INSIGHTS FOR

INTELLIGENT Investors

Stocks vs. Bonds:

How the Intelligent Investor Sustains Portfolio Income through Retirement

Sheaff Brock

Innovative Portfolios for Intelligent Investors

The future depends on what you do today.

—Mahatma Gandhi

STOCKS vs. BONDS

How the Intelligent Investor Sustains Portfolio Income through Retirement

In this issue of **INSIGHTS FOR INTELLIGENT INVESTORS**, we address the common misconceptions regarding stocks vs. bonds, and how intelligent investors are revising their thinking about retirement investment.

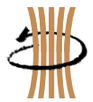
THREE KEY INSIGHTS YOU NEED TO KNOW:

1. Set the right withdrawal rate

2. Maintain optimal asset allocation

3. Avoid the bond trap

The experts at Sheaff Brock will look at each of these areas in more depth.



SUSTAINING PORTFOLIO INCOME
Through Retirement

The most fundamental question you face in planning for retirement is:

HOW LONG WILL YOUR RETIREMENT INCOME LAST?

Of course, this isn't an easy thing to determine. The answer depends on how much you have and how much you spend during retirement.

Although retirement budgeting is by no means easy, you may already have an idea of how much you'll need to fund your post-working years, based on your current lifestyle and realistic goals for your retirement lifestyle and activities.

The biggest unknown in retirement planning is investment performance—the returns your portfolio will deliver. While returns can't be controlled, they can be enhanced significantly by effective asset allocation—the proportions of a portfolio assigned to different types of assets.

The endurance of your retirement investment income depends on:

- Your withdrawal rate.
- Intelligent asset allocation (stocks vs. bonds)
- Maintaining this asset allocation with steadfast discipline

INSIGHT #1:
Set the right withdrawal rate

First, let's examine the issue of what is an appropriate withdrawal rate—how much income you take from your portfolio per year.

How do Intelligent Investors determine the optimal proportion (in dollars) of their total asset value that they can cash in each year and still sustain their portfolio?

Now that people are living longer, you should plan for retirement windows of 30 years. So setting the right withdrawal rate is more critical than ever.

Naturally, your optimal withdrawal rate depends on the size and growth of your portfolio. As a general rule, many advisors have traditionally recommended a withdrawal rate of 4 percent, assuming that this can be justified by a given portfolio. Since the market meltdown of 2008–09, this recommendation has commonly been trimmed to 3 percent.

Yet, recent definitive research shows that, for many, withdrawal rates are needlessly low because they're based on asset allocations that over-rely on bonds and under-rely on stocks.

The research proves that bonds, traditionally viewed as being safer than stocks for investors who are approaching or in retirement, actually pose more risk.

THE REASON: Bonds' inferior returns increase the chances that you'll outlive your money.

By embracing a more realistic view of stock versus bond performance and allocating assets accordingly, many retirees would be able to use a higher withdrawal rate and still sustain their account principal. For those retiring with $1 million—invested completely or largely in stocks—this withdrawal rate could exceed 4 percent.

The bottom line—with the right asset allocation, you will be able to set your withdrawal rate higher than you might think.

But first, let's look at ASSET ALLOCATION in a little more depth, to see how you can maximize how long your retirement will likely last.

INSIGHT #2:
Maintain optimal asset allocation.

Asset allocation models used for decades—and still widely used today—call for having less in stocks and more in bonds as you approach retirement because this supposedly reduces risk. But now, two authoritative studies have shown that this is flat wrong. The studies indicate that, as you approach retirement, you should have more of your total investment portfolio in stocks—as opposed to bonds—because of their superior returns.

A definitive study by Rob Brown, Ph.D., chief investment strategist for United Capital Financial Advisers LLC, examined 138 years of stock and bond market history—a period with three depressions and numerous recessions. Brown looked at potential outcomes for a hypothetical couple's retirement period of 353 months (nearly 30 years) with their $1 million retirement account in stocks versus bonds. Returns assigned to this portfolio were based on data from 1,300 different 353-month periods of performance of the S&P 500 for stocks and 10-year U.S. Treasuries for bonds.

In light of what has long been considered conventional asset allocation "wisdom," the findings are astonishing. The study found that, for the same withdrawal rate, the couple's odds of running out of money during retirement were about half as great with a portfolio 100 percent in stocks as they would be with a portfolio with 50 percent in stocks and 50 percent in bonds.

The greater the withdrawal rate used, the more this couple needed to have in stocks. With a portfolio invested 100 percent in stocks and a withdrawal rate slightly more than 4 percent, there was only a 5.8 percent chance that the couple's principal wouldn't go the distance. At the same withdrawal rate, a portfolio having 60 percent in stocks and 40 percent in bonds stood a 9.3 percent chance of not lasting, and a 50-50 portfolio had an 11.4 percent chance of running out.

THE REASON: The low return of bonds over time compared with stocks.

Conventional wisdom suggests that retirees should lessen their equity exposure throughout retirement as their time horizon shortens. Yet, as the chart below indicates, the exact OPPOSITE will actually better sustain your wealth—the highest success rate (95.1%) comes with an asset allocation that features 70% invested in stocks.

30-Year Retirements, Historical Average Capital Market Expectations
Success Rate for a 4% Withdrawal Rate

STARTING EQUITY ALLOCATION (%)	ENDING EQUITY ALLOCATION (%)										
	0	10	20	30	40	50	60	70	80	90	100
0	74.5	78.9	82.3	85.3	87.6	89.2	90.7	91.7	92.2	92.5	92.7
10	83.8	86.7	89.2	90.9	92.0	92.9	96.5	93.9	94.1	94.2	94.1
20	89.4	91.0	92.2	93.2	94.0	94.4	94.8	94.8	94.8	94.8	94.6
30	91.7	92.8	93.7	94.3	94.7	94.8	95.0	**95.1**	95.0	94.9	94.5
40	92.6	93.4	93.9	94.3	94.6	94.7	94.7	94.6	94.5	94.4	94.1
50	92.7	93.2	93.6	93.9	94.2	94.1	94.1	94.1	93.9	93.6	93.5
60	92.4	92.8	93.0	93.2	93.3	93.3	93.2	93.1	93.0	92.7	92.5
70	91.6	92.0	92.2	92.3	92.4	92.3	92.3	92.2	92.0	91.8	91.5
80	90.8	91.1	91.3	91.5	91.5	91.5	91.4	91.2	91.1	90.9	90.6
90	89.9	90.2	90.4	90.5	90.4	90.4	90.3	90.3	90.0	89.8	89.6
100	89.0	89.1	89.3	89.3	89.4	89.3	89.2	89.1	88.9	88.6	88.3

The Smiths vs. The Andersons: A story of asset allocation.

To Illustrate the allocation of stocks and bonds, let's use an oversimplified example involving two couples:

1) **The Smiths—who wanted to protect their investment dollars and earn guaranteed interest, and**
2) **The Andersons—who wanted to protect their lifestyle and their purchasing power throughout their retirement.**

To achieve their goal, the Smiths invested $200,000 in long-term bonds in 1994. With an average annual interest rate of 8.96%, their bonds earn them $17,920/year income and their initial $200,000 was completely protected. They felt safe. Unfortunately, that was 20 years ago.

Now, it takes almost $35,000 to purchase what $17,920 did back then. Their initial $200,000 was protected, but that buying power has been dramatically reduced as well.

The Andersons also invested $200,000 in 1994, but they chose a stock portfolio, with monthly withdrawals totaling 5% of the previous year's ending account value. This equates to $10,000/year income for their first year. They started out living on less than the Smiths, and fluctuating with the market, their annual income varied from year to year. But over the same twenty years, their income grew substantially along with their original investment.

At the end of the 20-year period:

	The Smiths	The Andersons
Total Annual Income	$ 358,400	$ 464,260
Value of Initial Investment	$ 200,000	$ 724,027
TOTAL VALUE	**$ 558,400**	**$1,188,287**

A comprehensive study by Morningstar on global stock returns, released this year, found that stocks are actually the safest type of investment in the long term. The study looked at 90 years of data from 20 countries.

Which means, over ANY 20-year period in history, the Andersons would ALWAYS end up with more money than the Smiths.

So, how should you allocate?

Like we said before, it all depends on how much annual income you care to withdraw.

Assuming your goal is to maintain your finances through retirement, the chart below gives you some idea of your chances.

Research confirms that the odds of your money lasting through retirement are between 4 and 10% greater with a higher concentration of stocks. And, as the rate at which you withdraw each year goes up—greater than 4%—the more your investment needs to be in stocks.

The Lowest-Risk Portfolios

IF YOU ANNUALLY WITHDRAW THE FOLLOWING FROM YOUR INVESTMENT ACCOUNT (in dollars):	AND YOUR PORTFOLIO'S RATIO OF STOCKS TO BONDS IS:	THE ODDS OF YOUR MONEY LASTING THROUGH RETIREMENT ARE: (in percentages)
$ 28,700	70/30	100.00%
$ 30,000 = 3%	70/30	99.92%
$ 32,500	70/30	99.77%
$ 35,000	70/30	99.62%
$ 37.000	70/30	98.85%
$ 40,000 = 4%	80/20	97.62%
$ 41,940	80/20	95.00%
$ 42,500	100/0	94.23%
$ 45,000	95/5	90.23%
$ 45,160	100/0	90.00%
$ 47,270	100/0	85.00%
$ 47,500 = 4.75%	100/0	84.23%

Annual dollar withdrawals, increased by inflation rate each month, assuming an initial $1,000,000 investment, based on a 138-year comparison of portfolio mixes. **Source:** United Capital Advisors LLC

INSIGHT #3:
Avoid the bond trap.

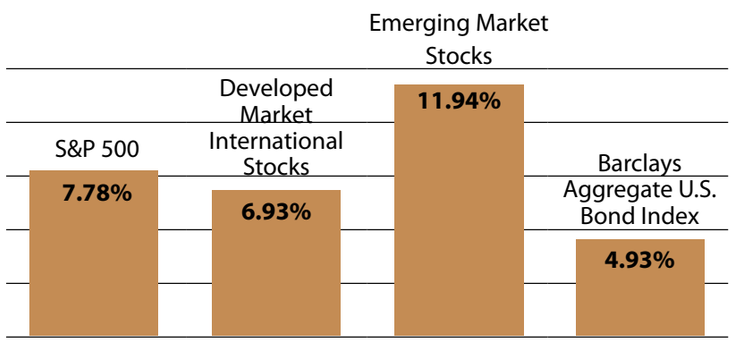
For decades, many advisors have led investors into a bond trap with incorrect assurances of protection against risk. This has significantly reduced the potential for their investment to grow and has jeopardized their retirement income.

The classic asset allocation—one still widely used today—calls for significantly increasing investment in bonds as you age, according to a shopworn formula. Advocates of this approach have altered this formula a bit to reflect longer life spans, but the change isn't much better because it's based on the assumption that stocks carry more risk.

One reason for stocks' superior performance is the dividends paid regularly by blue-chips (established large-cap companies). Dividend income is almost bond-like in its reliability. But unlike bond yields, dividend income isn't static; it can rise when the company has a good year. With bond yields, you're looking at the same dreary figure (guaranteed, but dreary) year in, year out, while stockholders in the same companies may get a raise in a good year.

Bond advocates fixate on the potential for down stock markets to damage portfolios shortly before or soon after people retire. But this doesn't make sense because most people don't spend every dime of their retirement investment account in the first few years of retirement. Instead, they cash in investments according to their withdrawal rate. Moreover, stocks' long-term superior returns fortify portfolios from dips prior to or during retirement.

Average Annual Returns: June 2004 – June 2014



Source: Kenny, Thomas. "Stocks vs. Bonds: The Long-Term Performance Data." About Money, 1 July 2014. <http://bonds.about.com/od/Issues-in-the-News/a/Bond-Market-Returns.htm>.

* Indices used are: U.S. large company stocks: S&P 500, U.S. small companies: Russell 2000 Index, developed market international stocks: MSCI EAFE, emerging market stocks: MSCI Emerging Markets, emerging market bonds: JP Morgan EMI Global Diversified Index, high yield bonds: Credit Suisse High Yield Index, long-term U.S. government bonds: Barclays U.S. Government Long Index, long-term U.S. corporate bonds: Barclays Corporate Long Investment Grade Index, TIPS: Barclays US TIPS Index, corporate bonds - all maturities: Barclays Corporate Investment Grade Index, Senior Loans: S&P / LSTA Leveraged Loan Index.

According to the studies, there's not merely a risk that bonds will underperform stocks; it's a statistical certainty.

Stick with your plan.

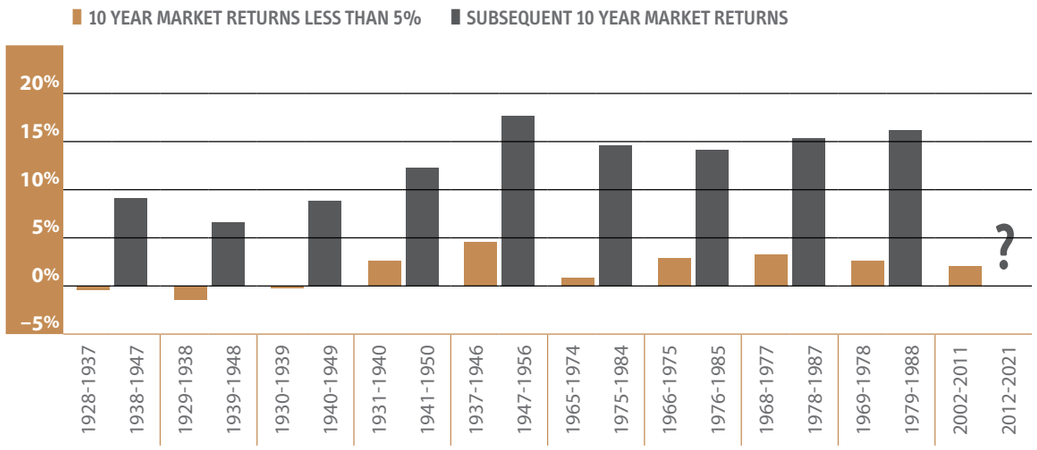
It's only natural to be concerned about market declines, but these dips are always followed by periods of growth. A study conducted by Davis Advisors examined the worst 10-year market periods since 1928. In each of these, the decline was followed by a period of good returns. For example, during the 10-year period ending in 1974, the overall market returned an annual average of 1.2 percent. But from 1975 through 1984, the market roared back, returning 14.8 percent annually.

Unfortunately, many investors react to market declines by panicking and selling low, converting what might have been nothing worse than short-term paper losses into long-term actual losses.

On the other hand, investors who stay the course, keeping their asset allocation intact, stand a better chance of reaping long-term gains that add to their investment income.

In every case as indicated in the chart below, the 10-year period following a disappointing 10-year stretch produced satisfactory returns. And these periods of recovery averaged 13% per year. In fact, 2012 and 2013 were both very good years for stocks, so perhaps the history of good decades is rhyming once again.

Poor Periods for the Market Have Always Been Followed by Stronger Periods



Source: Thomson Financial, Lipper and Bloomberg. Chart represents when the annualized market returns were less than 5%. Periods where there is not a subsequent 10-year period are not shown. The market is represented by the Dow Jones Industrial Average for the period from 1928 through 1957 and by the S&P 500® Index for the period from 1958 through 2013. Investments cannot be made directly in an index. The performance shown is not indicative of any particular investment, and past performance is not a guarantee of future results.

The same is true with portfolio under-performance (compared with the overall market). Selling prematurely, contrary to your asset allocation, can throw your plan out of kilter.

Reacting emotionally to market developments or portfolio underperformance can play havoc with your asset allocation.

Maintaining a stock allocation in companies of different sizes and industries reduces the risks inherent in any single category—because gains in one category can offset losses in another. If you've allocated 30 percent of your portfolio to large-cap stocks and suddenly sell half of them (because they're not doing well) to buy stocks in another category, you've changed your risk exposure and may be lowering your portfolio's long-term returns.

Instead, you should maintain your asset allocation with discipline, avoiding the emotion that can derail sound risk management.

By setting the right withdrawal rate, maintaining optimal asset allocation, and avoiding the bond trap, you can enjoy your retirement with confidence that your hard-earned savings will continue to pay off for a lifetime—and beyond.

For more **INSIGHTS FOR INTELLIGENT INVESTORS**, or more information regarding investment strategies, contact the expert consultants at Sheaff Brock.

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Sheaff Brock Investment Advisors in the News

Ranked by *Financial Advisor* in the Top 50 Fastest-Growing RIA firms, July 2014.

abc NEWS

Monthly contributors to *Market Moves*, the investment column at ABCNews.com.

THE WALL STREET JOURNAL

Quoted in *The Wall Street Journal.*

Featured in *Financial Advisor* magazine, June 2014.

About Sheaff Brock

We are a fee-only independent investment firm specializing in portfolio management for high net worth individuals. Our goal is to build and preserve your wealth over the long term.

And, as our INSIGHTS FOR INTELLIGENT INVESTORS SERIES points out, our approach to money management is unique and challenges many traditional assumptions about investing. Driven by discipline, data and a proven track record, we customize our proprietary strategies to preserve your capital and meet your specific needs for income and/or growth while also reducing volatility and risk.

Meeting your individual needs

To make sure that your investment income lasts longer than you do, Sheaff Brock firmly believes that effective asset allocation and solid portfolio management are the most important part of any client's financial plan. So we'll establish a strategy tailored specifically to your needs and analyze opportunities by using a top-down as well as a bottom-up approach. We'll set and maintain an asset allocation for you that is designed to achieve optimal returns while controlling risk. We'll then determine the optimal withdrawal rate for your portfolio, and keep you informed along the way.

At Sheaff Brock, we won't just manage your portfolio. We'll provide you with analysis, educate you about market environments and report on your investment performance. We work continuously to understand your needs, not just when you first come to us, but throughout our relationship.

Focused on your success

And you can be confident that we are focused entirely on your outcomes. At Sheaff Brock, we work hard for your long-term success. As a result, our clients tend to stay with us for a very long time. We have also been recognized as one of the nation's top wealth managers by many of the country's financial publications, including *Bloomberg Wealth Manager*, *Financial Advisor* magazine, *Reuters*, and Consumer's Research Council. And Sheaff Brock principal David Gilreath is a regular contributor to ABCNews.com's investment column, *Market Moves*.

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Sheaff Brock Investment Advisors LLC
is an independent investment management firm that builds and maintains innovative portfolios for intelligent investors. The firm manages more than $1 billion in assets for high-net-worth individuals nationwide.

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