Tower Bridge Advisors

Independent. Experienced. Client Focused.

Special Report — Investing for Retirement

Now more than ever, individual investors are finding it difficult to manage their investment portfolios. Bond yields are at an all-time low. The US economy is in recovery, but growth is sluggish at best. Taxes are set to increase in January if Congress does not take action. Instability in Europe threatens to impact world markets. Given this economic environment, we felt it would be helpful to outline what we see as the key issues facing people who are saving for retirement or are already retired and trying to maximize the value of the savings that they have amassed over their lifetime.

Here at Tower Bridge Advisors, most of our client assets represent accumulated earnings, inheritance, or the proceeds from the sale of businesses in some combination. Our typical client is wealthier than average and either is already retired or interested in building a nest egg for retirement. Everyone shares three primary goals in some combination. They want to see the value of their investments grow, they want the portfolio to generate cash income to meet current needs, and they want to preserve their asset base. Age, risk tolerance and income needs will help to dictate the mix of assets. Today there is a wide choice of available investment options, a list that keeps growing as Wall Street invents new instruments and derivatives. For the purpose of this this report, we have restricted the focus to three asset classes; stocks, bonds and cash.

Historical Perspective

For many years, cash and bonds served as the foundation for retirees and conservative investors who had built a sufficient pool of assets to meet their present and future income needs. Cash paid 4%, plus or minus while bonds paid a bit more depending on credit rating and duration. A million dollar investment in a pool of cash and fixed income assets could generate cash income of $50,000 or more per year while leaving the corpus intact. The biggest risk was that inflation would erode the purchasing power of these assets over time and, for that reason, it was always prudent to complement a fixed income portfolio with other assets that better withstood the ravages of inflation. Stocks and real estate would be two asset classes that provide some inflation protection in normal times.

But, alas, these times are not normal. Cash returns zero today. Bonds don't yield much more. 10-year Treasuries yield 1.5%. Thus, $1 million invested in a mix of cash and bonds today no longer generates $50,000. It now generates about $10,000. If you are willing to take some degree of credit risk, for instance buying A or BBB rated corporate bonds, you might be able to double or even triple that yield. Similarly, if you were willing to buy 15-30 year bonds you could get more income. But either decision entails taking a level of risk that makes many conservative investors uncomfortable. Understand that the Federal Reserve wants holders of cash to take more risk. In its view, the willingness to take risk is the foundation of future growth. That may or may not be true but the truth of the theory is irrelevant. What is relevant is that one needs more assets today than a decade ago to generate the same income from a fixed income portfolio, even if one is willing to take added risk.

(Chart courtesy of Contrarian Investor)

What to do?

That leaves conservative investors in a bind. They can take added credit risk and hope there isn't another economic meltdown similar to 2008-2009, they can lengthen maturities and hope that bond prices hold steady (i.e. inflation doesn't rear its ugly head), or they can change their asset mix to favor other asset classes that provide more income. Let's look for a minute at some of those asset classes:

1. Common stocks – we mention common stocks here in the context of an income substitute. Only for a brief time in the mid-1950s has the yield on the S&P 500 exceeded the yield on 10-year Treasuries, until today. Now the S&P yield of 2% is about 50 basis points higher than the yield on Treasuries. Indeed, building a blue chip portfolio yielding 3% or more isn't a very difficult task today. In many cases, the dividend yield on a blue chip stock is significantly higher than the yield on a 5-10 year bond issued by the same company even though the dividend is subject to annual increases and the income stream on the bond is fixed. These are not normal times! Stocks are clearly more volatile than bonds in terms of price, making stocks a riskier investment. Twice in the last dozen years we have witnessed a stock market that fell by 40% or more. But for companies that continued to pay or increase their dividends, most of the time the stock price has recovered. Unfortunately that hasn't proven to be 100% true. We saw what happened to bank stocks post-2008.

2. Preferred stocks - Think of these as bonds of infinite maturity. Most have fixed coupons although some have variable rates and some are convertible into common stock. The traditional fixed coupon preferreds generally offer well above average dividend yields but their stock prices are very sensitive to changes in interest rates. Most are not redeemable. Within the category of preferred stocks, there is a small number of floating rate preferreds. Most have their interest payments tied to LIBOR or the prime bank rate which will vary as these rates change. Generally, rates are reset quarterly. In theory, the floating rate nature of the income stream suggests that the principal value might be relatively stable. But preferreds aren't bonds. They entail more risk. Companies can choose to stop paying preferred dividends without risking default or bankruptcy. Many of the floating rate preferreds are issued by banks or other financial organizations that are very leveraged. Thus, the principal tends to move around depending on investor concern about the possibility of earnings evaporating, leading to a possible cessation of preferred dividend payments. In 2008-2009, the principal value of some of these preferreds fell by more than 40% although none missed a payment and the value of most of since recovered.

3. High yield (non-investment grade) bonds - Also known as junk bonds, the name says it all. You get paid more in annual interest and hope that the principal gets repaid when due. This sounds like a huge risk for someone used to buying Treasuries. But the reality is that over time, the added income generated by high yield bonds almost always more than compensates for the increased risk of default. With that said, junk bonds are not for the faint-hearted. Indeed, since your biggest concern is the ability to repay principal, these bonds take on equity-like characteristics. They rise in value in good times when the risk of default is low, and they fall, often sharply, in bad times when fears escalate. In order to diversify risk, most individual junk bond investors buy high yield bond funds managed by sophisticated pros. Many of the most popular funds concentrate on BB and B rated bonds, the best quality within the junk category. In 2008-2009 leading junk bond funds fell by 30-35%. That sounds terrible but it was better than the 45-50% decline in the leading stock indices. In the meantime, the bond funds paid big dividends sometimes exceeding double digit rates. The best time to buy junk bond funds is when fears and yield spreads are highest. At the moment, that isn't the case. These funds, however, still have appeal for income starved investors, if used in moderation, and have continued to do well over the past couple of years.

Conclusion

Trying to pull this all together, investors need to determine for themselves their risk tolerance and the size of the asset pool needed to generate their desired income. The greater the tolerance for risk, the more one can accept the use of bond alternatives in order to generate more income. But clearly, it isn't going to be prudent for anyone to build a portfolio of junk bonds, preferreds and high yielding common stocks. Cash and quality bonds will remain the backbone of a fixed income portfolio. But just as clearly, in a world where government policy and turmoil abroad is forcing interest rates to artificial lows and bond prices to artificial highs, prudent investment strategy would suggest that stocks (all stocks) may be more fairly priced today than bonds or cash. That implies an asset allocation shift away from traditional bond investments toward common stocks or some alternative risk-based income producing asset (e.g. income producing real estate). This shift in asset allocation will be necessary as long as monetary policy forces interest rates (after tax) to remain below the normal and projected level of inflation.

None of the income alternatives mentioned above is necessarily superior to the others. Our firm's preference is to buy a diversified list of very high quality blue-chip stocks of companies with persistently high levels of free cash flow that allows them to raise their dividends every year. There are many companies that have raised dividends every year for a decade or longer that provide current yields well in excess of the S&P 500 index. These stocks go up or down with the mood of the market but they tend to be less volatile than average and the pro-

Conclusion (continued)

tected dividend offers downside support. We like these conservative common stocks for another reason. In a world trying to get rid of too much debt, it is likely that overall growth rates over the next decade are going to be moderate at best. Historically, stocks have returned 8-9% per year through a combination of dividends and price appreciation. Over the next decade it might be more reasonable to presume average returns somewhat lower, perhaps 6-8%. Against that backdrop, quality companies that pay dividends averaging close to 3% that have the ability to increase that dividend by an average of 5% or more per year look rather attractive.

There is no one precise asset allocation that is optimum. It will vary from each individual for all the reasons mentioned previously. Again the keys are:

1. Risk tolerance
2. The size of the total asset pool
3. Annual income needs

Finding the right mix isn't a simple matter and often requires professional assistance. The task is made more complicated by the absence of long term tax policy in the United States. Hopefully, that will be rectified over the next year. The Federal Reserve and Congress didn't mean to rob retirees of their income but that is the consequence of their actions. When the rules of engagement change, one has to adjust. Traditional income vehicles today rarely fulfill one's entire needs. As bond prices continue to fall, the necessity to adjust only increases. Staying in cash and CDs while living off principal is clearly an unsatisfactory solution. Now is the perfect time to review asset allocation both for the near term and the long term.

Selecting an Investment Advisor

Choosing an investment advisor is one of the most important and difficult decisions you will face. You need to be able to trust that person with all of your financial information, and be assured that they will act in your best interests. We feel there are a number of factors you should consider when making this important choice.

Relationship- Is the advisor interested in truly understanding all the details of your financial situation in order to best design an investment strategy that makes sense for you?

Experience- Has this person been through enough economic cycles to have the perspective to make the best decisions for your portfolio?

Knowledge- Does this person have the background and credentials that attest to their expertise in making investment decisions?

Compensation- Is this person compensated by any means other than providing sound advice? Are they paid a commission based on volume of trading or do they receive fees from the products they recommend?

Ongoing Communication- Is your advisor available when you have questions or there is a change in your circumstance? Is your advisor proactive in contacting you on a regular basis to review your portfolio and communicate their strategy?

Given the importance of this decision, we recommend you do a thorough assessment of an investment advisor before you commit to working with them. These basic questions should help you make that assessment.

About Tower Bridge Advisors

At Tower Bridge Advisors we work with our clients to understand every aspect of their financial situation. We start out by understanding a client's needs for income and growth along with their risk tolerance and tax situation. We then create an asset allocation that makes sense for them, and then build a customized portfolio of stocks and bonds to meet their needs. We continually monitor the client's portfolio and frequently discuss any changes in the client's life situation so that we can adjust the portfolio accordingly.

The team of investment professionals at Tower Bridge have, on average, over 25 years' experience analyzing investment options and building client portfolios. Our experience, coupled with our focus on client service make us a great solution for investors who are struggling to manage their finances in these difficult times. As an independent, employee owned firm, we always put the interests of our clients first.

For more information, or to set up a meeting to discuss your investment needs, please contact Nick Filippo at 610-260-2222.