

# KEYSTONE FINANCIAL PLANNING

## ELECTRONIC NEWSLETTER

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### **Want to retire? Save until it hurts**

The stock market boom of the 1990s did a great disservice to the average retirement investor: it made her feel that big stock returns were the key to retiring in style. From 1990 through 1999, big American stocks grew by an average of 18.2% per year, based on the Standard & Poor's 500 stock index. A \$50,000 investment in the index turned into \$266,000 by the end of the decade.

Unfortunately, American consumers went on a spending and borrowing spree and let their retirement savings contributions slide. Savings rates fell to historic lows. Workers seemed to be saying that since the market was always going to climb so fast, it would make up for their lack of savings.

The most brutal bear market since the Great Depression has given us a big dose of reality. Stocks fell by 49% from early 2000 through the low reached on Oct. 9. Many retirement portfolios were devastated, and some lost even more than the stock market because investors were pouring money into growth stocks that fell even harder than the overall stock market.

Now retirement savers who are within 10 years of leaving their jobs are wondering whether they will ever make up their losses. Some retirees are being forced to return to work and cut expenditures. Will the stock market bail them out? Chances are that it won't. Yes, the market usually recovers strongly from deep bear markets. But there is no guarantee that it will resume a long period of double-digit gains. Historically, the stock market has returned much less than it did in the 1990s, and there have been plenty of extended periods of weak growth or even zero growth.

What's the solution? Boost your savings. Unless you are already independently wealthy or have an incredible pension plan, you should probably be saving at least 10% of your gross income. Gross income means total income before deducting taxes, not what's left in your take-home paycheck. Those who began saving later in life or who were really hurt by the bear market should aim for a 15% saving rate or better.

Of course, this is a daunting task for most of us. How can you suddenly adjust to living on 10% or 15% less income? The answer is to start somewhere and increase your saving rate over time. If you can put away 4% or even just 2% of your income today, begin immediately. Set up an automatic payroll deduction system so that the money is socked away before you can spend it. Using an employer-provided retirement savings plan is the easiest arrangement. If that isn't possible, set up an outside IRA or even a taxable account and have money directly withdrawn from your savings or checking account each month and deposited into the account. Now comes the trick: Every year, or every time you get a pay increase, boost your savings deposit. If you get a 2% raise next year, add half of it to your retirement savings. If you do that every year, it won't take very long to reach a savings rate of 10% or more of your income.

Saving more can make a huge difference in your ultimate wealth. Someone who earns \$75,000 per year, saves 5% of their income a year, and earns a 6% return on investments will have \$138,000 in 20 years. If the same worker saved 15% of his earnings each year, he would have \$414,000 in 20 years.

## **Active managers blow their chance to outperform**

The past several years have given active investment managers plenty of opportunities to show that they can add value to the investment process. Recent studies have shown that individual stocks have become much more volatile than in the past, giving active managers a chance to demonstrate their stock-picking skills by picking winners and avoiding losers. In addition, large up and down movements in the stock market as a whole—from the bull of the late 1990s to the bear of 2000-2002—should also have given active investment managers a great opportunity to beat passive market indexes.

Unfortunately for investors, it hasn't been so. A recent study by Professors Ernest M. Ankrum and Zhuanxin Ding found that during the period from July 1988 through December 2000 individual stocks here and abroad became more volatile than in the past, with wider price swings. Their statistical analysis of this period found that there was no evidence that active mutual fund managers were able to outperform the indexes.

Another study by Standard & Poor's of the period September 1997 through September 2002 came to a similar conclusion. During that period, the S&P 500 Index beat 63% of all actively managed funds. On average, large stock funds lost more during the period than the index did. The S&P Midcap 400 Index beat 93% of funds that invest in midcap stocks, while the S&P Smallcap 600 Index beat 67% of actively managed smallcap funds.

The studies also showed that the risk of active management increased because individual stocks were riskier during recent years. The risks of concentrating in individual stocks were higher because the potential losses were greater.

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