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Polaris Educational Series

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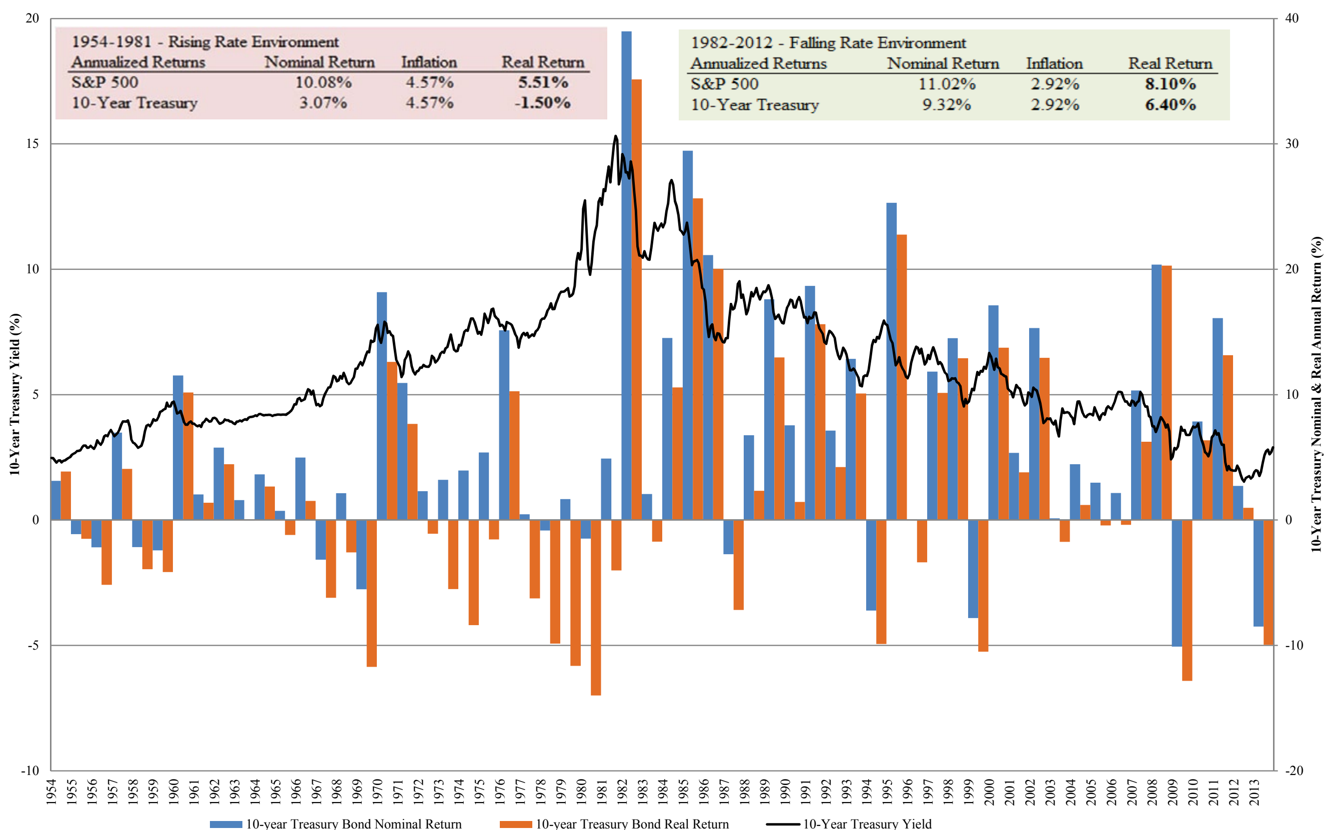
What is Risk?

Real Returns in a Rising Interest Rate Environment Part II

Last year I wrote about the effects of rising interest rates on traditional asset allocation models. In our **March educational e-mail**, we discussed how an equally weighted portfolio in stocks and the 10-year Treasury note would have fared during a rising interest rate environment (from 1954 through 1981) versus a declining interest rate environment (1982 through 2012).

In this write-up, we discussed how a 50/50 stock to bond ratio during the rising interest rate environment netted an investor a meager 2.01% net of inflation return. In contrast, the same allocation would have given them a 7.25% return in a falling interest rate environment. Below you will find the same chart and returns found in our March 2014 write-up.

Real Returns in Rising Rate vs. Falling Rate Environments 1954-2013



1954-1981 - Rising Rate Environment

Annualized Returns	Nominal Return	Inflation	Real Return
S&P 500	10.08%	4.57%	**5.51%**
10-Year Treasury	3.07%	4.57%	**-1.50%**

1982-2012 - Falling Rate Environment

Annualized Returns	Nominal Return	Inflation	Real Return
S&P 500	11.02%	2.92%	**8.10%**
10-Year Treasury	9.32%	2.92%	**6.40%**

Sources: Polaris Wealth Advisers, Standard & Poor's, Morningstar. Data for the 10-year Treasury Yield were provided by the St. Louis Federal Reserve. Returns above are annualized total returns, which include reinvestment of dividends. Inflation data was calculated using information provided by the Bureau of Labor Statistics. Real returns are expressed as the nominal return minus the inflation rate for the periods provided. All information contained in this presentation is considered to be accurate but cannot be guaranteed for its accuracy. Thus, all information contained herein is provided "as is" and without warranty of any kind, either expressed or implied. Investments are subject to risk. Past performance is not indicative of future returns. Data are as of 12/31/13

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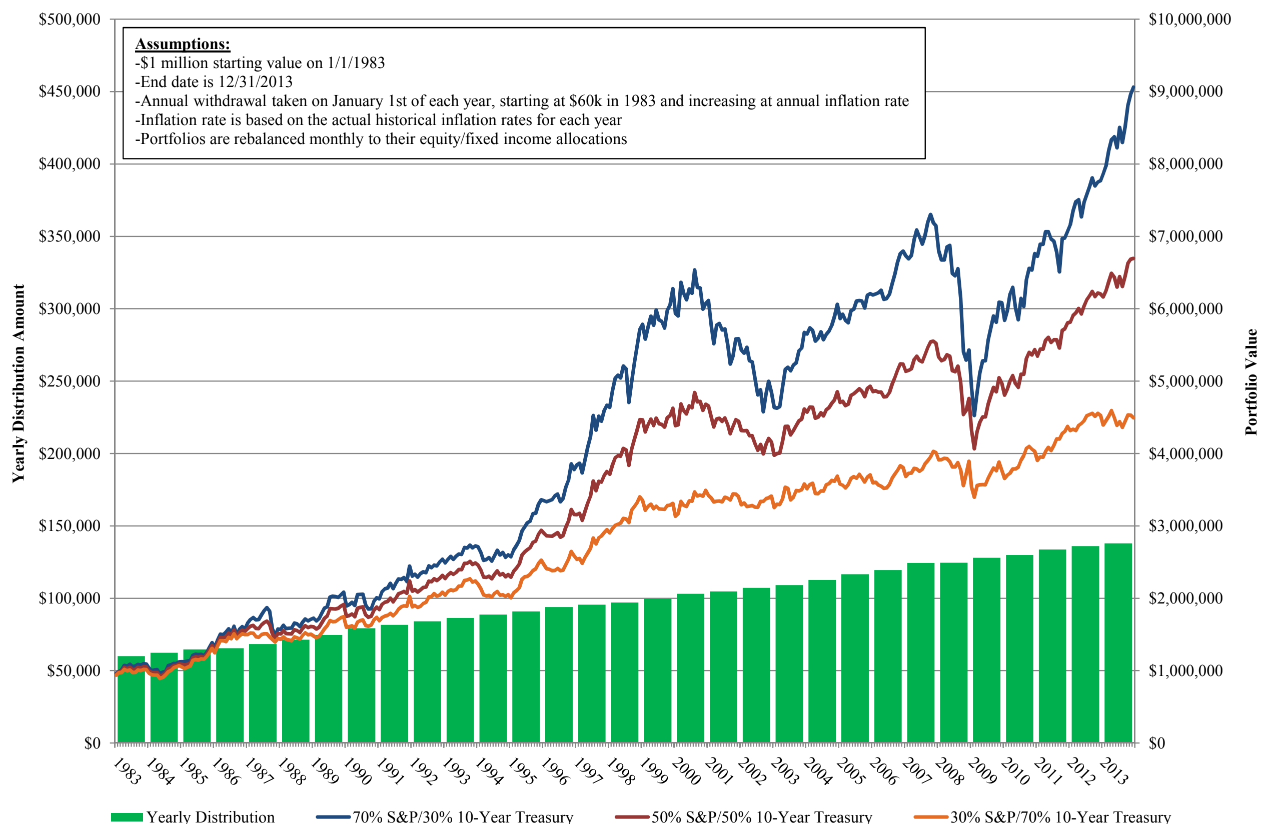
Clients found the educational piece to be very strong, so I decided to take our study one step further and apply the real returns that occurred to a hypothetical retiree's portfolio. We assumed our retired investor had a $1 million portfolio and needed to withdraw $60,000 per year from their portfolio. We increased their withdrawal each subsequent year to account for inflation.

We envisioned two different scenarios: one with our retiree beginning retirement in 1982, at the beginning of a declining interest rate environment, and the other with retirement beginning in 1954, in a rising interest rate environment. We ran three different portfolios against the real results of the market using an aggressive portfolio (70% stocks & 30% bonds), a moderate portfolio (50% stocks & 50% bonds) and a conservative portfolio (30% stocks & 70% bonds). None of our studies took into consideration any of Polaris' dynamic investment techniques. Each portfolio was rebalanced monthly back to its original stock to bond ratio.

In the declining interest rate environment, all three allocations did very well (as we expected) for our retiree. The "aggressive" 70/30 allocation not only provided our retiree with their needed income, but they finished 30 years later with over $9 million. Even the most conservative portfolio (with a 30/70 stock to bond ratio) provided the needed income and finished with approximately $4.5 million in total assets. You can see this in the chart below.

Growth of $1mm in a Falling Interest Rate Environment 1983-2013



Sources: Polaris Wealth Advisers, Standard & Poor's, Morningstar. Data for the 10-year Treasury Yield were provided by the St. Louis Federal Reserve. Returns above are generated from annualized total returns, which include reinvestment of dividends. Inflation data was calculated using information provided by the Bureau of Labor Statistics. Portfolios are rebalanced on a monthly basis back to their equity/fixed income allocation targets. All information contained in this presentation is considered to be accurate but cannot be guaranteed for its accuracy. Thus, all information contained herein is provided "as is" and without warranty of any kind, either expressed or implied. Investments are subject to risk. Past performance is not indicative of future returns. Data are as of 12/31/13

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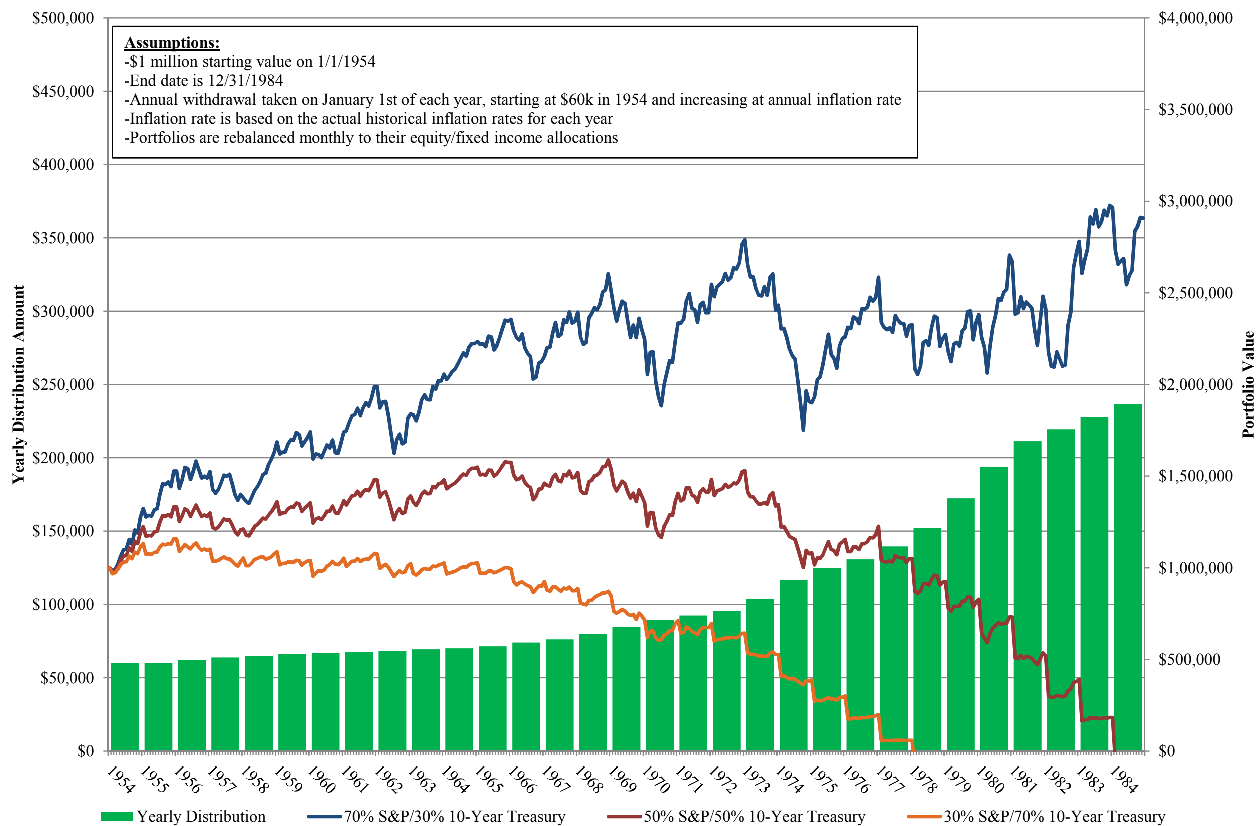
Our retiree did not fare as well in the rising interest rate environment. Had our retiree chosen a conservative portfolio (30% stocks / 70% bonds) their funds would have been depleted in just 24 years. Even if our retiree had chosen the moderate portfolio (50% stocks / 50% bonds) they would have run out of money in 29 years. Only the aggressive portfolio (70% stocks / 30% bonds) was able to provide the income needs of the investor while outpacing inflation. Even with the higher stock allocation, the aggressive portfolio investor finished with just under $3 million in their portfolio.

Growth of $1mm in Rising Interest Rate Environment 1954-1984



Sources: Polaris Wealth Advisers, Standard & Poor's, Morningstar. Data for the 10-year Treasury Yield were provided by the St. Louis Federal Reserve. Returns above are generated from annualized total returns, which include reinvestment of dividends. Inflation data was calculated using information provided by the Bureau of Labor Statistics. Portfolios are rebalanced on a monthly basis back to their equity/fixed income allocation targets. All information contained in this presentation is considered to be accurate but cannot be guaranteed for its accuracy. Thus, all information contained herein is provided "as is" and without warranty of any kind, either expressed or implied. Investments are subject to risk. Past performance is not indicative of future returns. Data are as of 12/31/13

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Conclusion

This raises the question once again, "What is risk?" Is risk a one or two year drop in the stock market, or is it a multi-decade erosion of buying power in which the investor runs the real risk of running out of money during retirement?

While I don't think that our country will experience the inflation seen in the late 70s and early 80s, I believe traditional allocation mixes are broken. At the very least it begs the question, "Have you properly allocated funds for retirement?"

To reiterate my March 2014 educational e-mail, I strongly encourage you to consider the overwhelming evidence that bond yields may remain low for an extended time period into the future. When rates do start to rise, there will be a negative impact on bond prices and on the total return you may receive in your portfolio (please revisit **"The Risk of Investing in Bonds,"** March 2013).

I recommend that you work with your Polaris Advisor to assess whether your current bond allocation is still appropriate for you. Your advisor can help you consider strategies that align with your goals and objectives while diversifying risk. Keep in mind that if an investor is going to increase their stock exposure, I discourage a "buy and hold" strategy (a.k.a. "set it and forget it"). As you know, Polaris manages money in a dynamic manner. We lower your exposure to the stock market when we feel that risk outweighs possible future returns. And while no one can predict future market conditions, we hope to repeat our past successes of protecting our clients from the full downside of the stock market.

To review our strategies and techniques, please call your Polaris Advisor.

As always, I look forward to your comments and questions.

Sincerely,

Jeffrey J. Powell
Managing Partner

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