

Market Outlook

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The End of Retirement?

The question of retirement is discussed so frequently these days that most commentary falls on deaf ears. But a recent episode of PBS's *Frontline* program entitled "Can You Afford to Retire?" thrust the subject square into America's living rooms. Rather than offer the usual platitudes and sugar-coated conventional wisdom, "Frontline" gave a bleak assessment of America's prospects for retirement.

"I think this is a crisis in the making," said Alicia Munnel, director of the Boston College Center for Retirement Research. "I think 10 or 15 years from now, people who approach their early 60s are simply not going to have enough money to retire on."

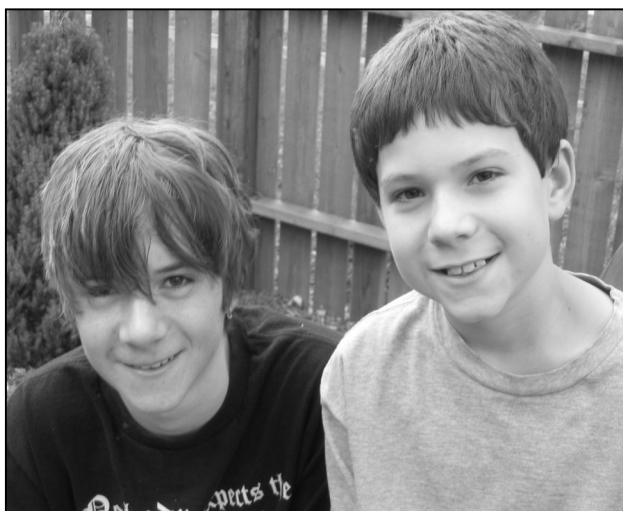
Only about half of the U.S. workforce is covered by any sort of retirement plan. Of the half that is covered, there has been a sea change in plan structure.

Gone are the days of the fixed pension, having been replaced by 401(k) style "defined contribution" plans. Not only has the lifetime income of the pension disappeared, but the investment risk has shifted to employee's shoulders as well.

Traditional pension plans (a.k.a. defined benefit plans) are increasingly being closed by healthy companies, not just rust-belt has-beens. Even since I wrote "The Pension Promise" (Market Outlook, December 2005) several announcements to "freeze" pension plans have been made, not the least of which was IBM. Although *Frontline* focused on the bankruptcy of UAL Corp. (United Airlines) and the trail of broken dreams and promises in its wake, it also addressed the fact that American savings rates are simply too low.

"Most people we interviewed have no idea what it costs to replace a lifetime pension," said reporter Hedrick Smith. To maintain their living standard, experts estimate that a couple would need to save 10 to 15 times

their salary in a 401(k) by the time they retire. That's equal to about 15-18% of salary over a career. According to Jack VanDerhei of the Employee Benefit Research Institute (EBRI), the average baby boomer is entering retirement with only about three times salary, enough to last seven or eight years. With life expectancies of 18 years after age 65, this implies retirees living on nothing but Social Security for a decade or more.



Worried about grades, guitars, games, and retirement

Many retirees have already learned this, and have returned to the workplace. From Wal-Mart greeter to truck driver, they have all realized that this is the only way to stretch their inadequate savings.

"What is the meaning of retirement if the only way you can live is to work?" asks Notre Dame professor Teresa Ghilarducci. "The answer is there is no meaning to

retirement anymore. We are now shifting from lifetime pensions to lifetime work. It's the end of retirement."

The Two Handed Piano Player

One underlying assumption to *Frontline's* "expose" is that rates of return will mimic the past. While no one is so naïve as to expect the fat gains of the late 1990s go-go years to return, most retirement forecasts are based on the idea that the stock market will provide average returns over the planning horizon. Since the 1920s, large capitalization, blue chip stocks have returned about 12.4%, including dividends. Thus, it seems pretty safe to use a conservative assumption that today's investor will receive "only" the average return.

But let's take a look at the same data another way. Since few of us have investment horizons of 50 years or more, University of Denver intern Scott Miller and I looked at 10-year time horizons. We calculated the 10-year compound annual growth rate (CAGR) of the S&P 500 (dividends reinvested) and found a striking view of

what “average” looks like. Ten-year CAGRs varied from a peak of about 20% (1959, 2000) to a low of about 0% (1974). For instance, in 1974, an investor looking back at the previous 10 years would have had a total return of 0%, including dividends. In contrast, in 2000, an investor would have been reveling in average annual returns of 19.4% over the 10 years prior. It’s no wonder stocks reached such heights of popularity in the late 1990s.

There is a very important lesson to learn here: Investors generally enjoy long stretches of returns far *above average*, or suffer long periods of returns far *below average*. This explains why investors in the mid-1970s thought stocks were a sucker’s bet, while investors in 1999 were planning to retire at age 50 and day-trade their way to riches. Where you find yourself in this cycle can have a dramatic effect on your retirement security and well-being.

The chart below shows that long-term CAGRs are falling, with the most recent reading at 8.9% (April 2006). This compression of returns is a headwind that all savers face today, and are likely to face for quite a few more years. It is my firm belief that we will approach very low CAGRs, before embarking on another major secular rise in returns. The low point will be marked by low price/earnings ratios, high dividend yields, and a general disillusionment with stocks.

Thus, the successful investor must be like the two-handed piano player. On the one hand, savings rates must be as high as we can practically make them. On the other, we cannot assume “average” returns will be achieved, and will have to actively shepherd our savings to, and through, retirement. Truly, we are all portfolio managers now.

One criticism of *Frontline’s* “Can You Afford to Retire” was that it was long on identifying problems, but short on solutions. Aside from saving as much as humanly possible, what can one do?

I believe the answer is three-fold. First, you must have a road map of where you are going. Without a plan, there is a huge probability of being off-target. If you are, of course, by the time retirement nears, it will be too late to take any corrective action. Praxis has a program in place to calculate retirement scenarios for clients, along with an ongoing monitoring service to update the projection annually.

Second, ignore Wall Street’s hot air and focus on quantitative and measurable characteristics of the securities you own. Remember, it’s *what you own* that helps you or hurts you. You must have a good idea of why you own particular stocks or mutual funds, and when they are starting to go “off the tracks.” Personally, this approach has been invaluable in making sure investments “show up for work every day.”

Finally, try to be an independent thinker. Rather than be distracted by what others are doing, or saving, or the returns they are bragging about, focus on the matter at hand: how are you going to get from here to retirement and beyond? The first and second points above can help you achieve the third. With the CAGR cycle clearly pointing lower, should you be complacent with your 401(k) investments? Probably not. Conversely, if low P/E ratios converge with low CAGRs when you are age 65, should you avoid taking stock market risk? Again, probably not. Taking advantage of the secular low in returns will probably add a great deal to your retirement security, even if you are already retired.

