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What can we Learn From Lean Times?

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2008 was a difficult year for most investors. Hardly any asset class was spared and even well-designed asset allocation plans, meant to reduce volatility, have not weathered this storm.

2009 brings some reasons for cautious optimism. While I believe we have a very difficult recovery ahead of us, I believe that the pain we are enduring will lead to a much more stable future.

Investing requires a tolerance for discomfort when things seem to be not working, and it requires an ability to avoid overconfidence when things are going well. Risk tolerance means different things to different people. Your definition of acceptable risk from two years ago could be significantly different now.

During these times, we will be better served by looking carefully at our goals, our circumstances, and our resources. To increase the likelihood of reaching our goals, we need to develop and confirm investment and spending strategies.

Maintaining sufficient cash or cash equivalents to cover your short-term needs is the first step. Short-term means anything for which you require funds in the next three years.

Keeping spending within the limits of your resources is one of the more important things you can do for your financial security. Live within your means. Taking on debt makes you vulnerable. Are there any spending categories you can reduce and shift the money into more meaningful expenditures? We find that long-term damage to retirement plans often results from overspending.

This financial storm with its combination of low interest rates and declining account values might require you to take a closer look at your expenses. If you are retired, a general rule of thumb is that you can withdraw 4% of the value of your account each year. If you are spending more than that, even the good cycles may not sustain your account throughout retirement.

Many people are holding a high percentage of their assets in cash. Just as people were scared to miss out on the frenzied bull market of a few years ago – afraid to be left

behind – many will be afraid to get back into the markets near the bottom. That is precisely the time to reinvest. None of us can know, until after the fact, when the market has hit rock bottom. We do know historically that when the market has been oversold by a fearful populace, the long-term result may be excellent.

John Hussman, president of Hussman Investment Trust, says that if the S&P 500 were to decline to between 500 and 550, it would match the worst historical troughs for market valuations. These levels are emphatically not *forecasts* – they represent extreme outcomes. Unfortunately, they also cannot be ruled out in the context of a de-leveraging cycle plagued by utterly misguided policy responses.

Understanding the upside is also essential. At those levels, S&P 500 stocks would be priced to deliver total returns over the following decade in the likely range of 14% to 17% annually, according to Hussman. Lower valuations imply higher long-term returns. Do you think anyone in the midst of the Great Depression would have forecast an increase of almost 150% over the following 10 years and almost 1,300% over the following 20?

My own sense of the world tells me that we tend to lose sight of the important things in life. Compared with ages past, we live a remarkably comfortable existence. In our individual lives, we are often wise enough to see trauma or misfortune as a catalyst to positive change, as motivation to move out of a comfortable rut and take chances that will lead to something better.

Our society will emerge from this trauma with more wisdom about saving and investing, and spending and consuming, and about what is really important. We will no longer take so many things in our economic world for granted.

We are learning a lot from these difficult times.