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IS IT TIME TO SAY "GOOD-BYE" TO VOLATILITY?

After fearing they were going to drown a couple of years ago, it appears many individual investors are ready to jump back in the pool. When share prices dropped precipitously in 2008 and 2009, individual American investors, often referred to as "retail customers," couldn't stand the pain. They sold their shares, took their losses, and licked their wounds, wondering how they were going to deal with diminished account balances and delayed retirement dreams.

Then, as often happens, markets rebounded. Strongly. But most retail investors stayed put. Jeff Cox, writing for CNBC.com on January 4, 2011, noted that "Mom-and-pop investors have been only marginal players in the market rally of the past 21 months. High-frequency traders and large financial institutions have come to control most trading, with retail players likely only one-quarter or so of actual market volume."

However, since December 2010, analysts have also reported an uptick in deposits to mutual funds, along with other indications of increased retail customer activity. It appears the average American is once again ready to entertain some risk in exchange for the possibility of higher returns. And, at this point, it is fair to ask…

Is this a prudent financial move or a typical "herd response" that often ends badly?

Research consistently shows that **a large percentage of individual investors make less than optimal investment decisions**. Historically, retail investors are more likely to buy high and sell low, instead of the other way around. And some observers see current retail customer activity as another example of the same thing. In a February 26, 2011, *Wall Street Journal* article (*Once Bitten, Twice Bold: Look Who's Buying Stocks*), weekly columnist Jason Zweig observes "It looks as though many of the retail investors now getting back into stock are the same people who bailed from the market just before the start of a historic bull run." (For an extensive review of this behavior, check out DALBAR's annual Quantitative Analysis of Investor Behavior at dalbar.com.)

So what's the answer? How can individual investors make better decisions?

Personal education and guidance from competent professionals definitely helps. And adhering to a program that regularly reviews and rebalances your assets might keep you from making poorly-considered, emotion-driven decisions.

And, of course, there's always this option: **Stop taking investment risk.**

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

– Charles Mackay,
from *Extraordinary Popular Delusions and the Madness of Crowds,* published 1841

In This Issue…

Is It Time To Say "Good-Bye" to Volatility? Page 1

Have 401(k)s Fallen Short? Page 3

Assumed Annual Rate of Investment Return: *What The Pros Expect* Page 5

Prudent and Compassionate End-Of-Life Planning Page 6

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There is a strong case, both mathematical and psychological, for limiting financial risk. Electing to use "safe" accumulation vehicles that deliver consistent, yet smaller, annual gains might seem like a "slow road" to wealth, but potential losses from this approach are greatly reduced (in some cases almost non-existent). And losses are killers, both mathematically and psychologically.

Here's a key insight: **Years of investment gain can be quickly undone by just a few losing periods**.

Volatility, the up-and-down daily fluctuation that characterizes many equity investment vehicles, is an ongoing reminder that ***you can lose money***, no matter how many historical models tell you otherwise. And the presence of volatility is not necessarily an indicator of better results. In fact, often the same results can often be achieved with less risk – and far less psychological agitation.

THE MATH OF A LOW / NO-RISK APPROACH MAKES SENSE

Consider this hypothetical example:

OPTION 1. Starting with $10,000, suppose an investment yields the following annual returns for the next 10 years. At the end of 10 years, the account balance is $14,842.

Out of 10 years, 2 were losers, but the average annual gain from the other eight years was 6.75%.

This illustration is purely hypothetical, but most people with experience in fluctuating investment vehicles would probably see this example as plausibly realistic. The annual gains and losses aren't extreme, nor is the ratio of good years to bad ones.

In contrast, suppose we find a conservative alternative investment vehicle. Instead of the opportunity for higher returns, the emphasis is on consistency and safety. To further simplify our example, the annual rate of return will remain the same for all 10 years.

OPTION 2.

The ending balance for Option 2: **$14,802 –** just $40 less than 10 years of higher-risk investing in Option 1! In only three of the 10 years did this conservative hypothetical investment out-perform the first option – and in three other years, the annual rate of return from Option 1 was at least ***twice*** that of Option 2.

OPTION 1

YEAR		ENDING BALANCE
1	8%	$10,800
2	12%	$12,096
3	5%	$12,701
4	7%	$13,590
5	- 3%	$13,182
6	4%	$13,709
7	3%	$14,121
8	- 9%	$12,850
9	5%	$13,492
10	10%	$14,842

OPTION 2

YEAR		ENDING BALANCE
1	4%	$10,400
2	4%	$10,816
3	4%	$11,249
4	4%	$11,699
5	4%	$12,167
6	4%	$12,653
7	4%	$13,159
8	4%	$13,686
9	4%	$14,233
10	4%	$14,802

By the way, it is worth noting that as long as the 10 annual return numbers from Option 1 remain the same, they can be arranged in any order and still produce the same results. This speaks to a crucial element of volatility: **Losses, even though they occur less frequently, have a large impact on long-term returns – no matter when they occur.**

Remember, this is only a hypothetical math exercise. But looking at the results, would choosing Option 1 (and the accompanying volatility) be worth the emotional angst just to end up with an extra $40 after 10 years?

COUNTERFACTUAL REGRET: WHY IT'S OFTEN HARD TO PLAY IT SAFE

Financial behaviorists are smart people who try to figure out why the rest of us are so irrational when it comes to money. And the hypothetical situation illustrated here provides great fodder for these researchers. Considering the minimal difference in the two approaches, why would someone choose the more volatile option? Obviously, there are other factors at play besides just the math.

In his *WSJ* piece, Zweig discusses a psychological component called "counterfactual regret." Counterfactual regret is described as the "haunting sense of what might have been." Zweig quotes Michal Strahilevitz, a business professor at Golden Gate University in San Francisco who studies how investors behave, to explain how it applies to many of today's retail investors.

"These investors have been double traumatized," Strahilevitz says. "First in 2008 and 2009, they suffered until they said, 'I can't take it anymore' and sold all their stocks. And now they've had to deal with the trauma of watching the market go up and realizing they'd be better off if only they hadn't gotten out." This counterfactual regret is the reason that some investors will plunge impulsively back into the market that hurt them so badly. "They're willing to risk more in the hope of not being losers again," Prof. Strahilevitz says. "It's 'Damn the rationality, I just want to feel good.'"

Take another look at the ending balances for the two accumulation strategies in this article. Now imagine there are two people, one who selects Option 1, the other who takes Option 2.

After two years, Person 1 has an account balance almost $1,300 greater than Person 2 and by the end of 4 years, the advantage for Person 1 has grown to $1,900. From their $10,000 beginning, that's a difference in gain of almost 20%. For Person 2, the counterfactual regret has kicked in big time – "Look at what I've missed! I should have invested like Person 1."

At this point, what is Person 2 likely to do? Jump over to Option 1 – just as the plan hits the first bump in the road. And because Person 2 hasn't accumulated as much as Person 1 over the past four years, Person 2's ending balance will be even lower than Person 1 at the end of five years. And Person 2 will not only regret not getting in Option 1 at the beginning, but will also regret switching in Year 5. Now the financial behaviorists have another example of "double trauma."

"RECOVERING OUR SENSES" – ONE BY ONE

Recall the quote by Charles Mackay on page one. Psychological diagnoses like counterfactual regret may provide plausible explanations for the decisions of the masses,

but those explanations do not mean following the herd is mandatory. One by one, some people step out, follow a different path – and often avoid mistakes that occur in the herd mentality.

The American financial culture of the past several decades has been saturated with the idea that everyone can be an investor, that even the smallest accounts can be put at risk to reap the potential profits. But the other side of the story, about the potential losses and their long-term impact, needs to be mentioned as well. As an accumulation strategy, there are many benefits to a "safety first" approach.

This is not an argument that individuals should avoid all financial risk. Especially when substantial assets have been accumulated, allocating modest percentages to more volatile financial products might make good sense. But sometimes the impulse to take a risk isn't really a financial issue; some of us are just looking for the same adrenaline rush that comes from betting, jumping off a bridge, or sky-diving. Or we're trying for a "quick recovery" for past mistakes. Recognizing this, it is to our advantage to "recover our senses" and remember the value of steady progress. One of the best strategies for financial success is "don't *lose* money!"

WANT TO CONSIDER CONSERVATIVE ACCUMULATION STRATEGIES AND TAKE VOLATILITY OUT OF THE PICTURE?

FOR IDEAS ON HOW TO MAKE THIS IDEA WORK IN YOUR UNIQUE CIRCUMSTANCES CONTACT US TODAY!

Have 401(k)s Fallen Short?

Misunderstandings, Unrealistic Expectations, Unintended Consequences

The headline and accompanying photo in the February 19-20, 2011, weekend edition of the *Wall Street Journal* was attention-getting. As a North Carolina couple stared vacantly across a field at sunset, the above-the-fold headline declared:

Retiring Boomers Find 401(k) Plans Fall Short.

WSJ reporter Jason Henry led off his article with these sobering words:

> **The 401(k) generation is beginning to retire, and it isn't a pretty sight.**
>
> **The retirement savings plans that many baby boomers thought would see them through old age are falling short in many cases.**

Actually, this pronouncement is sort of old news. Ever since the stock market tanked in late 2008 and 2009, devastating the account balances of many 401(k) retirement accounts, an anguished cry has arisen lamenting the "failure" of the 401(k) to deliver on its retirement promises. Some similar headlines, from earlier:

- **Real Change: Outlaw 401(k)s,** by Dan Solin, *Huffington Post*, January 6, 2009
- **The Failure of Our 401(k)s,** by Tim Rutten, *Los Angeles Times*, January 10, 2009
- **401(k)s Still Fall Short As A Retirement Strategy,** by John Ydstie, *NPR*, March 4, 2010

If you dig down into each of these articles and others like them, you will find the real problem: Most Americans don't have enough money saved up to retire, and, other than Social Security, they don't have a pension either. So why blame the 401(k)? The answer is a combination of misunderstandings, unrealistic expectations, and unintended consequences.

First, a little history. 401(k) plans grew out of the clarification of the tax treatment for the long-standing practice of allowing employees to defer some or all of their non-salaried compensation (typically year-end bonuses). According to Jeanne Sahadi, a CNNMoney.com writer (in January 2001), "At the time it was common for employees to be given the choice to defer half or all of their non-salaried compensation, often bonuses, into a company's cash-deferred profit-sharing plan." In 1978, these clarifications were formally stated in Internal Revenue Code Section 401(k).

Some creative pension experts examined the rules, and concluded that instead of employers declaring bonuses and giving employees the choice to defer, it would also be possible to allow the employees to defer part of their regular salary on a pre-tax basis, and offer an employer match as extra incentive, particularly for low-paid employees. The first officially recognized 401(k) which gave tax incentives to employer-sponsored salary reduction retirement savings plans was established in 1981.

Twenty-five years later, a November 2006 Investment Company Institute Report would declare "401(k)s are now the most prevalent retirement savings vehicles in the United States." A March 24, 2010, *msn*/*BusinessWeek* article by Chris Farrell affirmed this preeminence saying, "The 401(k) has since evolved into the largest private-sector employer-sponsored retirement plan in the U.S."

A Big Misunderstanding. It is interesting to note that the same *BusinessWeek* article also described the 401(k) as the "main U.S. corporate pension plan." But a 401(k) ***is not a pension***, and this misunderstanding has become one of the reasons for disenchantment with 401(k)s.

The fundamental features of a pension are its certainties and well-defined terms. Provided they meet the vesting requirements, retirees with a pension understand they will receive a specific amount every month. The amount to be paid is determined by a formula which typically includes average annual salary and years of service. While a lump-sum distribution may be allowed in some circumstances, there are no partial withdrawals or irregular distributions; the main objective of the pension is to provide a stream of income as long as the retiree (and/or a beneficiary) is alive. The responsibility for making sure those pension promises are kept falls to the employer. The employer is responsible for the funding, investment, and administration of the plan.

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In contrast, a 401(k) is much more open-ended and flexible. Loan provisions, lump-sum distributions, partial surrenders and irregular payments are permitted. While most deposits are payroll-deducted, employees can stop making deposits and use catch-up provisions to add extra dollars. All of these actions are determined by the plan participant. The employee provides the funding, makes the investment decisions and determines how the money will be distributed.

Unlike pensions, which are pools of money to make payments to many people, each 401(k) is a separate financial entity. The success or failure of a 401(k) is based entirely on the actions of the individual (the employee) managing the account.

When first established, the 401(k) was intended to serve as a retirement income **supplement.** As Tim Rutten put it, "Congress…envisioned the provision mainly as a way for workers to supplement their companies' traditional defined-benefit pension plans and Social Security."

But for a variety of reasons, the number of employers offering pension plans has declined significantly in the past 30 years (more on that later), leaving the 401(k) as the primary retirement plan for a large percentage of Americans. Today's reality is that a supplemental retirement account, under the funding and direction of an employee, is now being asked to perform like a large retirement fund under the oversight of investment managers and actuaries.

Unrealistic Expectations. Farrell nicely capsules the fact that the 401(k) was also a product of its time. "The rise of the 401(k) largely coincided with one of the great secular bull markets in history from 1982 to 2000." In this environment, investing in capital markets "took on the characteristics of a powerful mass social movement, especially in the 1980s and '90s." Getting rich in the stock market became part of the American Dream.

Although determining the full economic value of a pension is a complicated calculation, people looked at the oversized returns that were coming from high-flying equities markets and thought "Who needs a pension when I can make more with a 401(k)?" The math seemed magical. Generous employer matches and the prospect of double-digit annual returns made 401(k)s the trendy strategy to accumulate a lot of money, and retire early.

Unfortunately, 401(k) participants have encountered two bear markets since 2000. To make matters worse, many employers reduced or eliminated matching contributions as the economy tightened. Now the math is no longer magical, but depressing.

If a pension plan appears to be suffering from poor investment performance or inadequate funding, law requires the company to make up the difference. But most individuals have not had the financial wherewithal to simply add more money to cover their losses and keep their retirement objectives on track (and even if they did, they might have been constrained by contribution limits).

Unintended Consequences. Around the same time as 401(k)s were being introduced, Congress also established tighter guidelines for pension plans. Shorter vesting schedules were imposed, which meant companies had to increase their pension funding, since more employees would be eligible for payment, even if they didn't stay with the company for more than five to seven years. These increasing financial and regulatory obligations prompted many companies to suspend or terminate their pension plans, and offer 401(k)s as replacements. For employers, this decision simultaneously lowered administrative and funding costs, while transferring the responsibility for investment decision-making to the employee.

"Nobody bothered to ask employees whether they wanted to swap their pensions for choice or ownership," says Rutten, "nor did anybody stop to notice that very few people are suited by background, ability or temperament to actively manage investments." But as more and more employers realized the economic liabilities inherent in pensions, switching to 401(k)s was an easy corporate exit strategy, a no-brainer.

Does the 401(k) need to be fixed?

The answer depends on what you want to accomplish. As a supplemental retirement program, the 401(k) has pros and cons. The automatic payroll deduction feature appears to be a great help in getting individuals to save regularly and consistently. A substantial employer match can help participants achieve greater accumulations at a faster pace – if your underlying investments are profitable.

On the other hand, 401(k) investment choices are restricted by the preferences of the employer; a self-directed IRA offers a much wider spectrum of investment choices. And 30 years ago, the operative paradigm was one of deferring tax today, then distributing the deposits and earnings at a lower income tax rate in retirement. Today, fewer people are sure they will be in a lower income tax bracket when they retire. Hence, the increasing attractiveness of Roth IRA accounts, which feature after-tax deposits with tax-free withdrawals in the future.

As a primary retirement program, one of the biggest challenges with a 401(k) is how to translate an account balance into a stream of income in retirement. The *WSJ* article mentioned at the top of the article notes that the Center for Retirement Research finds the average 401(k) holds just under $150,000. That might seem like a big number, but when the Center calculated the monthly income for a retiring couple from an annuity guaranteeing lifetime income, the result was $9,073 annually, or $756/mo. Suddenly, $150,000 doesn't seem like a lot of money. This exercise highlights an often-overlooked point: the key number in a retirement plan is not the account balance but how much monthly income can be derived from the accumulation.

The biggest issue with 401(k)s is how much responsibility should be placed on average Americans to oversee their financial future. A week after the *WSJ* article came out, the paper's "Letters to the Editor" page was flooded with comments, and most of them were none too complimentary about the financial savvy of their peers. As one writer put it,

> **"I have co-workers who have no idea how to get into their accounts and if they do, they have no idea what to do. Certainly there are seminars, financial planners, articles and other avenues available for people to learn from others' knowledge and expertise. Instead of taking control of their own money and growing it, people put their heads in the sand, hope for the best and attempt to blame others for their financial morass when their retirement funds run short."**

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Recognizing the apparent financial illiteracy of many Americans, some experts are calling for new retirement plans and/or 401(k) modifications that mandate "approved" investment options, require minimum funding levels, and offer guarantees. But as long as 401(k) plans continue to place the burden on the individual for funding, investment selection and retirement income translation, personal education and oversight are musts. Like a home, a 401(k) requires regular maintenance, and as the owner, this is your responsibility.

HOW OFTEN DO YOU REVIEW YOUR 401(k) ACCOUNT?

WOULD YOU LIKE AN IDEA OF WHAT THE INCOME TRANSLATION IS FOR YOUR CURRENT 401(k) BALANCE?

Assumed Annual Rate Of Investment Return: *What The Pros Expect*

While defined-benefit pension plans (i.e., those plans that provide a specific monthly retirement check from a formula based on years of service and average annual salary) have largely disappeared from the private sector, many public entities have continued to fund and maintain pensions. Because of faltering economic conditions and a perception of the disproportionate cost to taxpayers, these public pensions have become hot topics of discussion, particularly the cost of funding these plans.

In order to provide ongoing paychecks to a large group of retirees both now and in the future, pension plan operators must integrate a wide range of variables to determine how much money will be required for successful operation of the program. These factors include the number of retirees, life expectancy, marital status in retirement, the age at which retirement will begin, and an assumed annual rate of investment return.

Of these factors, the assumed annual rate of return, also called the discount rate, is arguably the most subjective. The discount rate represents what a pension fund believes it can realistically earn from its investments on an annual basis when averaged over the course of 20 years or more. In any given year, investment returns are likely to be higher or lower than the long-term assumed rate.

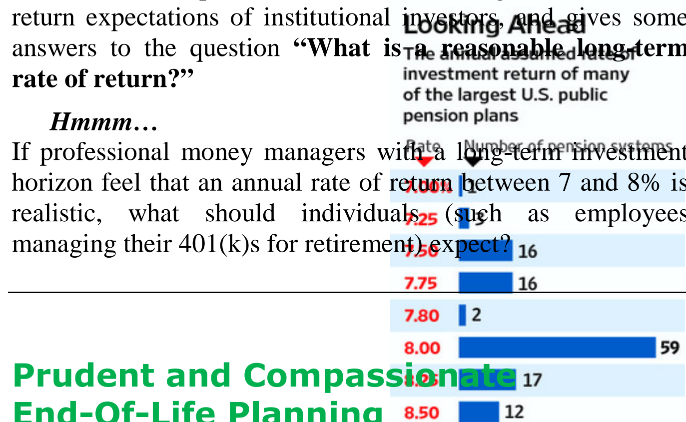
Short term, moving this number up or down can greatly affect current funding requirements. Long term, when real returns show a minor deviation from expected returns, either up or down, it can result in a tremendous difference in how much it costs (in taxes) to provide pension benefits. A March 21, 2011 posting on the New York State Teacher Retirement System website (www.nyssba.org), noted that a 1% increase in annual return over a teacher's working lifetime would result in a 26% funding reduction.

Recently, the discount rate for The California Public Employees Retirement System (CalPERS) came under scrutiny because the fund's actuary recommended lowering the discount rate from 7.75% to 7.5%. Lowering the rate would mean higher funding obligations, a tough requirement for a state already struggling to balance its budget and avoid insolvency. After dozens of local officials met with the fund's actuaries in mid-March to indicate their municipalities would be hard-pressed to deliver the increased funding that a lower discount rate would require, CalPERS announced on March 21, 2011, that the rate would remain at 7.75%.

When some commentators questioned the wisdom of maintaining the higher investment assumption, CalPERS officials noted that "over the past 20 years, including the two recent recession years, CalPERS has earned an average annual 7.9% rate of return," and also added that its discount rate was below the average for other public pensions in the U.S, citing statistics on the 126 largest public pensions provided by the National Association of State Retirement Administrators.

The data provides an interesting look at the return expectations of institutional investors, and gives some answers to the question **"What is a reasonable long-term rate of return?"**

Hmmm…
If professional money managers with a long-term investment horizon feel that an annual rate of return between 7 and 8% is realistic, what should individuals (such as employees managing their 401(k)s for retirement) expect?



Prudent and Compassionate End-Of-Life Planning

Preparing for a loss is never easy. But **not** preparing for it can make a tough situation even harder. This can be particularly true when a family member or loved one is in failing health and close to death.

As medical knowledge and procedures have progressed, so has longevity. But while people are living longer, the nature of the end of life has changed. Instead of a brief illness or medical condition that often shortly resulted in the passing of an elderly person, today's medical care may keep the patient alive, but frequently in a condition of diminished capacity.

"More than 75% of people will be unable to make some or all of their own medical decisions at the end of life," says Rebecca Sudore, a physician at the University of California, San Francisco, speaking to Laura Landro in a March 15, 2011, "Informed Patient" column published in the *Wall Street Journal*, "but we don't prepare patients and families to deal with this situation, and it's frightening and difficult for them to know what to do."

In response to these stressful dilemmas, medical and legal experts have increasingly encouraged aging adults to provide advance directives. Living wills, personal directives, advance decisions or durable powers of attorney are all instructions given by individuals, specifying what medical actions are preferred in the event that they are no longer able to make decisions due to illness or incapacity, and telling who is authorized to make such decisions on their behalf. Because many of these end-of-life medical issues may also require financial decisions, most well-prepared estate plans include advance directives.

Polst Documents

The two principle issues addressed by advance directives are primarily legal and procedural. The first is determining

who is designated to speak and act on behalf of the incapacitated individual. The second item is clarifying the level of medical attention and intervention requested by the individual. Some states are attempting to codify these requests with standardized Physician Orders for Life-Sustaining Treatment (Polst) documents. Already approved in 14 states, Polst documents are considered official medical orders that provide detailed instructions as a complement to existing advance directives. Some states even register the Polst documents and keep them on file.

Five Wishes

While the legal and medical issues surrounding the end of life are significant, personal, emotional and spiritual factors weigh heavily as well. This awareness led to the development of the Five Wishes document, first introduced in 1997. Described as "the living will with a heart and soul," the Five Wishes document is an advance directive created by the non-profit organization, Aging with Dignity. Recognized as a valid advance directive in 42 states, Five Wishes "talks about your personal, emotional and spiritual needs as well as your medical wishes." The Aging with Dignity website states "14 million copies of Five Wishes are in circulation, distributed by 23,000 organizations."

Be aware that, because it addresses some heavy end-of-life concerns, completing the Five Wishes will be a very emotional process for most people.

The first two wishes are very similar to the information related in standard advance directives:

1. **The person I want to make my health care decisions for me when I can't.**
2. **The kind of medical treatment I want or don't want.**

It's the questions and answers from the next three wishes that will tug the heartstrings.

3. **How comfortable I want to be.** This section includes statements about the level of pain relief you desire, and other comfort-related measures, like cool cloths, massages, and music.
4. **How I want people to treat me.** This specifies whether you want visitors, to have people pray for you, hold your hand, and whether you want to go home**.**
5. **What I want my loved ones to know.** Probably the most poignant section, this allows you to tell family and friends they are loved, to ask forgiveness, and to express final thoughts on your life.

None of these decisions are easy to contemplate, for ourselves or our loved ones. But from a functional perspective, making these end-of-life decisions isn't much different than completing a will or executing a trust. Whether you use a Polst, Five Wishes, or some other advance directive, providing clear instructions today can go a long way toward eliminating unnecessary burdens from what will already be a sad occasion.

Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believed reliable, please note that individual situations can vary, therefore the information should be relied upon when coordinated with individual professional advice.

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