DON'T LET YOUR INVESTMENTS TAKE YOU FOR A RIDE

MEET PHIL

I'd like to introduce you to Phil: Phil is a savvy investor—he knows that when it comes to the stock market, time heals all wounds. He's 74 years old and he has weathered the roller coaster ups and downs of the stock market like a champ.

1987

At 41 years old, he survived Black Monday with little loss because he listened to his advisor's sage advice to stay the course and remember that his investments were part of a long-term strategy.

1999

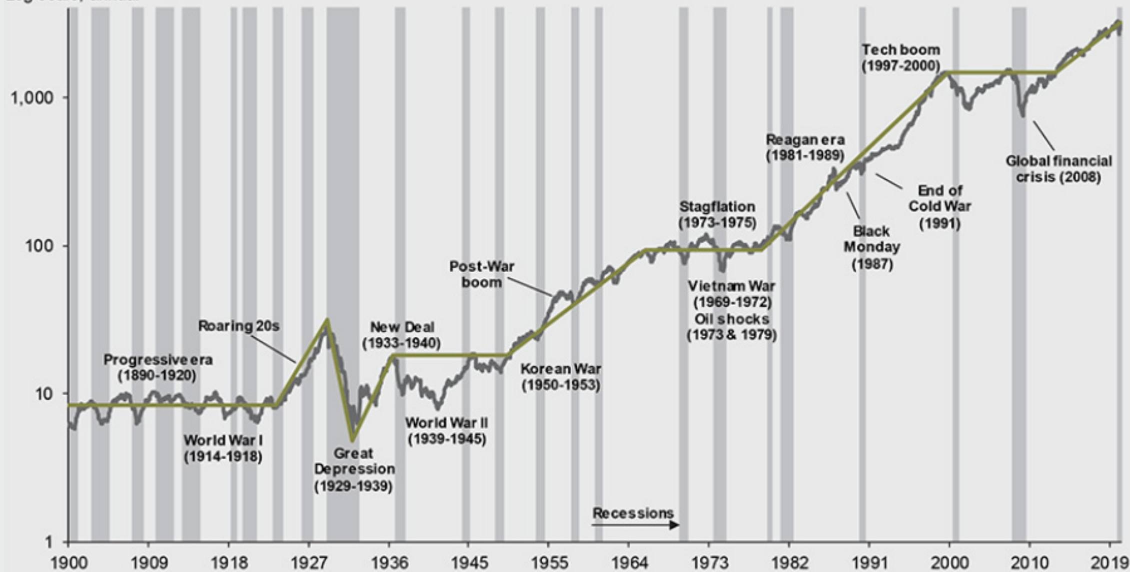
During the dotcom bubble, Phil stayed diversified and didn't panic—hanging on to the few stocks that would go on to become great winners.

2007

In 2007, Phil was 61—four years away from his planned retirement. He's been a great saver all his life and was well-prepared to stop working at age 65. His goal was to retire with $1,000,000 and he was well on his way.

S&P Composite Index
Log scale, annual

Figure 1



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns. Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Guide to the Markets – U.S. Data are as of June 30, 2020.

2008

When the housing market crashed in 2008, Phil once again stayed the course. Although he lost money on some rental properties he purchased in 2006, Phil's primary residence was paid off and he maintained confidence in the stock market's cyclical history. He had faith that his portfolio would recover within a few short years, but decided to work an additional two years to recuperate some the losses that he'd suffered.

2013

When Phil turned 67 in 2013, the market had recovered well, and Phil was confident and ready to retire with the $1 million that he had planned. With the help of his trusted financial advisor, he began taking income from his portfolio gains.

PHIL'S INVESTMENT PLAN

In so many ways, Phil is an ideal client. He plays the long game, he doesn't panic during market dips, and he's willing to take some risks for better returns. There is however, one significant short sight in Phil's investment strategy: **his objective doesn't evolve with his time horizon.**

You see, when Phil survived Black Monday he was still working. Although he suffered some losses in his portfolio, his income was tied to his employment, not his investments. In other words, he had plenty of time to wait for the market to recover before he would need to withdraw funds from his portfolio.

Even in 2008, while he was nearing retirement, he still wasn't dependent on his portfolio for income. Since he didn't have as much time for recovery (as he did after Black Monday), he made an adjustment to his retirement strategy by working an additional two years to make up for the losses that he suffered.

Phil took this flexibility for granted after his retirement, continuing to take risks in favor of higher returns. His strategy was further validated by a historical ten-year bull run after the 2008 crisis recovery. For ten years his stock rose very consistently with only short-lived market dips. This situation gave Phil a misplaced confidence in his portfolio gains.

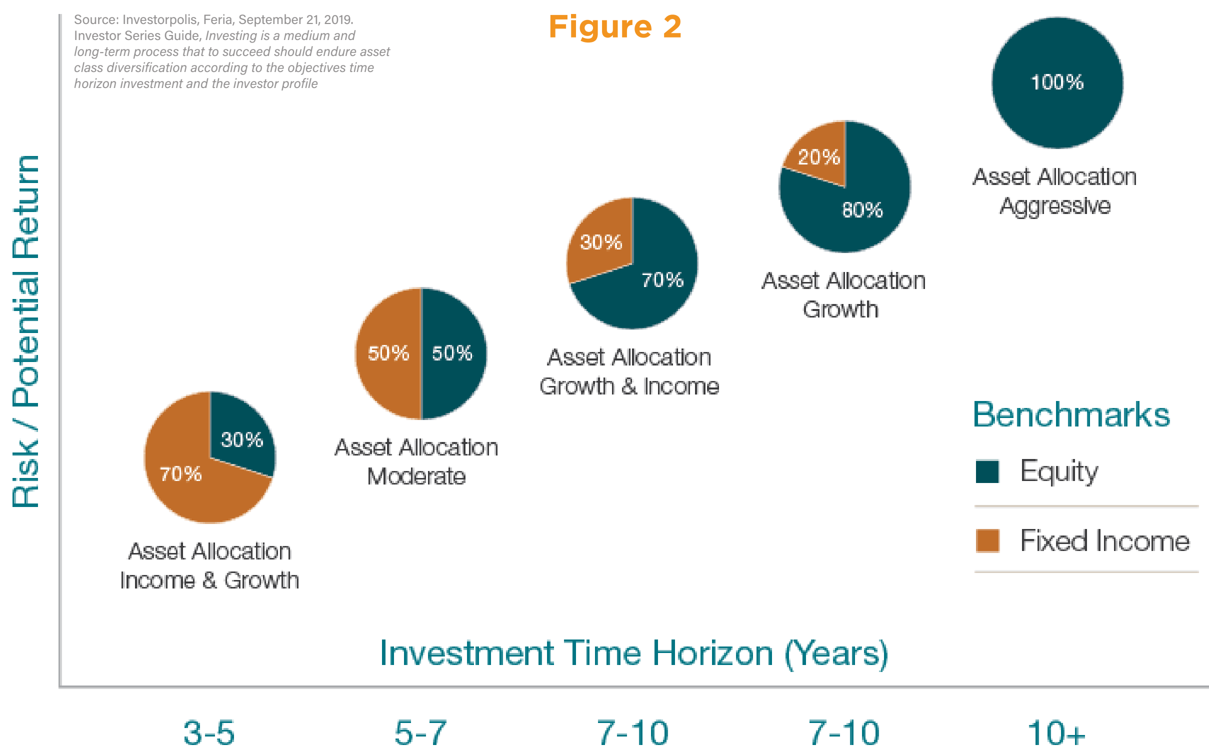
Now, at 74 years old, Phil is living through a global pandemic and lost over $200,000 from his portfolio in the first quarter of 2020. And although the market's recovery may be inevitable, it'll also be eventual. Without any gains, Phil doesn't take any income for those three months and must make significant cuts to his spending and lifestyle.

2020

TIME HORIZON AND ASSET ALLOCATION

A strong portfolio must account for the amount of time before an investor will need access to the funds; this is called an investor's **time horizon**. As seen in Figure 2, an investor with a shorter time horizon should have allocation that's concentrated on income, while an investor with a longer time horizon should have an allocation more focused on growth. There are a few reasons for this:

- **Market recovery time:** Since the stock market has historically recovered from losses, an investor with a longer time horizon can focus on growth because they'll ultimately have time for the market to recuperate before they need the funds.
- **Retirement funding:** Retirees generally depend on their investments to fund their retirement and provide income. Fixed income products allow retirees to take funds regularly without the risk of market downside.
- **Capital preservation:** While most retirement plans account for regular expenditures, many don't account for emergencies or other isolated expenditures. Fixed income products allow investors to take income while preserving their capital for future use or to leave to their heirs.
- **Liquidity**: Retirees' "long-term plans" are far shorter than a younger investor's. A middle-aged investor, for example, may be saving for a child's college expenses (15-20 years away) and their retirement (25-30 years away). Meanwhile, retirees are generally looking to fund medical expenses, travel, and other pursuits that fall within a five- to ten-year span. This means that their investments shouldn't be tied up for decades to come (such as a growth-oriented stock that's expected to see its greatest returns after ten or more years).



GROWTH VS. INCOME

Many investors (like Phil) prefer to take income from their portfolio's growth, rather than from a fixed income product. In theory, taking income from one's portfolio growth sounds great, but in practice, it's a flawed approach. Growth and income are two very different investment objectives and growth alone isn't a sustainable vehicle for income. The reason is simple: the market goes up and down, and growth depends on it going up, and up alone.

By chance, Phil was able to rely on the growth of his portfolio for the first seven years of his retirement, due to a steady (but still unpredictable) bull market.

ACCUMULATION PHASE VS. DISTRIBUTION PHASE

While many investors understand the market and its history very well, not all investors account for the fact that the human lifespan has no regard for market cycles. One must consider their personal time horizon: when they'll need access to the funds, and how often.

The accumulation phase refers to the years when a person is earning money and continues to accumulate their wealth. For example, on Black Monday, Phil was comfortably in his accumulation phase. This phase prepares investors for the distribution phase, which refers to the years when an investor relies on their accumulated wealth to live. During the 2008 housing crash, Phil was only a few years away from the distribution phase. During the COVID-19 pandemic, he was emphatically in the distribution phase.

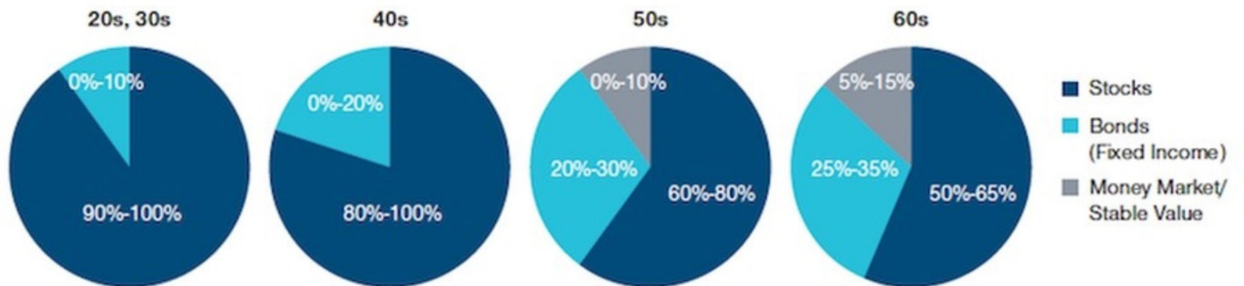
An IRA or a 401(k) is a very basic (and essential) example of how these phases work for most investors: putting aside money while you're still working, to build a "nest egg" for your future.

WHY ARE SO MANY INVESTORS MISSING INCOME?

Asset allocation models have historically used bonds for the fixed income portion of an investor's portfolio. Figure 3 shows asset allocation models that are used widely throughout the financial and wealth manangement industry.

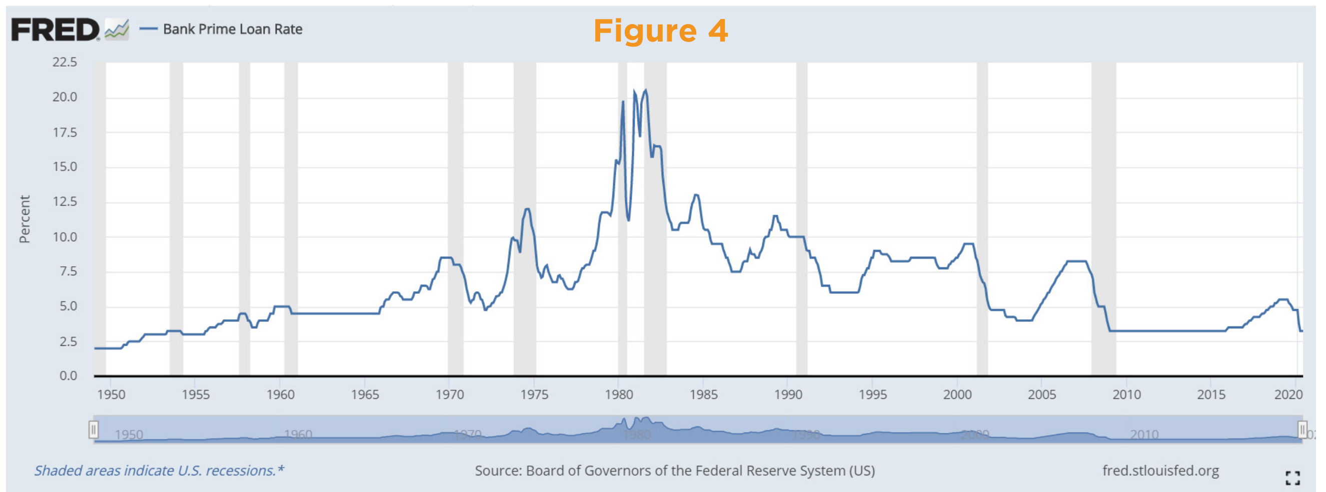
Figure 3

Model Asset Allocations By Age



Source: T. RowePrice, Judith Ward, January 13th, 2020. Four Moves to Make Before a Market Downturn

However, with recent falling interest rates, as shown in Figure 4, bonds haven't been nearly as lucrative as they were when many of these allocation models were developed. At the height of the bond market in the early 1980s, bonds were paying around 20%, while today, the average rate is around 2.5%. This has left many investors frustrated and underwhelmed by their "fixed income" returns and many have all but eliminated bonds from their portfolio, leaving them vulnerable and undiversified.



LACK OF PRINCIPAL

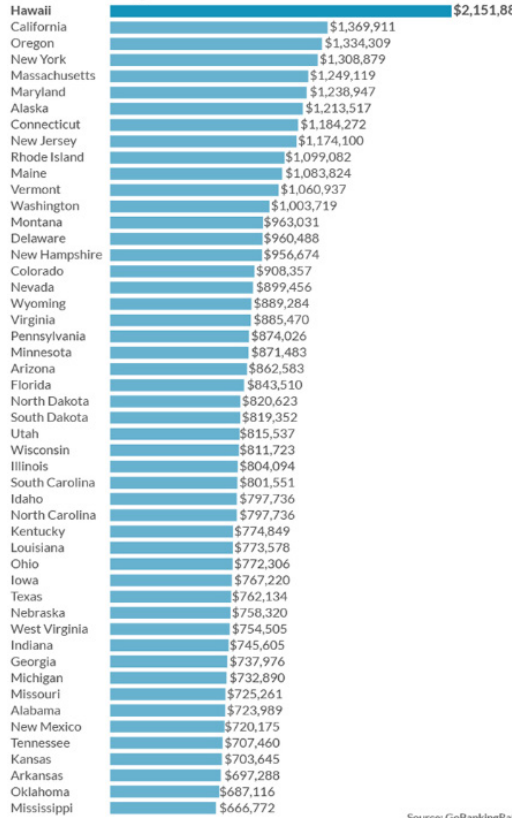
A decline in interest rates depriving retirees from the income they need is compounded by another issue sweeping the nation: most Americans have saved far less than they need for retirement. This makes a holistic and balanced portfolio all the more vital.

As demonstrated in Figure 5, the average cost of retirement in the United States ranges from state to state. The lowest average being $666,772 (to retire in Mississippi) and the highest average at a whopping $2.1 million (to retire in Hawaii).

Upon comparing these numbers to those in Figure 6, which shows how much the average American has saved for retirement, it's clear that most aren't fiscally prepared to retire, Therefore, an incomplete portfolio that's entirely dependent on the whims of the market furthers the already risky financial situation that most retirees are faced with.

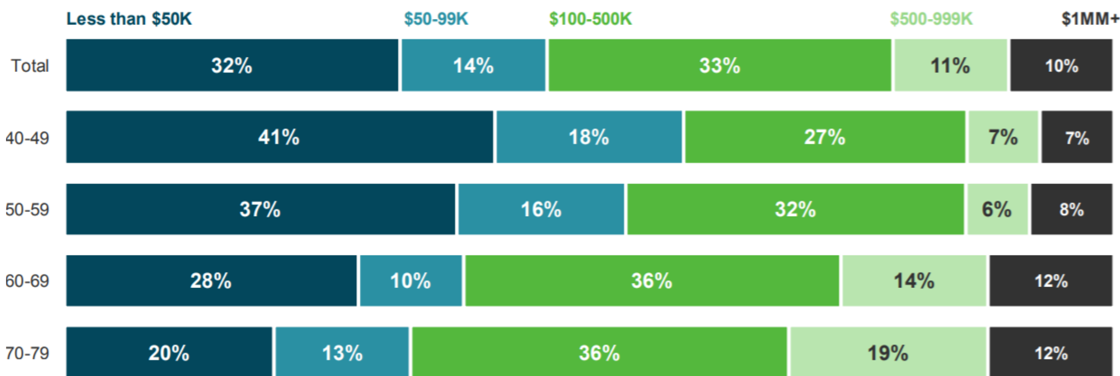
Figure 5

How much you'll need in each state to retire



How much do you currently have saved for retirement?

Figure 6



Source: The Harris Poll on behalf of TD Ameritrade n = 2000

GROWTH “HEDGING” STRATEGIES

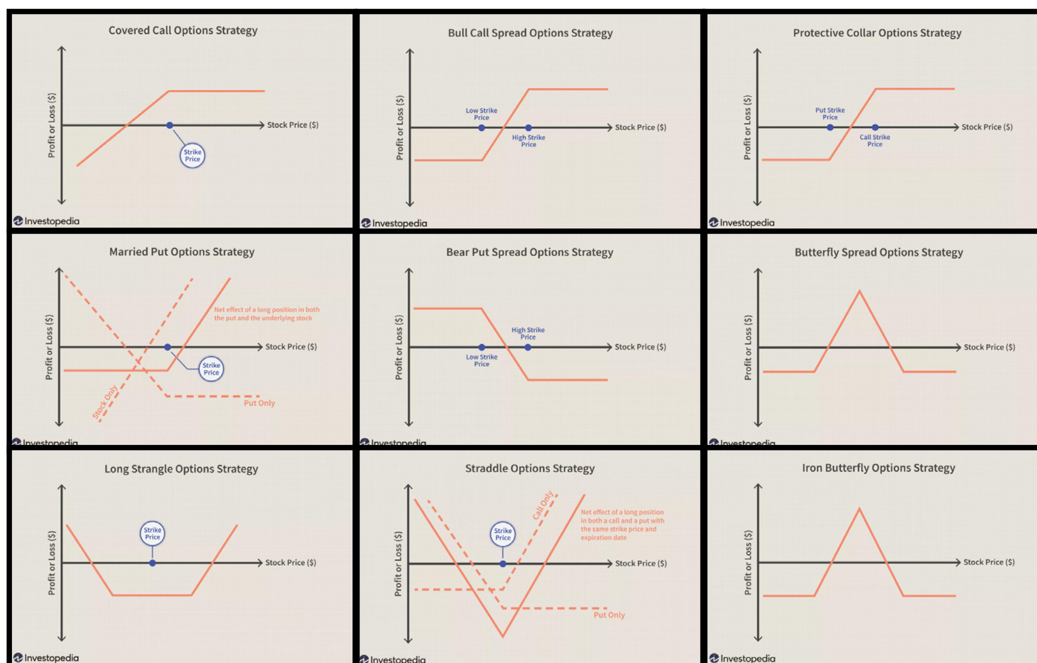
Without any bonds in their portfolio, some of the more aggressive (growth-oriented) investors have turned to option strategies to hedge their portfolios. While option strategies can offer many benefits, they’re far more complicated than most investors (and even many financial professionals) realize. Some of these strategies will cost the investor a premium, while others have unlimited loss potential and may limit the upside opportunity of equity investments.

Aside from needing to understand the strike price, risk potential, tax implications, the expiration, and the rights or obligations you have in your options agreement, you also need to understand how to apply and combine these strategies in such a way that mitigates loss potential without giving up too much upside in the market. Make no mistake, this is a full-time commitment to do properly and requires much research and attention.

One must also remember that while these strategies (when used intentionally and intelligently) can act as a hedge, they don’t necessarily provide income. Much like equity investing, the risk and timing of options is heavily dependent on the market and better suited for an investor with more time to recuperate losses.

Executing options as a hedging strategy is both complicated and risky. Figure 7 shows only a few of the strategies that options traders may utilize. There are many more, and further, many ways to combine them. Unfortunately, for investors who aren’t well-versed in options trading, this can be a time-consuming and unfruitful experiment.

Figure 7



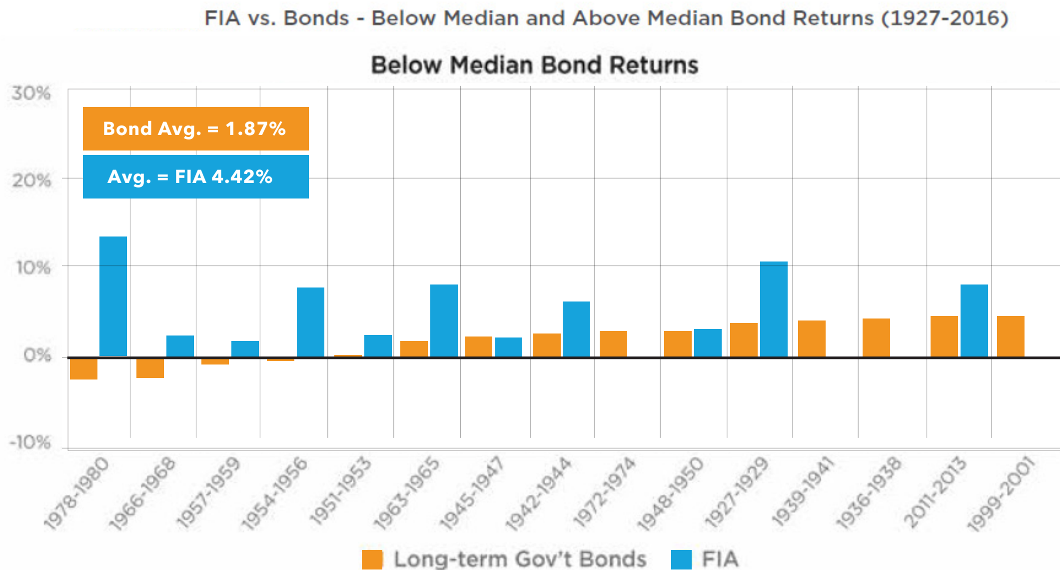
Source: Investopedia, Lucas Downey, May 29, 2020. Options & Derivatives, Options Trading Strategy and Education, *10 Options Strategies To Know*

USING ANNUITIES FOR GROWTH-ORIENTED INVESTORS

Many investors and financial professionals think of annuities as solely an alternative investment for a risk-averse clientele that simply cannot stomach market losses. The reality is, that while annuities are a great option for risk-averse clients, they also prove an excellent tool for growth-oriented investors, allowing them to diversify their portfolio and provide guaranteed income.

Particularly in a low interest-rate economy, annuities provide a far more lucrative income option compared to bonds. As shown in Figure 8, a fixed Indexed annuity (FIA) not only has far greater returns than long-term government bonds over time, but also offers far greater protection from downside risks.

Figure 8



Source: 2017 SBBI Yearbook, Roger G. Ibbotson, Duff & Phelps; Zebra Capital; AnnGen Development, LLC

Guaranteed income is an important part of any diversified portfolio, but especially for investors that are in (or close to entering) the distribution phase of their life. Guaranteed products, such as annuities, allow investors to take advantage of market gains without the great potential for loss while creating greater flexibility in the growth portion their portfolio. For example, an investor like Phil, who was cashing out his gains to create income, could've instead re-invested those gains and continue to capitalize in a bull market while relying on income from his annuity. Alternately, in a bear market, Phil wouldn't have to lose income, or worse, liquidate stocks while they're in decline.

Many investors believe that investing is all about weathering the ups and downs of the market, waiting only a matter of time to come back out on top. And while this strategy has historically been true over the long-term, the intermittent economic slowdowns can have a disastrous effect on one's investment plan, especially for those in or nearing retirement.

After a ten-year bull run, it can be easy to forget that the most integral part of investing is looking at the big picture and knowing that your investments are on the right track, suited to your particular needs and phase of life.

100 Oakridge Drive
Stafford, VA 22556

(540) 720-5656

www.ilgfinancial.com

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