CONLON DART
wealth management

Volume XIV, Issue III Third Quarter 2017

Understanding Your Risk Capacity

This is the second part of a two-part series about risk.

When getting to know our clients, we often have a conversation about investment risk so that we can gain a better understanding of what risk *feels* like to them. Our goal is to gauge each client's ability to navigate particularly volatile periods in the markets. We typically supplement this conversation with a carefully designed risk tolerance questionnaire. This process works well for us—and for our clients. Rarely do we change a client's investment mix in a way that shocks them due to an improper reading of their risk tolerance.

Your risk tolerance—the degree of variability in investment returns you are willing to withstand—is only one part of the risk assessment equation. An equally important component is *risk capacity,* which measures the amount of risk you can withstand and still accomplish your financial goals.

Balancing these two often-competing components of risk—helping you to accomplish your financial goals while not losing sleep over your portfolio's inevitable ups and downs—can be a real challenge. Despite all the preaching you hear about the importance of investing for the long haul (we, too, plead guilty), not everyone is temperamentally suited to a high risk/high reward investment plan, which entails taking several steps backward before moving forward to meet your savings goals.

As we noted in Part One of this series, knowing your own risk profile is critical to your investment success. To better understand the role of your risk capacity in this process, let's imagine two hypothetical investors.

Julia would like to retire in three years and spend more time in her garden. Julia is a competitive dahlia grower and can't wait to become… well…*more* competitive. A diligent saver, Julia has built a $2 million portfolio over her thirty-year career. We worked with a Julia on a much-needed expense tracking exercise and concluded that in addition to her Social Security income, she will need an additional $80,000 per year from investments after retirement.

Like Julia, Quinn and Maria have also built a $2 million investment portfolio. In addition, they have a formal plan in place to sell their successful dry cleaning business, which will net them another $2.5 million when they fully retire next year. Free at last, Quinn and Maria will have time to enjoy their San Juan Island vacation home, where they plan to spend six months each year. With their passion for world travel, and

(continued on page 3)

> **"Here's what I have learned. If you retire to spend more time with your family, check with your family first."**
>
> *~David Letterman on retiring from Late Night.*

Herds, Bubbles and the Madness of Crowds

Recently, former Federal Reserve chair Alan Greenspan, age 91, opined that we are in a bubble. We've all heard that one before. We've also experienced bubbles, first with the dotcom crash at the turn of the century and later with the real estate boom and bust, which lead to the Great Recession.

Greenspan suggests our next bubble will be of a different variety. In a recent interview, he said: "By any measure, real long-term interest rates are much too low and therefore unsustainable. When they move higher, they are likely to move reasonably fast. We are experiencing a bubble, not in stocks, but in bond prices."

Greenspan is not alone in his thinking, of course. Many prognosticators have argued that bonds have been tremendously overvalued (in bubble territory) for nearly a decade.

(continued on page 4)

Aging Without Support

"...the American Geriatric Society thinks that nearly one-quarter of Americans over age 65 lack someone to care for them if they become physically incapacitated or experience cognitive decline."

Probably the most forgotten minority in America is the "elder orphans"—aging retirees who no longer have a spouse (if they ever had one), no kids and no caregiver.

According to The Gerontologist magazine, about one-third of 45 to 63-year-olds are single, and most of them never married or are divorced. Meanwhile, about 15% of 40-44-year-old women have no children. These statistics don't tell the full story of a small but significant aging population who are growing older without a support network—the American Geriatric Society thinks that nearly one-quarter of Americans over age 65 lack someone to care for them if they become physically incapacitated or experience cognitive decline. And many will; statistics show that 69% of Americans will need long-term care at some point in their lives—usually later in life.

How are these people coping? An article in a recent issue of U.S. News & World Report says that the best advice is to plan for long-term care needs with an LTC policy and/or a home that is retrofitted for an elderly occupant. It's also important to make social connections and avoid being lonely. A 2012 study found that the loneliest older adults were nearly twice as likely to die within six years as the least lonely, regardless of health behaviors or social status. The most powerful finding was that human connection helps ward off depression.

One way to raise the connection level is to retire in a college town, where the elder orphan is surrounded by young people and can stay engaged with activities like mentoring. At the same time, it is recommended that these people find like-minded retirees who can look out for each other. Some have actually gone so far as to create communities that act like surrogate families.

The elder orphans need someone to speak up for them if they're incapacitated, which means finding a friend who knows their Social Security number, keeps their insurance card, knows which medications they take, and can be designated as the durable power of attorney for health care against the day when they start losing cognitive capacity. As a last resort, this person could be hired; an attorney who specializes in elder care law might either serve in that capacity or find a professional who is willing to do so.

Written by Robert Veres,
(financial services writer/ commentator)

Risk Capacity...

(continued from page 1)

with three kids and five grandchildren living on both coasts, we are certain Quinn and Maria won't be sitting around much.

In addition to their two Social Security checks, we calculated that Quinn and Maria will need to withdraw about $215,000 from their investment portfolio annually (including $25,000 a year in college savings for their grandkids) in order to safely cover expenses throughout an action-packed, 30-year retirement.

When we evaluated Julia's risk tolerance, we found her to be a resilient investor more than able to withstand a moderate level of volatility in her portfolio. But what about her *capacity* for risk? In other words, is the amount of risk she is taking with her investments aligned with her financial goals? We then set out to understand whether Julia should be taking on more, or perhaps less risk for her retirement plan to succeed.

Fortunately for Julia, her spending plan doesn't seem to be overly ambitious or sporadic. Instead, the $80,000 she will need from her portfolio each year should comfortably cover her core living expenses and also provide a buffer for surprises such as high medical costs or unexpected house repairs.

Using a 4% withdrawal rate, Julia can pull $80,000 from her portfolio each year ($2 million x 4%). Meeting this income goal would be a struggle if Julia's portfolio mix were too conservative and failed to align with her higher capacity for risk. In this instance, a low-risk bond portfolio earning a mere 3% would have underachieved on both fronts—her capacity and her tolerance for risk.

Quinn and Maria have a decidedly lower tolerance for risk than Julia. A day-trading victim of the dotcom bust, Quinn eventually eased the family portfolio back into the stock market years later—just in time for the awful bear market of 2008-2009. Today, "burned twice" as Quinn says, their portfolio sits largely in high-quality bonds. Though bonds don't pay much—maybe 3% on average—they are attractive to Quinn and Maria because they offer far fewer downside surprises.

By applying the same 4% withdrawal rate to Quinn and Maria's portfolio, we learn that it will generate about $180,000 per year. However, their core spending comes in at $215,000 per year, $35,000 above their desired withdrawal rate. Given that a portfolio of bonds and cash will have a hard time eking out even a 3% return, it's clear that something has to give.

While we appreciate the story behind Quinn and Maria's low tolerance for risk, it is clear that their portfolio won't be working hard enough for them. Using our new risk parlance, their portfolio is being under-utilized from a risk capacity perspective. Given the circumstances, we offered Maria and Quinn this blunt assessment: either ratchet up your portfolio's risk capacity or plan to lower your spending goals. Put another way, we asked Quinn and Martha to consider giving *more* of a say to their risk capacity and *less* of a say to their risk tolerance.

Balancing risk tolerance and risk capacity is a tricky business that is easier said than done. Our aim in this complicated discussion is to help you achieve a healthy balance in order to reach your goals. We want to know whether you need the risk, can afford the risk, and are willing to take the risk, so that we can help you bring your financial goals and spending into alignment.

- Mitch Conlon

Upcoming Conlon Dart Speaker Series

Leading experts exploring matters of personal finance

Join us for an informative session with Mike Cherry, a cyber security expert who will discuss the latest cyber threats facing individuals and what you can do to help prevent them.

We are also proud to bring you Grady Smith of Dimensional Fund Advisors. Grady will discuss the distinction between well run companies and well priced stocks, as well as share research and market insights as only Dimensional can.

Thursday, October 26 from 4:00-6:00 pm in our 1st floor Lobby level conference room. Family and friends welcome.

R.S.V.P.: kphan@conlondart.com

Finding Clarity in the Complex.

Conlon & Dart LLC
720 Olive Way
Suite 1850
Seattle, WA 98101

Phone: 888-777-4015
Fax: 206-728-1255
info@conlondart.com

www.conlondart.com

Herds...

(continued from page 1)

More prominent are those proclaiming domestic stocks are nearing bubble-level pricing. In this morning's Wall Street journal alone, I noted two such headlines: "This Market Can't Go on Much Longer" and "The Math that Proves this Market is Kaput."

Herding often happens when people think they are following the "smart money"

We at Conlon Dart aren't quite so doom-and-gloom in our attitude, but we do believe it is always good to be wary, and to be careful not to follow the herd.

A term used more and more frequently these days by traders and portfolio strategists is "crowded trade." I don't know if there is a precise definition of this term, but it implies a large imbalance of sentiment, or group-think favoring a particular stock or sector. A crowded trade also suggests a heavy presence of short-term speculators versus long-term holders. It might be used to explain the current rich pricing of technology stocks, for example.

One might also think of a crowded trade as a precursor to *herding*. In an investment sense, herding means that in uncertain times, people tend to copy the behavior of others. There may be no better example of this than the aforementioned dotcom bubble and subsequent crash, when investors bid up companies that had little more than a business plan into multi-billion-dollar valuations.

Herding often happens when people think they are following the "smart money." It is compounded by the fact that those moving into the herd are often in catch-up mode. Their perception is that everyone but them is making money. To diffuse anxiety and the fear of missing out, investors join in.

At the extreme, this is how bubbles are formed.

None of this is to suggest you need to go into Bubble Alert. Many things are expensive: Seattle homes, technology stocks, bonds… the list goes on.

It also doesn't mean you need to sell and go to cash. It does, however, argue for a contrarian bent, or at least a healthy skepticism. Frankly, we suggest taking that stance in any investment environment.

- Mitch Conlon

Stat Bank

79...Number of times Congress has increased the nation's debt ceiling going back 55 years to 1962.

(Federal Reserve)

337...The number of calendar days the S&P 500 has gone without a 2% or greater 1 day drop, the longest stretch without a 2% tumble since February 2007.

(BTN Research)

42...Percentage amount of consumer spending in the United States is represented by Americans who are age 55 and older.

(Moody's Analytics)

$321,994...Projected lifetime spending for retirement health-care premiums for Medicare Parts B and D, supplemental insurance and dental insurance for an average 65 year old couple retiring this year.

(HealthView Services)

95...Percentage of companies in the S&P 500 (476 firms) that have underfunded pension plans.

(Bloomberg Businessweek)

2,422...The medium square footage of all new single family homes built in the U.S. in 2016, an increase of 523 square feet over the last 25 years.

(Joint Center for Housing Studies of Harvard University)