Pinney&Scofield

Building long-term relationships with long-term investors

January 14, 2022

Dear Client,

Twenty-twenty-one was one of the greatest years for the S&P 500 and not because it had its' highest return. That was done back in 1933 when it returned an astonishing 54%. Last year's return was slightly more than half that record at 28.7%. What made it one of its greatest years is its strong upside and limited downside. The index reached all-time highs 70 times during the year. This means it reached a record high on nearly a third of all the trading days. There has only been one year with more all-time highs. That was in 1995 with a total of 77. And the downside of the S&P 500 last year was small. Its worst day saw a 2.5% correction. The worst peak to trough correction for the year was just over 5%. This puts it in the bottom 10% of all drawdowns since 1928. If you look at a one-year graph for the index it is relatively smooth with a strong upward tilt.

Yes, it was an extraordinary year but what does it tell us about tomorrow? Will this strong market continue? With every new year comes predictions from the "experts" on what the markets will do. As you know, we are not in the predicting business. Instead, we think of ourselves as "anti-predicters" which means to sift through the noise of the financial press to deliver long-term sustainable portfolios designed to meet our client's financial goals. It's not always "exciting" or "sexy" but it delivers results and that's what matters. To give you a sense of what we see out there, here are some headlines throughout 2021 that we "anti-predicted" (i.e. ignored), apparently one minute we were supposed to buy, the next sell:

On February 22: Are Equity Return Forecasts Too Pessimistic?
On April 26: The Stock Market's Collapse is Near
On May 6: The Consensus is Wrong about Stocks, Bonds, and Inflation
On May 10: The S&P is Going to 4,500
On September 24: Don't Be a Dip and Buy the Dip
On November 28: The Market is Not in a Bubble; The S&P Could Reach 5,000 in 2022

Through it all, the S&P 500 just chugged along. Get ready for the next set of headlines in 2022. At the end of the year, someone will declare themselves "right" and be a hero while someone else will make excuses why it will just take more time until their prediction turns out to be "right." As "anti-predicters," we see a binary choice, markets will either go up or down and, like flipping a coin, if you say the same thing every year eventually you will be "right." You could add a third choice, "sideways," and then everyone will spin that data to say they were in fact "right." We will continue to "anti-predict" and ignore the noise, thank you very much.

But it does leave us with important, real questions about the future. Inflation is in the headlines and the prospect for rising interest rates is real. How do these factors impact assumptions and projections upon which we base our financial plans? To answer this, we look beyond what the markets will do over the next 12 months. Market returns over the last two years are not likely to be sustained and there will be a correction. When that correction will occur is unknowable. The one prediction we are willing to make is the markets will reward long-term investors.

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Statistically, with the markets at all-times highs, the future expected rate of return does, indeed get lower. Lower expected returns coupled with higher inflation and low interest rates can impact future real spending ability and has many re-evaluating sustainable draw rates from portfolios, that's where the rubber hits the road so to speak. For decades, a popular rule of thumb to determine a sustainable draw rate has been the "4% rule" which posits that you can withdraw 4% of your portfolio annually and not run out of money over a 30-year period, a typical retirement span. The 4% draw rate works as follows – the first year you take 4% of your portfolio and then that dollar amount is what you withdraw every year adjusted for inflation so in real terms you withdraw a fixed dollar amount every year. The percentage only applies to the first-year distribution.

The 4% draw rate came about in the 1990's and assumes a portfolio is weighted 60% in stocks and 40% in bonds. Interest rates in the 1990's were higher than they are now so the income generated by the 40% in bonds was greater than what can be earned in today's market environment. Many are taking the current markets conditions and extrapolating them over the next 30 years and saying if the projected income component is lower today than it was then and if inflation stays elevated, then 4% is too high, it is not sustainable. There is a current study that says it should be reduced to 3.3%. This is a major reduction.

We use an analysis tool with data going back to 1926 that allows us to look at the success of different draw rates over different time periods using the same technique as the 4% rule. For a 30-year timeframe, of which there are 790 monthly 30-year rolling periods since 1926, there is a huge dispersion of outcomes depending on when you start. For instance, if you withdrew 4% from a $1M portfolio starting in August 1938, you would make it through the 30 years but only have $386k remaining. If you were fortunate to start withdrawing the same 4% in April 1979, you would have over $5M remaining. This disparity of when you start is known as "sequence of returns risk" and it can play a major role in the success of your portfolio. A big market correction in the early years can have a bigger impact on the success of your draw rate than a correction in the later years. It is from this risk that the current skepticism of the 4% rule arises with some arguing investors should invest more conservatively early in their retirement when they are spending more - their retirement "go-go" years. As they get older and spend less in their "slow-go" and "no-go" years, they can increase the risk. This is counter to traditional thought which has investors getting more conservative as they get older.

Whether you use 4% or 3.3%, it is simply a rule of thumb. One we do not think you should follow. Instead, the amount you withdraw should be re-evaluated each year in the context of your financial plan.

We'll end with a couple of administrative notes. First, for those of you who made Qualified Charitable Distributions from your IRA, you need to report the total of all charitable giving to your tax preparer. Schwab issues 1099-Rs with all IRA distributions reported as normal distributions with a box checked "Taxable Amount not Determined." This means it is up to the taxpayer to adjust for the amount that went to charities, reducing the taxable amount your preparer puts on your tax return. Please contact us if you have questions or need assistance.

Second, be aware there may be a slight discrepancy between the value of your accounts we're showing on the enclosed reports versus what's on your December Schwab statements. The discrepancy comes from adjustments made to dividends paid by Vanguard funds on December 31. Vanguard did not send the adjustments before Schwab printed their statements while our system did receive them before printing these reports. This means our numbers are in fact correct versus Schwab. ***Schwab has informed us that the data has been corrected for current account values.*** For those of you taking RMDs in 2022, this also means the RMD amount listed on your December statement may be slightly overstated so check with us before fulfilling your RMD requirement.

John, Richard, Mary, and Ryan