IMPORTANCE OF FINANCIAL DEFENSE

Poole Locke Associates

Retirement Income Source®

Importance of Financial Defense

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The great Alabama coach "Bear" Bryant once said, "Defense wins championships," and you can bet that almost every great coach in nearly every sport has shared that same philosophy. Just think about some of the great sports dynasties, teams that won championships year after year: the Green Bay Packers under Vince Lombardi, the Boston Celtics under "Red" Auerbach, or the Yankees under Joe Torre. The list could go on and on.

All these teams knew how to score, yes, but they all started with the premise that a strong defense made their offense better. Strategically, they knew how to win games, but they focused first on strategies that ensured they wouldn't lose games.

Why is that same approach so critical when it comes to your finances and — in particular, saving and investing for retirement? It's simply because when you're talking about your "life savings," losses can potentially have a huge impact on your life! How huge? Well, consider the fact that if you have all or most of your investments invested for growth in the stock market and your portfolio loses 50% of its value, you will need to regain 100% of it to break even. That takes time and depends on whether the market keeps growing or drops again.

The fact is, this very thing has happened to domestic investors in the US twice since the year 2000. From the beginning of 2000 through 2002, the stock market, based on the S&P 500 Index, dropped almost 50%. It took until October 2007 to recover. That means it took approximately two years for the market to drop by nearly 50% and then five years to make a 100% gain and get back to where it was some seven and a half years earlier. Then, lo and behold, it dropped again when the Financial Crisis hit. This time, it took roughly seven years to recover to its previous high. So, there have been two drops of around 50% or more and subsequent rebounds since the turn of the century.

Time is Money

So, let's go back to the question, "how huge" was the impact of all this on investors unaware of the importance of financial defense? To gauge the full impact, we need to look further than the fact that these investors twice had to re-double their lost gains with virtually no portfolio growth; we also need to consider the amount of time that elapsed.

For an investor to recover from a 50% loss with a 100% gain over, say, 10 years, he or she would have to average 7% a year over the length of that recovery period. By the same token, to make the recovery over 7 years, he or she would have to average about a 10% annual growth rate. In that sense, those investors from March 2002 to October 2007 were lucky because they made that 100% break-even gain in only four-and-a-half years, which represents an annual average growth rate of 16%. That sounds pretty good until you factor in a little thing called inflation. From 2000 to 2020, investors lost approximately 42% of their buying power due to inflation. That means what was worth a dollar in 2000 was worth only 58 cents 20 years later.

But let's go further and factor in something called "lost opportunity cost." Whether we're talking 4 years, 7 years, or 13 years, consider the fact that investors waiting and hoping to recover capital gains and losses over all that time could have been earning money elsewhere. For many parts of the 2000 to 2007 period, for example, those investors could have had their money in FDIC-insured bank CDs that were averaging somewhere between 3-5% annual returns for 5-year CDs.1 The 3-5% they could have earned while their market losses were recovering to previous levels is the lost opportunity cost.

The point is that when you add inflation to lost opportunity cost, it's pretty easy to see that those investors who were so relieved when their portfolios finally regained their original value over the course of several years, didn't really recover or break even. They did, in fact, experience losses, and depending on what alternative investment options they might have pursued, those losses might have been significant.

Two Questions

So, with two major, prolonged drops of 50% or more having occurred since 2000 (in addition to a third short drop of around 40% at the start of the Covid-19 crisis), investors today — especially those at or near retirement age — need to consider two questions:

1. Is another major prolonged drop possible?
2. If it happens, how huge an impact might it have on my retirement goals?

Regarding the first question, the answer is "of course" because anything is possible, especially in today's era of global economic uncertainty. As for the second question, it depends on how much attention you're paying to financial defense in your own portfolio right now. But, to give an idea of the potential personal impact that a prolonged major drop can have on someone utterly ignoring financial defense, let's take a worst-case scenario:

Let's say a gentleman who retired in 2000 stayed entirely invested for growth in the stock market and started to draw income. Let's assume his portfolio value was $1 million when he started, and he was drawing $50,000 per year. We said before that from 2000 to 2007, the market dropped by 50% and then recovered. That's a net result of zero growth over seven years — which means that if this retiree was taking out $50,000 a year over that time, he would have taken $350,000 out of the portfolio. With zero growth, he would have had $650,000 left seven years later. That sounds bad enough, but the reality would have been even worse.

In the years when the stock market dropped and he still needed to take out his $50,000 per year, his investment advisor or mutual fund company would have had to liquidate more shares in those years to give him that same amount of income. As a result, this poor retiree would have cannibalized the fund. By the time the market came back in 2007, he might only have had $500,000 or less left invested: half of his original portfolio or less!

Misguided Optimism

It may seem surprising to think that an investor such as the one in the example above might remain committed to a growth-based strategy even after an experience like that, but it's not uncommon. Part of the reason is human nature. Some people are hardwired to be optimists, which is an admirable quality, but it can have its drawbacks where investing is concerned. The main reason that even people who have been badly impacted by financial losses continue to ignore financial defense is that much of the financial services industry does likewise.

A lot of people in the industry are salesmen first and advisors and educators second, and their first priority is to move product. It's easier to move well-known products that are "sexier," and in their case, that means primarily growth stocks and mutual funds. For a salesman, these tools are the path of least resistance, meaning the easiest sell. Coincidentally, they also happen to be the ones with the best potential to earn them high fees and commissions over the long run.

The main reason so many brokers and advisors virtually ignore financial defense, however, is simply that much of the financial world is in the business of selling optimism. It starts, not surprisingly, with Wall Street, whose CEOs and shareholders have a vested interest in keeping you invested for growth in the markets. They know you're more likely to stay invested if you're optimistic and believe the market will forever be on the upswing. From there, a majority of brokers and advisors fall dutifully into the role of becoming "cheerleaders," stubbornly urging you to hold on and trust in your growth-based strategy no matter what, and even after you've reached the age when asset protection and reliable income should be your top priorities.

Take Action!

So, how can you get started on building a financial strategy with a solid defense that Vince Lombardi would have been proud of? Simple: Contact a qualified financial advisor who specializes in the universe of income-based investments designed to help protect your principal and generate more reliable income through interest and dividends. This is income you can spend or, if you don't need it, reinvest in order to grow your portfolio organically, or "the old-fashioned way," with far less worry over damaging losses that could impact your life and sideline your retirement plans!

Source:

1. https://www.bankrate.com/banking/cds/historical-cd-interest-rates/

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