The Thoughtful Investor™

James W. Olsen, CFP® Legacy Investment Strategies Second Quarter 2012

The High Cost of Low Interest Rates

With the Federal Reserve now indicating that its policy of low interest rates will continue into 2014, collateral damage is expanding. The impact of low rates is particularly painful for older investors who rely largely on bank deposits and individuals living on fixed income, reducing their purchasing power and eating away at financial security. And it is also contributing to serious underfunding of long-term liabilities.

With interest rates no longer keeping up with inflation, older investors are tapping into their savings at an increasing rate. As savings fall, these investors are reducing consumption, affecting employment at businesses the older savers may once have patronized.

One rationale for low interest rates is to force investors to turn to riskier investments such as funding expansion of the economy. But the pursuit of higher earnings is also resulting in higher levels of fraud. In California, a financial consultant is now facing prison charges for killing an investor who sought the return of his monies that had gone to pay the personal expenses of the con artist. Top 10 lists of investment scams are everywhere including the North American Securities Administrators Association "Top 10" list of investment scams shown below. While these investments could be legitimate offers, their structure makes them adaptable to fraud.

1. Investment pools targeting distressed property.
2. Fraudulent energy investments.
3. Fraudulent gold and precious metals offers.
4. Unregistered or fraudulent promissory notes.

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This is Not Your Grandparents' Retirement

Retirement is taking on a new face as the average life span lengthens and financial uncertainty keeps more older Americans in the job market.

The trials and tribulations of Social Security illustrate the changing demographics quite dramatically. When Social Security was initiated in 1937, 40 to 50% of the U.S. adult population died before reaching age 65. Today more than 70% of working age men and more than 80% of working age women can expect to live to 80 or 85 years of age. And they are living healthier lives. In fact, the greatest health risk may well be retiring.

The Longevity Project, a major study by psychology professors Howard S. Friedman and

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The Wind Power Price

Wind energy is high on the current Administration's list of alternative energy supplies to be exploited, virtually at any cost. But is the cost too high in terms of environmental impact? According to the ***LA Times***, each year, about 2,000 raptors, including an average of 67 golden eagles, are killed by the 5,000 wind turbines along the ridgelines of the Bay Area's Altamont Pass Wind Resource Area.[1] This is according to on-site surveys conducted by field biologists. "The toll, however, could be higher because bird carcasses are quickly removed by scavengers," the paper reports. Biologists are concerned that the eagle kill exceeds by more than three times the number of replacement eagles produced by the area's current population of nesting eagles.

What makes the death count even more questionable is the fact that wind energy, to be reliable, needs up to 90% of its capacity backed up to prevent blackouts—usually with coal and gas plants.

Logging in the forests of the Northwest was virtually shut down to protect the spotted owl, but wholesale slaughter of other raptors is permitted because it meets a government green priority. Is there something wrong with this?

[1] "*Wind power turbines in Altamont Pass threaten protected birds*," Louis Sahagun, Los Angeles Times, June 6, 2011.

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5. Securitized life-settlement contracts marketed under the implication of less risk and guaranteed returns.
6. Affinity fraud, i.e. marketing a Ponzi scheme to members of a particular group.
7. Increased use of bogus or exaggerated credentials.
8. Claims of mirror trading investment transactions placed or executed by a skilled and knowledgeable third party.
9. Fraudulent private placements.
10. Advice from unlicensed agents.

Defined benefit pensions plans, such as public employee benefit plans, are particularly vulnerable to underfunding in periods of low interest rates, which undermine the performance of the plan's bond investments. Pension plans base current contributions from the employer on future return expectations. In 2011, California pension fund CalPERS decided to keep its assumed investment return rate at 7.75% to avoid requiring more funding from cash short governments. In March 2012, the pension fund admitted its expectations were a little high and recommended lowering return expectations to 7.25%.

According to the *Sacramento Business Journal*, CalPERS earned 1.1% in the 2011 calendar year and an average annual 5% in the past decade, and 7.5% over the past 20 years.[1] CalPERS isn't alone in failing to meet its return expectations. Without internal earnings, public pension funds will have to turn to government and ultimately taxpayers to meet their obligations to public employees under current contracts. Underfunded corporate pension plans tend to fall on the Pension Benefit Guaranty Corporation, which is also underfunded. According to Credit Suisse, of the 341 companies in the S&P 500 index with defined benefit pension plans, 97% are underfunded today, the *Wall Street Journal* reports.

Underfunding is also reflected in defined contribution plans, such as 401(k) plans. When asked if they felt their employees were saving sufficiently for retirement, only 5% of U.S. businesses replied yes when surveyed in 2011.

Low short-term rates are also encouraging increased borrowing at short maturities, raising the risk that when it comes time to refinance, increased interest rate costs may prove beyond the borrower's capability. The U.S. government is squarely in this crowd. The U.S. Treasury currently has $10.7 trillion in outstanding publicly-held debt on which it pays an average interest rate of 2.24%. More than $5 trillion falls due within the next 36 months. If this debt is refinanced at the historical average of 5%, interest costs will more than double to in excess of $535 billion, twice CBO's projection for total federal spending on Medicaid this year, reports the *Wall Street Journal*.[2]

And lastly, the tools used by the Federal Reserve to keep interest rates artificially low have the potential to increase inflation, further eroding investment portfolios and increasing costs across the board.

The unintended consequences of the Federal Reserve's focus on stimulating the economy through record low interest rates may be imposing a long term costs far greater than any short term benefits. Time will tell.

1 "CalPERS may lower assumed rate of return," *Sacramento Business Journal* by Mark Anderson, Wednesday, March 7, 2012. http://www.bizjournals.com/sacramento/news/2012/03/07/calpers-may-lower-assumed-rate-of-return.html?ed=2012-03-07&s=article_du&ana=e_du_pub

2 "Uncle Sam's Teaser Rate - *Low interest rates disguise the federal debt bomb.*" *Wall Street Journal,* March 12, 2012.

The Outlook for Bonds is Murky at Best

Bonds are traditionally considered a conservative investment, with U.S. government bonds typically considered the most conservative and safest of your bond choices. But under the current low interest rate scenario, a new investment in bonds may be an investment in a guaranteed loss.

Let's start with current bond rates.

Security Term Type	Interest Rate %	Yield %	Price Per $100
2-Year Note	0.25	0.31	99.88
5-Year Note	0.875	0.90	99.88
7-Year Note	1.375	1.418	99.71
30 Year TIPS	0.75	.077	99.34

http://www.treasurydirect.gov/RI/OFNtebnd

Based on February 29, 2012 sales reported by the U.S. Treasury, returns on newly issued U.S. Securities were as shown to the left.

Given an official inflation rate of 2.9% annually, monies invested in these securities lose purchasing power every year. If you look at inflation rates calculated before the elimination of energy and food costs from the calculation, the loss in buying power is even more significant. To add insult to injury, interest returns may well be taxed in the future at the investor's personal tax rate, which could erode returns by more than 40% for incomes in the "rich" category.

In the past, falling interest rates have increased the value of outstanding bonds that paid higher interest rates. The reason is simple. A bond with five years to maturity that pays 5% annually is more valuable than a new five-year note paying 0.875% annually. As a result, if the 5% bond is sold before maturity the holder would receive more than its face value. This is what has contributed to the outperformance of bonds over the last few years.

The problem is today's interest rates have little if any room to fall to provide a comparable boost in value. And when interest rates begin to rise, as they inevitably will, bonds issued at today's low interest rates will fall in value. Even if held to maturity, low

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Life Expectancy for Social Security				
Year Cohort Turned 65	Percentage of Population Surviving from Age 21 to Age 65		Average Remaining Life Expectancy for Those Surviving to Age 65	
	Male	Female	Male	Female
1940	53.9	60.6	12.7	14.7
1950	56.2	65.5	13.1	16.2
1960	60.1	71.3	13.2	17.4
1970	63.7	76.9	13.8	18.6
1980	67.8	80.9	14.6	19.1
1990	72.3	83.6	15.3	19.6

Source: Social Security Administration, http://www.ssa.gov/history/lifeexpect.html

Leslie R. Martin, followed participants over eight decades. It found that "[T]he continually productive men and women lived much longer than their more laid-back comrades. ... It was not the happiest or the most relaxed older participants who lived the longest. It was those who were most engaged in pursuing their goals." Studies of countries with different retirement ages have also found that those who continue working in their 60s have better memories than those who retire early. Heading off dementia also appears to be directly correlated in most cases with keeping active.

As a result, when we look at retirement planning with clients today, the question we ask more and more is not "when do you anticipate retiring," but "when do you anticipate needing access to your investment funds."

Among the non-traditional retirements we have seen our clients embark on are:

The new career – Sometimes retirement is just a chance to start over in a new employment opportunity. It's a chance to explore different talents and ideas you may have, or maybe step back to a lower stress position.

The new business – Which says it all. The challenge here is to preserve your accumulated assets and limit the amount of risk exposure to the new business.

The senior resource – Service firms where knowledge and experience provide insights into current issues, such as law firms and CPA firms often include the "senior" advisor, a semi-retired partner who fills in when needed or offers a historical perspective to client issues.

The director retiree – Retirement becomes an opportunity to serve on boards of both for profit and non-profit organizations, bringing a lifetime of experience to the position.

The senior rainmaker – The senior rainmaker puts to work a lifetime of connections in the industry to bring in new business. This can include attending conferences and luncheons to keep the firm visible to potential and existing customers, serving on advisor boards that contact potential clients, and much more.

The retiree volunteer – Work is replaced by part- to full-time volunteer activities, typically focusing on a lifelong passion that there was limited time to pursue while working.

The retired student – Retirement may be an opportunity to pursue studies in a new field.

The retired travel writer – Writing about travel experiences can give an added zest to the adventure and provide write offs and potential income.

The political retiree – Older Americans are the staple of local political organizations from manning poll booths to participating as electoral delegates. Many are also running for public office and not retiring from public service until well into their 70s and 80s.

The philanthropist retiree – Senior years may also be the time to change the world one person at a time. Many older Americans have launched into second careers as philanthropists, missionaries, and foreign aid workers.

Where your plans for retirement and your need for cash will be in the future depends a great deal on the person you think you will be in retirement. Make certain that is part of your discussion with your financial adviser!

New Disclosure Requirements Will Change Investment Reporting

Two new rules take effect this year that will show up in your investment reports.

The first is from the U.S. Labor Department requiring detailed disclosure of 401(k) fees so companies and their employees can see what they're being charged. This regulation will take effect for providers of 401(k) plans by July 1. If you are an employee covered by a 401(k) plan, you will receive the additional disclosures later in the year. The regulation is designed to help employers and employees better evaluate retirement plan providers and understand the impact of fees on returns, so they can make comparisons and more informed choices, according to the Labor Department.

The second change is from regulations issued by the Internal Revenue Service to implement a provision in the Energy Improvement and Extension Act of 2008. The regulations require reporting of basis and other information by stock brokers and mutual fund companies for most stock purchased in 2011 and all stock purchased in 2012 and later years. The reporting will be to investors and the IRS.

The goal of the regulation according to the IRS is to help investors more easily and accurately report their gains and losses. "Form 1099-B, Proceeds from Broker and Barter Exchange Transactions," long used to report sales prices, will be expanded to include the cost or other basis of stock and mutual fund shares sold or exchanged during the year. The expanded form will also be used to report whether the gain or loss realized on these transactions is long-term (held more than one year) or short-term (held one year or less), a key factor affecting the tax treatment of gain or loss. The expanded form, to be first used for calendar-year 2011 sales, must be filed with the IRS and furnished to investors in early 2012.

When selling less than 100% of a position, there are at least four reporting methods on stock sales: first-in, first-out; last-in, first-out; highest-cost, first-out; and specific identification. If a customer doesn't specify, IRS rules specify first-in, first-out as the default—which could raise taxes paid. Before selling a partial position, make certain to designate how you want the sale reported and make certain your broker offers the option.

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interest rate bonds impose a cost on the investor of lost opportunity.

What does this add up to for the investor today? You must understand the relationship between returns and bond values and the risk of investing in these securities in a low interest rate environment. You may want to weigh the current gains in your bond portfolio with the wisdom of liquidating those positions depending upon your investment needs.

While U.S. government securities are generally considered among the safest investment, not all bonds or bond issuers are created equal. If you are pursuing high interest rates in your bond investments you are incurring more risk. In addition to inflation eroding the value of your investments, bond risks include the potential for issuer default, having your bonds called (i.e. paid off prior to maturity), currency risk in terms of foreign bonds, and illiquidity, depending upon your investment. If you have a sizeable bond portfolio, this may be a good time to talk to your financial advisor.

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