Client's Corner

RETIREMENT INVESTMENT PLANNING:

The Two Fatal Misperceptions

IN 2019, NOT COUNTING DIVIDENDS, THE STANDARD & POOR'S 500-Stock Index—as good a barometer of the general level of stock prices as we have—went up 29%.

Nobody called that "volatile."

Then, in the pandemic year 2020—responding to monetary and fiscal intervention on a historic scale—the Index rose another 16%. Finally, in 2021, the S&P 500 went up ***another*** 27%. Indeed, in the three years from the first trading day of 2019 to the last trading day of 2021, the Index went from 2,507 to 4,766, a total gain of 90%. ***In three years.***

Please believe that—all day every trading day during these three remarkable years—I listened intently for one single utterance of the dreaded "V" word. And heard perfect silence.

Whereupon, in the year just ended—sparked by total economic, political and even geopolitical chaos—the Index finally declined. From its peak on January 3 to a trough (so far) on October 12, the S&P 500 went down 25%. It strengthened slowly and fitfully thereafter, managing to close down "only" 19.4% on the year. (For the record, this was only the tenth of the last 42 years in which the Index closed lower.)

More than "inflation," more even than "recession," the buzzword of the year 2022 was ***"volatility!"***

The narrow inference I would have you take from this admittedly somewhat laborious demonstration is that most people are walking around with a fatally flawed definition of "volatility." Properly used, the word would simply describe the significant randomness of equity returns below ***as well as above*** their long-term trend—which has been compounding at around 10% for close to the last century.

The larger and far more ominous inference is that human nature reacts to declining markets far more emotionally than it does to rising ones. This isn't merely a semantic or even intellectual quibble. It highlights one of the two overwhelming misperceptions that threaten one's ability to make—and stick with—a plan for not running out of money in retirement. Simply stated:

Many investors overreact to the equity market's random—and historically temporary—price declines. They sell their long-term equity holdings at panic prices and end up buying them back—if at all—at much higher prices when the panic subsides.

Again, the issue is not just "volatility" as a misnomer. It's panicking out of the equity investments whose historically increasing dividends might have sustained you through decades of a rising-cost retirement. This, to me, is one half of a conversation you ought to have with your financial advisor as early in this new year as practicable. The question: **Might I be paying far too much attention to random movements in equity prices, and too little to the relative steadiness of equity *dividends* outpacing inflation?** (Remember: it is your dividend income, and not your account statements, you'll be taking to the supermarket in retirement.)

This line of thinking raises the second of the two fatal misperceptions that combine to derail investors' retirement plans. Again stated as simply as possible:

People seriously underestimate how long they're actually going to live in retirement, and therefore how much their cost of living may very well rise over that long retirement.

This phenomenon is often referred to somewhat bizarrely as "longevity risk," but I believe we'd be better advised to think of it as "longevity reality." One or both of a non-smoking couple retiring today may live another three decades. At trendline 3% inflation, it will cost around $2.40 in the thirtieth year of retirement to buy what one dollar buys today. (And remember that inflation at 3% is a number to which we're currently struggling to get back down.)

Just one man's opinion, but I've never found an income source that offset rising living costs as effectively (and effortlessly) as have mainstream equity dividends. Just in the last three decades (1992-2022), for example, when the Consumer Price Index went up 2.2 times, the cash dividend of the S&P 500 increased 5.3 times. If there was a better way to invest so that your actual cash income continually outstripped your actual cash cost of living, I don't know what it was. (Ask your financial advisor to perform this analysis for any three-decade period you choose; I think you'll find the results comparable.)

The best way to have completely missed this was (and remains) fixating on the short- to intermediate-term randomness of equity ***prices.*** (Even at that, the Index went into 1992 around 417 and finished 2022 at 3,840—an increase of over nine times.)

Allowing yourself to fall prey to either of these misconceptions would, I believe, seriously impair your chances to create and maintain an inflation-fighting income in retirement. But both—overreacting to "volatility" ***and*** underestimating how much your cost of living may go up during your retirement—could very well be game over.

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Sources: S&P 500 prices and dividends: Standard & Poor's, NYU Stern School. S&P 500 lower close in only 10 of 42 years: JP Morgan Asset Management's "Guide to the Markets," 12/31/22 edition. CPI inflation: Bureau of Labor Statistics, inflationdata.com.