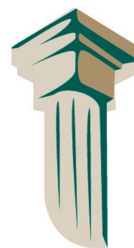
in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE



FINANCIAL RESOURCES G • R • O • U • P

A Registered Investment Advisor

Extra! Extra! It's Not All Bad News

When unemployment numbers are lumped in with stock market prices, the numbers don't appear to add up. Can these numbers offer investors insight into what might happen next as they look for signs of economic recovery?

Investors have been bombarded with what seems like a persistent barrage of bad economic news. While the headline-grabbing unemployment rate continues its meteoric rise toward 10 percent (and possibly higher), it is important to remember that it is a lagging indicator of economic activity — the economy typically starts to grow well before the unemployment rate peaks.

In fact, there are a significant number of positive signs for the economy. Consider the following:

▲ In June, the University of Michigan consumer confidence survey rose for the fourth straight month to 69, its highest level in nine months.

▲ In the week ending June 27, the advance figure for seasonally adjusted initial unemployment claims was 617,000, a decrease of 13,000 from the previous week's revised figure and well below the peak of 674,000 reached in the last week of March. This is important because the peaking of new claims for unemployment is one of the more reliable indicators of the end of a recession.

▲ In May, retail sales rose 0.5 percent, the first increase in three months.

▲ The May index of leading indicators increased sharply for the second straight month.

▲ By July 7, the spread between three-month Treasury bills and three-month Libor (the London Interbank Offered Rate) had fallen to just 0.36 percent, down from a peak of about 4.6 percent after Lehman Brothers declared bankruptcy. That figure is well within what is considered "normal" range. The spread is an indicator of banks' willingness to lend to each other, and this decrease is a strong signal that confidence has been restored to the banking system.

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Shelf Life

I felt my standpoint shaken
in the universal crisis.
But with one step backward taken
I saved myself from going.
A world torn loose went by me.
Then the rain stopped and the blowing.
And the sun came out to dry me.

— Robert Frost, an excerpt from "One Step Backward Taken," Steeple Bush, 1947

Why Monte Carlo?

In May, an article on Monte Carlo simulation by Eleanor Laise appeared in *The Wall Street Journal* and highlighted what some have pointed to as flaws in the simulation process. To be clear, Monte Carlo results are not a certainty. The simulations are a way to gauge a plan's chances of success.

While we generally agree with many of the critiques made, the article did not mention how investors and advisors should determine prudent spending rates and the appropriate asset allocation if they do not use Monte Carlo simulation. Further, we agree with critics, such as Laise, when they argue "the problem isn't Monte Carlo itself, but the assumptions that go into it."

Traditionally, practitioners have used what are known as straight-line estimates of returns to calculate future wealth. Straight-line estimates, by definition, assume no volatility. But in reality, returns vary from year to year. Monte Carlo simulation assumes that returns are volatile.

In a Monte Carlo simulation, annual returns are randomly selected based upon the given statistical parameters of return, volatility and correlation. This process is then repeated thousands of times, allowing one to see the range of possible outcomes. While not a perfect tool, we believe that Monte Carlo is the best way to evaluate issues such as prudent spending rates in retirement, wealth values at retirement and appropriate asset allocations.

Monte Carlo simulation helps determine an investor's portfolio asset allocation and need to take risk. However, it is not a crystal ball that will tell precisely how likely a plan is to succeed or fail. Monte Carlo simulation is an approximation of reality, not a replication of reality.

More Sellers Than Buyers?

By Kenneth R. French

Q. As stock prices were falling, many investors had the sense that people were fleeing the equity market in pursuit of safer alternatives. Does this make sense?

A. In a simple word: no. We know that for every seller, there must have been a buyer. There are no orphan stocks out there. So, if I have people fleeing from the market, there must be other people fleeing into the market. For every seller, there must have been a buyer.

The really interesting question is: What was going on? What we know is at the old prices, there were too many sellers. We had to lower the price to induce other buyers to come in to match the number of sellers.

There's certainly one and probably two different things that were driving prices. The one we know about for sure: future expected cash flows. We are in a recession, future expected cash flows are coming down, that's going to lower price. The price today, that's the present value of those future expected cash flows.

And probably there's a second component to the drop in the price. We know volatility went up enormously. So, essentially risk went up. There's also a sense that risk aversion seems to have gone up as well. If we look back in the data, there's actually more than a hint, there's a pretty strong suggestion that historically in periods like this, expected returns go up. The data aren't powerful enough to prove that it's there, but there's more than a hint that in volatile periods where people tend to be more risk averse, expected returns go up.

But what happens to price when expected returns go up? Remember, the price, that's the discounted value of all those future expected cash flows. The expected cash flows fell, that dropped price. But then on top of that, expected returns, the discount rate, has probably also gone up.

It's as though I said, "In the bond market, interest rates went up. What happened to bond prices?" Same thing in the stock market: expected returns go up, prices go down. Part of the drop in price is to accommodate those higher expected returns. Let me emphasize I'm talking expectations here, there's no promises. In fact, one of the reasons we think the expected return is higher is because there's so much uncertainty.

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About This Commentary: This Q&A appeared in a June 9 video on the Fama/French Forum hosted by Dimensional Fund Advisors. The forum features observations from economists Eugene Fama and Kenneth French. To read more, visit http://www.dimensional.com/famafrench.

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These changes in the capital markets are all signs that the Federal Reserve's program of driving up the opportunity cost of holding cash (by driving short-term rates basically to zero) is working and investor willingness to take risk is being restored. Such changes also serve as an indication of why individuals should not panic when they see the unemployment rate continue to rise. As a reminder of why investors should not focus on the high, rising level of unemployment, consider the following.

Since 1950, the S&P 500 Index has gained, on average, 15 percent per year when the unemployment rate has been higher than 6 percent. However, when unemployment was less than 4.3 percent, the S&P 500 returned just 2.1 percent a year.

To be sure, there are plenty of things to worry about, such as rising budget deficits and the dire financial conditions facing many states. However, the market is already well aware of those facts. Thus, they are already reflected in prices. Finally, while economic data can tell us what has happened, no set of economic numbers can predict with certainty when a recovery will begin, and neither can any forecaster.

This is why Warren Buffett said, "A prediction about the direction of the stock market tells you nothing about where stocks are headed, but a whole lot about the person doing the predicting."

Making Plans

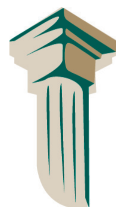
Three Types of Coverage to Look For in a Homeowners Policy
Homeowners with property valued at more than $500,000 can benefit from coverage that more fully protects items and property. Here's an overview of several types of coverage.

Named Peril Versus Broad Form
When personal property is covered on a named peril basis, it is covered only for those causes of loss specifically named in the policy. It is common to see 15 named perils and 18 standard exclusions. The more comprehensive broad form (or all risk) covers personal property such that all causes of loss are covered unless one is specifically excluded.

Actual Cash Value, No Cash Option Versus Full Replacement Cost, Cash Option
With actual cash value, homeowners receive the current value of a replaced item (replacement cost less depreciation). However, they do not receive reimbursement for such items until they provide receipts to their insurance company. In cases of a major loss, it may prove difficult to submit multiple receipts and wait for reimbursement. Full replacement cost — defined as cost to replace an item with a new one — offers reimbursement for an item in the event of a loss, regardless of whether it is replaced.

10% Increase Dwelling Versus Full Replacement Cost Guarantee
Without a home appraisal, an insurance company cannot know the true cost to replace a home. Many contracts state the homeowner is responsible for identifying the correct insurable value of the home and will only pay 10 percent more than the policy's listed coverage amount. With full replacement cost guarantee, an insurance company conducts a home appraisal and agrees to pay the amount necessary to restore a home to its current condition.

Source: Aon St. Louis



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