EFFICIENT WEALTH MANAGEMENT®
Intelligent Investing with Integrity

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Five Years from the Brink

It has been five years since the collapse of investment bank Lehman Brothers Holdings, a shock point in an era that saw the takeover or shutdown of many household-name financial institutions and the meltdown of the stock and housing markets.

Many investors remain confused about what they should take away from those tumultuous years. The financial crisis taught some basic lessons that could help investors navigate the post-crisis landscape and put themselves in a stronger position if the fears of a repeat are justified.

1. *Don't panic.*

Getting out of stocks on March 9, 2009—the day the S&P 500 closed 57% below its peak—might have seemed smart. There was no way to know the index was about to begin a rebound that has continued more or less to the present.

But the forgone gains could have been profound. If an investor had moved $100,000 into bonds that day, it would be worth $124,033, based on the total return of the Barclays U.S. Aggregate Bond Index through the five year anniversary, according to investment researcher Morningstar.

By contrast, an investor who put $100,000 into a portfolio comprised of 60% stocks and 40% bonds and left it alone would now have $214,080, based on the total returns of the S&P 500 and the Barclays bond index, over the same period.

2. *Retirement timing matters.*

For some time now, we've focused on what is called "sequence risk"—the danger that big losses early in retirement can upset your plan to live off your investments.

What can you do to hedge sequence risk? I recommend retired clients utilize our Cash Bucket to cover at least a year's worth of basic expenses. If necessary, be ready to adjust your withdrawal rate. The most common strategy for adjusting a withdrawal after you take a hit: forgoing a cost-of-living raise.

3. *Harvest your losses*

There is a bright side for investors who suffered losses in their taxable accounts: Losses on the sale of a holding can offset other capital gains, or they can shelter ordinary income up to $3,000 a year, or both. Losses larger than that amount roll forward for future use—with no time limit.

The strategy known as "loss harvesting" refers to selling an investment that has dropped in value, realizing a loss and repurchasing the holding soon after. The 2008 market drop provided an excellent opportunity for loss harvesting, given the near 40% decline for the year.

4. Home prices don't always go up.

Before the housing crash, many buyers didn't think twice about paying inflated prices or taking out second mortgages to fund everything from home improvements to lavish vacations.

Then home values tumbled by one-third or more, leaving millions of Americans "underwater," or owing more on their homes than they were worth. Some homeowners, feeling they could never recover, walked away. Others sold their homes for less than they owed on their mortgages.

5. Don't invest in what you don't understand.

Credit default swaps. Option adjustable-rate mortgages. Collateralized debt obligations. The products that did the most damage to investors during the financial crisis were often the most complex ones.

There still are many financial instruments that are difficult to understand and companies whose balance sheets could contain hidden traps. Many of these instruments are being sold as high yield investments. Investors should have a simple response when a product seems too complex: Run far and run fast!.

There is evidence some investors are doing the opposite. They have plowed billions of dollars into funds that invest in complex instruments such as master limited partnerships and floating-rate loans, which can contain risks that average investors might not fully comprehend.

In Conclusion: Don’t fight the last war.

The financial plumbing of the U.S. banking system has been changed substantially. The risks faced in 2007 are far different from those faced today. While we worry about market volatility, chronically low bond returns are creating mayhem with conservative investors’ retirement plans.

One is left with a difficult conundrum: Seemingly safe bonds are arguably riskier investments than unloved stocks with all their volatility.

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