stand that word, because everybody is chasing performance and talking about, "I want to outperform the S&P 500," while I'm not really sure you really want to do that, guys, that's a whole another subject.

I think that it's really important to take that into consideration, the averages. My point here is that, again, getting back to the original mistake, the number one mistake people make in retirement is, they don't run the numbers. When I talk about running the numbers, that means continuously. It is called planning, not a plan. You are not going to get that six or seven percent average annual return every single year. It's just not going to happen.

Not to say that you're going to adjust your life. You're going to go and live your life, but things, your portfolio...Sam, I know I'm talking for you, we adjust accordingly, OK?

SAM: Absolutely.

PATTI: Very important. It's interesting. We talk about the mistakes, and the things, etc. I often go back, and I'm going to date myself here, I often go back and I...We have an example internally of three different allocations, let's say.

Let's say that we've got somebody with a nice portfolio, a million dollars, and they're going to do $40,000 a year, pull that out. Let's compare three different approaches.

Put 100 percent in the S&P 500, put 100 percent in the bond market, or do a 60/40 – 60 percent in the stock market, 40 percent in the bond market. Let's take the decade of the '90s. If you had your money 100 percent in the S&P 500, that million dollars grew to over four million dollars. If you had 100 percent in the bond market, hey, you ended up with a million five. That 60/40 mix was at about 2.8.

Let's assume that you're going to retire at the end of 1999, and you say, "You know, Pattie, I've looked at these portfolios, and jeez, over the last 10 years, look at what the stock market has done. If I had done what you and Sam had recommended," – sorry, Sam. I know this is your baby – "if I had done 60/40, a diversified portfolio, yadda yadda yadda, I'd end up with a million three less in just 10 years. Why in the world would I ever want to

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do that?"

OK, guys. Fast-forward. Let's look at the next 10 years. The next 10 years, 100 percent in the S&P 500. Guess what? Ended up with $483,000, while that 60/40 blend, granted, it was worth less, but it ended up with almost $800,000. Keep in mind you're pulling $40,000 out per year rising with inflation.

It was a terrible decade, one of the worst decades in our economic history. That's why we don't chase returns. What has happened historically, and we say it all the time, past history is no guarantee of what you can expect in the future. It's often a really bad way to invest.

In fact, sometimes, and I'm not going to say you want to do the opposite, you really want to take – how would I say it – a very studied look at not just the short term. There's a term in our business, and I'm going to use this jargon. It's called recency bias. Be really careful about being vulnerable to that. That is yet another mistake people often make as it relates to retirement.

SAM: Yeah. If you chase daffodils, you're going to wish you had tulips.

PATTI: Oh, boy, is that the truth. We're planning this garden and we're getting lots of different types of investments, lots of different things blooming at different times.

Let's summarize the asset allocation. I guess there's two extremes, right, Sam? What would you say would be the two extremes you've seen in your experience?

PATTI: Sure. I would say that a lot of times, we either see one end of the spectrum or the other end. One end being, they're retiring, want to preserve their capital, I just want to be uber, uber-conservative, and we understand that.

There's also the other side where clients may feel like I don't quite have enough for retirement. I need to really get aggressive. I need to grow this money, so I need to invest in all stocks or I need to invest in the latest fast stock.

SAM: Greatest thing, right?

PATTI: Yeah, latest, greatest thing.

SAM: Bitcoin, here we come.

PATTI: Absolutely, because I need to make up for lost time. Truly, the answer is somewhere in the middle, but at the same time, also depends on what your needs are.

A lot of times, sometimes it may make sense to be aggressive even if you're coming closer

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to retirement, or if there is not a huge need for you to grow your assets, it's OK to be conservative. We need to run the numbers and make sure that it makes sense for your own situation.

SAM: I guess with the size of the companies in particular?

PATTI: I would also say that you got to know thyself, because we often assume that we understand how we're going to respond to a certain event, whether it be an incredible, great environment.

I saw in the '90s, it was a really tough time to be a financial planner, because everybody wanted to have everything in the large growth and nothing anywhere else. Equally so, you don't want to be overly conservative as it relates to this season of life.

Let's pull this together, Sam. I think we've got three really good takeaways. Number one, I love what you said. Retirement does not represent an end to your investment journey. It simply represents a shift. It's a shift. That's all, folks.

Number two, understand what you need to earn. We often refer to your personal. That's your drop dead rate of return that you need to know you're going to average over a long period of time. Then you create the model which historically over time has done about that or, frankly, better.

Then number three, please, please, please expect that things are not going to be average, because guess what? You aren't average.

Sam Baez, thank you so much. This has been terrific, a lot of fun. Thanks to all of you for joining us today for the Patti Brennan podcast. As always, if you have any questions, feel free to call our office. You can get our contact information on the website.

Until next time, I'm Patti Brennan, and thank you again so much for joining us. Have a great day.

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