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Client Newsletter

Whale-Sized Losses

The Real Lesson Behind JP Morgan's Missing $2 billion

Article Courtesy of Bob Veres, Inside Information

Large investment banks and brokerage firms are in the news again, with word that J.P. Morgan Chase suffered a $2 billion loss while trading for its own investment portfolio. If you're inclined to be amused by such things, word had apparently leaked out weeks before the losses were spotted that a mysterious individual dubbed "The London Whale"--who we now know is Bruno Michel Iksil--was taking strangely large positions in credit default swaps linked to corporate bonds. Other traders reported the unusual market activities to the Wall Street Journal, and four days after the article was published, on April 14, J.P. Morgan executives stepped in and stopped the trading activity.

The story prompted some to speculate that the firm's crack risk management department stayed diligently on top of the firm's speculative trading activities by carefully reading the newspaper.

But the lesson that was lost, amid the calls for new regulation and pronouncements that banks were too big to fail and too reliant on bailouts, is that once again a large brokerage firm was making huge bets and also advising customers on their investments. When a large institution trades into and out of the markets for its own profit, it sets up the most basic conflict of interest in its dealings with the investors who are receiving the advice of its brokers. If the firm made the mistake of investing in a dog stock that isn't likely to go up in value, or if the research department determines that a certain company whose stock the firm owns is about to report unfavorable news or deteriorating financials, then the brokers are told that what the company wants to unload is a wonderful "investment opportunity" for their customers.

Some resist acting on these blatant attacks on their customers, but--as evidenced by the actual volume of trading for the brokerage community's own accounts--many do not. It's a little like the real estate broker who spots a nice piece of property selling at a terrific bargain. Is he more likely to call his customers, or find a way to buy the property for himself?

Fortunately, registered investment advisors with the Securities and Exchange Commission--unlike brokerage firms--are strictly prohibited from these kinds of conflicts, and we embrace that position. It genuinely would not occur to most financial planning professionals to bet against clients or try to sell you something that we wanted to get rid of in our own portfolio, not because the regulators might find out, but because it is visibly the wrong way to serve the public and the community.

When the 2008 meltdown swept through the financial world, former Federal Reserve

Chairman Paul Volker proposed that brokerage firms and lending institutions be banned from trading in their own accounts, and the so-called "Volker Rule" bounced around Congress for a full year. Industry lobbyists finally convinced our elected representatives that it was a very bad idea to force brokers to stop speculating in exotic securities and simply give good investment advice to their customers, or to require banks to lend their money to businesses and consumers instead of making wild bets with it. What we didn't realize then, what J.P. Morgan's London Whale may have taught us, is that the consumer protections proposed in the Volker Rule might also be a great way to keep these large organizations solvent.

The London Whale: http://www.ritholtz.com/blog/2012/05/understanding-j-p-morgans-loss-and-why-more-might-be-coming/?utm_source=dlvr.it&utm_medium=twitter

Safe Savings Rates

Article Courtesy of Bob Veres, Inside Information

Here's a deceptively simple question: how much of your income should you save during your working years if you want to enjoy a comfortable retirement?

To answer the question definitively, you have to know how long you'll be working (and saving), how long you'll live in retirement, and what the investment returns will be both during the accumulation period and also throughout your retirement years.

Wade Pfau, a researcher who is currently director of macroeconomic policy program at the National Graduate Institute for Policy Studies (based in Tokyo, Japan), conducted an interesting study that tries to help us sort out the possibilities. To start with, Pfau assumed that a hypothetical person (let's call him Fred) would work for 30 years at a salary that goes up with the inflation rate, and then retire for 30 years. Each year, Fred would save the same percentage of his salary. Pfau also assumed that Fred would need 50% of his final year's income--on top of Social Security and any pension resources--to pay for retirement living expenses out of his portfolio.

In the first year of retirement, Fred would draw out 4% of his portfolio. After that, to maintain buying power, he would take out ever-higher amounts based on the inflation rate in each of the subsequent 29 years. For the entire 60 years, Fred's money is invested in an unsophisticated (but easy to calculate) portfolio consisting of 60% stocks and 40% bonds with a six-month maturity.

Then Pfau considered what would have happened for every rolling 60-year period from 1871 to the present and, looking backwards, calculated the percentage that Fred would have had to save to reach his goal.

The results? Pfau found that if Fred struggled to save and accumulate during a relentless bear market, he would often have a better-than-average chance of catching a bull market in retirement, and vice versa. The highest required yearly savings rate when he took into account the full 60 year period came to 16.62% for the unlucky person who entered the workforce in 1918. The more normal scenarios require Fred to save anywhere from 12% to 15% a year.

Of course, people who delay setting aside retirement money to later in life--if, for example, they start saving in their 40s and expect to retire at age 60--will see this savings percentage go up accordingly. Toward the end of his research report, Pfau discovered that if Fred only saved for 20 years, and expected a 30-year retirement, he should be prepared to set aside at least 30% of his annual income during this truncated savings period. On the other hand, if Fred set aside money for 40 years, his minimum savings rate drops dramatically, to between 6% and 14% percent.

It is important to recognize that this is a model, not a prediction of what will happen in the future. We don't know what future returns will be, either while people are putting money aside or during their golden years. Beyond that, we know that some people will spend more in their retirement years than their pre-retirement income, simply because they have more free time to enjoy.

Each person, and each sequence of years, is different, and requires more precise individual planning than any researcher can do in a broad study. But this study offers us a pretty good look at how the different variables can play out in the long lifespans we are enjoying today, a window into how easy, or hard, it can be to save for the third stage of our lives.

Article link: http://www.fpanet.org/journal/CurrentIssue/TableofContents/SafeSavingsRates/

All of us at Demming Financial Services Corp. would like to wish you a safe & happy summer!

Pictured from left to right. Top left: Sandy, Karen, Dave Sr., Dave Jr., Dorothy & Brenda.
Bottom left: Patrick, Rose Ann, Ann & Kathy.

As a friendly reminder, please send a copy of your 2011 tax returns if you have not already done so. You may email your returns to info@demmingfinancial.com, fax to #330.562.6086 or send by mail.

Dear Clients,

As we cross mid-year 2012, the U.S. economy grew modestly with confirmed 1.9% GDP growth in the first quarter. The capital markets have responded to this tepid growth with continued volatility. Volatility has two faces, up and down, and surprisingly we find the S&P 500 index up 8.31% year-to-date as the second quarter comes to an end. After a robust first quarter, the 2nd quarter brought domestic markets back down to earth posting modest losses of less than 4%. Headlines continue to be quite pessimistic, even though the economy has been showing gradual, but nonetheless non-dramatic, improvement over the past six months.

With Europe and parts of Asia slowing, foreign equities performed poorly until the very end of the quarter. Internationally, the broad-based EAFE index of developed economies fell 8.37% for the quarter despite a 6.79% gain in June. For the year, the index is up a scant 0.77%. Not surprisingly, the weakest component is EAFE's Europe index, down 9.11% for the second quarter, down 0.12% so far this year.

Although the environment does not look especially cheap versus three years ago, it is precisely during these periods where, when one looks back in time, we find that fertile ground for above-average returns may continue for quite some time. The statistical event called regression to the mean remains a dominant theme as we continue to recover from the scars of the financial crisis.

Looking back five years ago, we were at the end of an economic cycle that had been healthy, but modest by historical standards. By the second half of 2007, we hit the high-water mark prior to the fall from grace and the onset of the Great Recession. This is the first time in our career, which spans almost 35 years, that we have seen the S&P 500 flat over a five year period. When one looks back from July 2007 to the present, the primary commodity lost is simply time. For individuals in accumulation mode, this is not particularly stressful, but at the same time, there doesn't seem to be any kind of immediate reward. Statistically, it's been improbable that one could not see positive returns over a five-year period. We been conditioned for so many years to see declines for one- or two-year periods, but for rolling five- or ten-year periods we've expected to achieve higher returns by historic standards. In hindsight, we had above-average equity returns in the '80s that followed the dramatic declines of the '70s, above-average rewards in the '90s, and then dramatically below-average rewards in the 2000s.

Interestingly enough, when one looks back over rolling ten-year periods, particularly with a well diversified portfolio, we still continued to see reasonable returns – somewhere in the nominal 8% to 9% range per year. Returns over the last five years of this most recent rolling ten year period were essentially flat. This means an important component of returns over the past decade was to avoid irreparable declines during a period of catastrophic performance. Conversely, one had to participate in the initial recovery from the technology bubble and previous recession. A diversified portfolio allowed for modest but healthy returns during the overall ten year period.

It's with this knowledge that we look forward, even though there is plenty of pessimism both domestic and overseas. A key predictor of return is price. When prices are reasonable or low, then rewards should be, not necessarily will be, above average. History reminds us that we've seen these events before – and we speculate that's a product of age and service. As we look ahead and focus on the next five years, we would be surprised if we didn't enter a period that was significantly better than the last five. Only time will tell.

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ADDRESS CORRECTION REQUESTED