Jack Bogle Warns: Prepare for Two Massive Market Declines in The Next Decade

(But Heeding His Advice Could Destroy Your Retirement)

By Michael Morrow, Aspen Creek Wealth Strategies, Inc.

Sometimes smart people say foolish things.

On April 1, 2013 (yes, the date is ironic), Jack Bogle, the founder of mutual-fund giant Vanguard Group, was on CNBC, and CNBC anchor, Scott Wapner, asked Bogle: "You say, 'prepare for at least two declines of 25-30 percent, maybe even 50 percent, in the coming decade.' For a buy-and-hold guy, that's a little concerning, don't you think?"

Bogle replied: "Not at all. They come and go. The market goes up, and the market goes down. It's never failed to recover from one of those 50 percent declines. I went through one in 1973-1974, I went through one in 2001, 2002, 2003; I went through another one 2008-2009. They're kind of scary - often terrifying - but it's typical. ***Why it doesn't bother me is if you hang on through the cycle, that's the only way to invest***." (emphasis added)

Quotes like this, from people who drink too much of their own Kool-Aid, really bother me because of the significant risk they pose to retirees who don't have billions of dollars or time on their side. Bogle's quote also helps distinguish the difference between facts and truth, because though it is a fact that ***markets*** have always recovered from 50% losses, the truth is that not all ***retirees*** have recovered from 50% losses, since they needed to take distributions during market downturns. In other words, they cannot "hold on" as Bogle advises. This risk investors face during retirement is known as "sequence of return" risk. In simple terms, sequence of return risk means that in retirement, it can be more critical ***when*** you get returns than ***what*** returns you get. Notice I said "in retirement", because sequence of returns has no impact pre-retirement. The following chart illustrates $100,000 growing for 25 years before retirement with sequences of returns that are the opposite of each other. Note that since the average return was the same percentage, the amount available for retirement was the same.

Annual Income = **None**
Starting Value for Portfolio A and Portfolio B = **$100,000**

Age	Annual Return	Portfolio A Year-End Value	Annual Return	Portfolio B Year-End Value
41	-12%	$87,695	29%	$129,491
42	-15%	$74,541	18%	$152,281
43	-14%	$64,106	25%	$189,590
44	22%	$78,361	-6%	$178,404
45	10%	$86,040	15%	$204,272
46	4%	$89,754	8%	$221,183
47	11%	$99,537	27%	$281,124
48	3%	$102,224	-2%	$274,939
49	-3%	$98,944	15%	$315,355
50	21%	$119,722	19%	$375,274
51	17%	$139,716	33%	$498,739
52	5%	$147,121	11%	$554,098
53	-10%	$132,703	-10%	$499,794
54	11%	$147,432	5%	$526,284
55	33%	$195,938	17%	$614,175
56	19%	$233,166	21%	$743,148
57	15%	$267,442	-3%	$719,303
58	-2%	$261,558	3%	$738,723
59	27%	$332,440	11%	$819,245
60	8%	$359,961	4%	$854,607
61	15%	$412,156	10%	$938,354
62	-6%	$387,838	22%	$1,147,015
63	25%	$482,859	-14%	$986,443
64	18%	$567,841	-15%	$838,477
65	29%	$735,302	-12%	$735,302
	8%	$735,302	8%	$735,302

NO DIFFERENCE

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However, the following chart shows that sequence of return risk can be devastatingly destructive post-retirement. It illustrates taking income from portfolios that average the same percentage over time, but have the opposite sequence of returns. The result is that one retiree runs out of money, while the other has a nice retirement and leaves a nice inheritance. Note the investor who started retirement in a down market did not get to experience the up market at the end of his/her life.

Annual Income = 5% of first-year value adjusted thereafter for inflation
Starting Value for Portfolio A and Portfolio B = $735,302

Age	Annual Return	Portfolio A Year-End Value	Annual Return	Portfolio B Year-End Value
66	-12%	$608,058	29%	$915,383
67	-15%	$478,981	18%	$1,038,620
68	-14%	$372,924	25%	$1,254,080
69	22%	$415,677	-6%	$1,139,914
70	10%	$415,031	15%	$1,263,822
71	4%	$390,325	8%	$1,325,828
72	11%	$388,972	27%	$1,641,225
73	3%	$354,257	-2%	$1,559,902
74	-3%	$296,317	15%	$1,742,637
75	21%	$310,572	19%	$2,025,772
76	17%	$313,029	33%	$2,642,842
77	5%	$278,728	11%	$2,885,300
78	-10%	$198,994	-10%	$2,550,113
79	11%	$167,091	5%	$2,631,281
80	33%	$166,453	17%	$3,015,102
81	19%	$140,801	21%	$3,590,977
82	15%	$102,502	-3%	$3,416,756
83	-2%	$39,480	3%	$3,448,238
84	27%	$0	11%	$3,761,512
85	8%	$0	4%	$3,859,407
86	15%	$0	10%	$4,171,204
87	-6%	$0	22%	$5,030,357
88	25%	$0	-14%	$4,255,708
89	18%	$0	-15%	$3,544,793
90	29%	$0	-12%	$3,033,870
	8%	$0	8%	$3,033,870

BIG DIFFERENCE

This brings up one of the biggest concerns investors have: "Will I outlive my money?" Unfortunately, if they heed Bogle's advice, the odds may not be in their favor. In fact, Bogle's advice could be like candy-coated poison to retirees, since it tastes good initially, but could result in irreparable harm or death to their portfolios.

Not only are Bogle's trite quips about "buy and hold" dangerous for retirees, they are also potentially a conflict of interest, because to protect his assets from being reduced by investors withdrawing money from his mutual funds, his "buy and hold" advice puts his investors' assets at risk. But that should not be too surprising, since in a Frontline interview he said (or admitted), "we have a mutual fund industry that has become a giant marketing system [where] the idea is to bring in the most money by fair means or foul."

That said, in full transparency, every advisor has biases and prejudices for or against certain strategies or assets, including me. While I admit to my own conflict of interest, since I sell financial assets that compete with Vanguard, our philosophy of "Safety First" means our priority is to protect you from potential retirement landmines like sequence of returns, market losses, tax inefficiency, and healthcare-related issues. Our motivation comes from the scriptural principle that if you see your brother in danger and don't warn him, his blood is on your hands. [Ezekiel 3:18]

With that thought in mind, I have often said I would have enjoyed being a lawyer if I were not a financial advisor. The reality is that I often feel like a "public defender" fighting for uninformed, under-informed and misinformed

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investors against financial false prophets who peddle dangerous investment philosophies like "buy and hold" and inherently flawed products like traditional mutual funds.

That last statement may seem overly harsh, so let me explain the flawed DNA of most traditional mutual fund managers, of which most investors are unaware. First, though there is no prohibition of fund managers investing "outside" their stated fund objective, most traditional mutual fund managers feel it is their "fiduciary duty" to "stay in their lane", when, ironically, it is their fiduciary duty to protect and grow their investors' money. This flawed fiduciary perspective has cost retirees dearly. Secondly, though there is no prohibition of fund managers investing "against" the market (known as "shorting") to make money when the market is going down, most traditional fund managers, again, "stay in their lane" to the detriment of their investors. These two DNA traits caused many smart, but traditional, mutual fund managers to be foolish in the Great Recession and lose 50% or more of their investor's money. Of course, with Bogle and his Vanguard funds, they are known for their index funds, which strive to mimic the market exactly, which by definition limits any ability to avoid market downturns.

I'm guessing at this point you are ready for some good news, so here you go: Bogle claims that “buy and hold” is “the only way to invest”, when it is not. Our research shows that tactically managing risk (also known as dynamic risk allocation) can offer three distinct advantages over the “buy and hold” philosophy of most mutual funds:

1. Higher rate of return historically (of course, past performance is no guarantee of future performance)
2. Much lower “drawdown” risk (the percentage the investment drops from “peak to trough”)
3. Much faster recovery period (the time the investment takes to go from “peak to trough back to peak”)

This reminds me of a question I get asked: "How are you different from my current advisor or other advisors?" That's an understandable question, since most investors think, or feel, that all advisors are "cut from the same cloth". To answer that question, let's use the analogy of chess and checkers. Though chess and checkers are played on the same game board, they have different rules, different game pieces and different strategies. So, while Bogle (and traditional advisors) and advisors like me all play on the same financial game board, he is playing checkers, while we are playing chess. While his strategy is "buy and hold" ***asset*** allocation, our strategy is dynamic ***risk*** allocation. While his "game pieces" are mutual funds, our "game pieces" are tactical money managers and guaranteed indexed accounts. While the "rules" that he and most of his Vanguard fund managers operate by increase risk, the "rules" that we and our money managers operate by reduce risk.

Another strategy we use for retirees, due to sequence of return risk, is the "risk bucket" strategy for retirement cash flow, using the rule of 100 as a starting point. That is a mouthful, but in simple terms it means divide your portfolio into two buckets--one that is safer (i.e. guaranteed indexed accounts) and one that is riskier (i.e. tactical money managers). The rule of 100 states that you use your age as the percentage that goes in the safer bucket. For example, if you are 65, then 65% would go in the safer bucket and 35% in the riskier bucket.

If you are more conservative, or have less "margin of error" in your portfolio (i.e. you don't have enough assets to recover from a significant loss), then put more in the safer bucket. If you are more aggressive, or have more "margin of error", then put more in the riskier bucket.

The second part of the "risk bucket" strategy is to take distributions from the buckets depending on sequence of returns. For example, when the market is trending down, take more/most/all distributions from the safer bucket. On the flip side, when the market is rising, take more/most/all distributions from the riskier bucket (i.e. "buy low, sell high).

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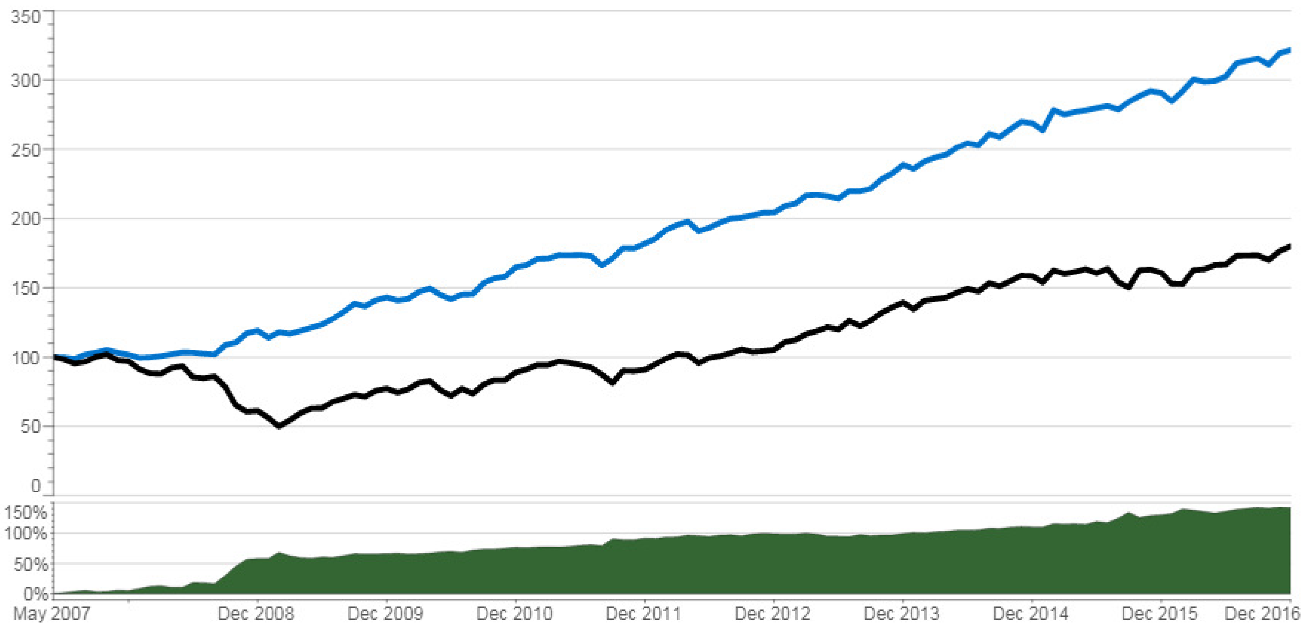
Implemented properly, the "risk bucket" strategy can significantly reduce sequence of return risk during retirement.

Since “pictures are worth a 1000 words”, let's look at a few of pictures that compare Bogle's "checkers pieces" to our "chess pieces".

Here is a chart that compares the total return of one of his "checkers pieces" (S&P 500 Index = black line) over the last 9 years versus one of the "chess pieces" in our riskier bucket (tactical money manager portfolio = blue line). The green graph at the bottom reflects the percentage increase of the blue line over the black line.



Here is the drawdown risk chart that shows maximum the drawdown risk and recovery period of the S&P 500 Index (black line) and one of our tactical money manager portfolios (blue line) over the last 9 years. Note that the S&P 500 Index was down over 50% and took over 4 years to recover. Though our portfolio had multiple drawdown periods, they were limited to about 6% and the recovery periods were limited to months, not years.

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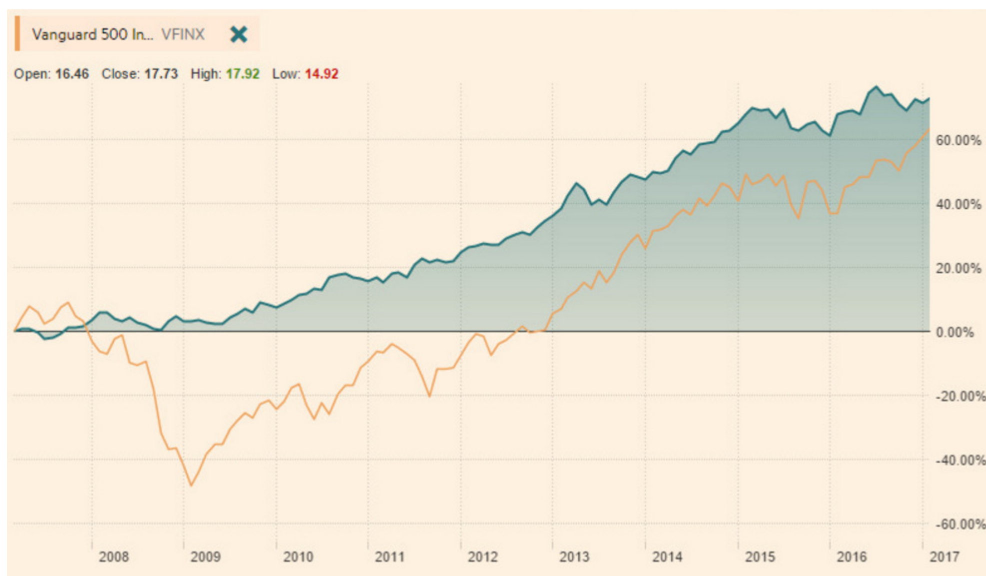
Let's pause for a minute to look at advisory fees in the context of this data. Bogle claimed in his Frontline interview that we have a "financial system that is failing investors because of those costs of financial advice and brokerage." An interesting note is that the blue lines of the previous two graphs are net of 1.99% annual management/advisory fees. With the previous charts in mind, I would propose that maybe it is the drawdown risk of low-cost funds, like his, that are "failing investors" and not the "costs of financial advice and brokerage" that have resulted in significantly less risk, combined with higher and more consistent returns.

That brings us to the next component of minimizing sequence of return risk, which is performance consistency. Here are the annual returns over the last 9 years of the S&P 500 Index and one of our tactical money manager portfolios.

	2016	2015	2014	2013	2012	2011	2010	2009	2008
Tactical Money Manager Portfolio	10.64%	8.19%	12.57%	16.87%	12.28%	10.21%	15.32%	20.27%	16.96%
S&P 500 Index	11.96%	1.38%	13.69%	32.39%	16.00%	2.11%	15.06%	26.46%	-37.00%

Though the S&P 500 Index outperformed our money manager portfolio 5 out of 9 years, the 9-year average of our money manager portfolio was 12.97%--more than double the S&P 500 Index average of 6.32%. This illustrates the importance of consistency and not having negative years.

This last chart compares one of his "checkers pieces" (Vanguard 500 Index fund) versus one of the "chess pieces" in our safer bucket (guaranteed indexed account):



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Guaranteed indexed accounts (GIAs), by definition, guarantee no market losses (i.e. no drawdown risk or recovery periods), but you still receive returns tied to the upside of the index. In fact, with this strategy, which includes a participation rate greater than the index, the returns would have been almost 75% higher than the Vanguard index fund—with none of the risk.

In summary, our "Safety First" philosophy and bucket risk strategy combine to offer good returns with low drawdown and sequence of return risks, allowing our clients to live out their retirement with increased confidence and peace of mind.

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www.Aspen-Creek.net

(719) 722-2992

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