

May 27, 2003

To: Friends and Clients of MLK Capital Management, Inc.

From: Lane Kerns

**Re: [Will You Be Able to Retire?](#)
[Best Case – Worst Case Scenario](#)
[401k-Investment-Advice.com](#)**

[Will Your Money Last as Long as You Do?](#)

I had two conversations last week with retired couples concerned about what is happening to their retirement portfolios. Their major concern is whether they will last longer than their money.

Most people do not seriously consider how much money they will have to accumulate to retire on their current standard of living until it is too late to do anything about it. Let's take a look at the problem both from the perspective of the retiree – as well as the pre-retirees (the rest of us) that are still working and have not yet retired.

Whether you are retired or a pre-retiree, the problem is the same. Where will the money come from? Of course there is Social Security - but at best that will provide a maximum of forty percent of your pre-retirement earnings - much less if you have an income above the Social Security wage base. So where does the other sixty percent (60%) come from?

If you are retired, you know the size of your retirement assets. The challenge is to make sure that they generate enough income to maintain your living standard without risking the loss of the money.

If you are pre-retirement you will eventually face the same problem as the retiree. Fortunately however, you have some time to increase the size of the pot of money from which you will draw your existence for 20 to 40 years after you retire. With the medical advances currently in the pipeline we will increasingly see the life expectancy of Americans advance toward age 100.

Regardless of how much you need in addition to Social Security, money will have to come from one of three sources:

Money at Work

- a) I am assuming here that everyone would like to assure they have an income that lasts as long as they do. Since we aren't really sure how long we are going to live, that means that the only safe thing to do is to live from the earnings our savings and investments generate.
- b) That means, don't spend principle. Live from Income or Capital Gains.
- c) What about inflation? For the past 100 years, inflation has averaged roughly 3% per year. Last week Alan Greenspan said that 2-3% annual inflation is needed for a healthy economy. The FED is now working hard to INCREASE the inflation rate up to the 2-3% range. I never thought I would see that in my lifetime.

That means – the first three percent (3%) of the earnings on your portfolio must be reinvested (not used for living expenses) just to have your portfolio grow enough to keep up with inflation.

- d) What does this do to fixed income investments like bonds and Treasury Notes? Bond yields are now 2-4% annually and dropping. You may have to hold bonds until their maturity date to get that full yield. What if interest rates start going up? Guess what, the interest rates on the bonds you own do not.

What about the inflation risk? Inflation could pretty much eat up the return on your bonds unless you own TIPS.

- e) The 10-year "inflation-indexed" bonds are formally called Treasury Inflation Protection Securities, or TIPS. These bonds pay about 3% plus the inflation rate for the 10 year life of the bond. Therefore, a government guaranteed safe 3% annual return after inflation is the most we can expect from bonds unless we increase our risk level.
- f) Even if you have a nice portfolio, would 3% create enough income? For each \$1,000 monthly income you need you will have to invest \$400,000 at a 3% return. $400,000 \times 3\%$ equals \$12,000 or \$1,000 per month. Not very appealing!
- g) We will talk about increasing returns while managing risk later in this letter.

Using up the Money you Have

- a) How long will an investment last if you spend 10% of the original amount per year with 3% annual earnings? In 12 years your money is all gone. If you increase that 10% withdrawal to make up for the rising cost of inflation, it won't last that long. Unless you are in your mid-eighties, your life expectancy is longer than 12 years.
- b) So, what is the solution – spend less – try to get higher investment return – hope you win the lottery – or keep working?

You at Work

- a) If you don't have a large enough retirement savings to generate an income adequate to support your standard of living - and you end up spending your retirement savings - rather than living from its earnings - you will eventually run out of money. Out of money means back to work or having to get help.
- b) According to the last US census: 22% of all Americans over the age of 65 have to keep working to pay their bills, 45% are dependent on relatives and 28% rely entirely on charity, welfare or Social Security.

Best Case – Worst Case Scenario

If the bond market won't create enough income let's look at living on Capital Gains (what you can earn in the stock market).

I have said in prior newsletters that I think we may be in a Secular Bear market. That means that the price of stocks is still so high in relation to their earnings (called Price/Earnings or P/E ratio) that even if the economy does well and corporate earnings grow, it may take ten years for the P/E ratios to get back to what they have averaged for the last 100 years. History tells us that they always – without exception – do get back to their historical average! Do we really think this time will be different?

Stock market valuations are 80% above the 50 year, 60 year or even 100 year mean average. In technical terms, the chances the stock market will do well in the next few years will be hindered by a regression to the mean of 17 times P/E. We could see another period like 1964 to 1981 where the stock market gained exactly 1/10th of one percent – not per year – total for the period.

Too much gloom & doom? Maybe. But if we are right and our system of managing money captures most of the gains while avoiding most of the losses it could make a significant difference in the quality of retirement for our clients. If we are wrong we will still enjoy market gains – but with reduced volatility. Whether I am right or wrong, the way we manage money will not change. We will be managing money the same whether we have a good market or a poor one. That's the nice thing about our system and trading rules.

ALTERNATIVES IF YOU NEED MORE THAN BONDS RATES TO LIVE ON?

Buy and Hold

- a. Buy and Hold asset allocation means you take what the market gives you with no risk management other than diversification. During the last three years diversification by itself has not worked to protect your assets. In a secular Bear market, no risk management means no growth! No growth means no income.
- b. Even with a conservative “buy and hold” mix highly concentrated in bonds, the combination of income and gains will not provide adequate income for any but the largest portfolios supporting very conservative lifestyles.

- c. With an aggressive mix holding a high percentage of equities, you will have the same growth as the market – which could be meager over the next few years.

Get Involved and “Actively Manage” Your Own Money

The problems are:

- a. You may not have the time to learn how to manage your investments and monitor them on a regular basis.
- b. You may feel challenged or overwhelmed by the abundance of data, opinions and ideas from many different sources.
- c. Even if you have the time and feel confident about your ability - you may not feel comfortable making financial decisions that will affect your entire later life.

Get Professional Help

- a. Brokers traditionally get paid to sell – not manage. Any broker that knows how to manage money has probably left his brokerage job to become an investment manager.
- b. Find a registered investment advisor whose interests are aligned with yours. That probably means that they:
 - i. Get paid when you get paid - not when they make a trade or sell you something. Their income should grow when yours grows and go down when yours goes down. In that way they have the same interest in your portfolio as you do.
 - ii. Have a track record that shows risk management skills.
 - iii. Should have risk adjusted performance that beats what the market can give you. (Beats Buy-and-Hold asset allocation.) If they have not demonstrated that they have a system that can protect your money in a down market, there is no possible way you can earn capital gains in a secular bear market.

If I am wrong about the next few years being tough ones in the market, and we return to a bull (up) market without the pain of a secular bear (down) market, this kind of management system will still get the investment gains and you will sleep better at the same time. What we are talking about is missing most of the down cycles while capturing most of the gains.
 - iv. Hire someone who your widow/widower will be comfortable working with. If you make a good decision on picking an investment manager, your spouse should be acquainted with that person or firm so that she can develop the same level of trust that you have. That trust should be there before they have to rely on it by themselves.

Our Management Style has Worked in Both up and Down Markets with Greatly Reduced Risk

1. Since the first of the year, our most aggressive account has had more stability and less volatility than bonds. We have outperformed the bond market.
2. The chart below shows a five year picture of the relationship between investment risk taken and the return received for taking that risk. The data point labeled (1) T-Bills shows that T-Bills (Think Money Market Funds), have returned 4.00% compound annual return over the last five years with Zero percent risk.
3. The S&P 500 (2) S&P 500 shows substantially higher risk with a standard deviation of almost 19%. (Bigger standard deviation numbers mean bigger risk and volatility) It also had a lower return equal to a minus 2.42% per year.

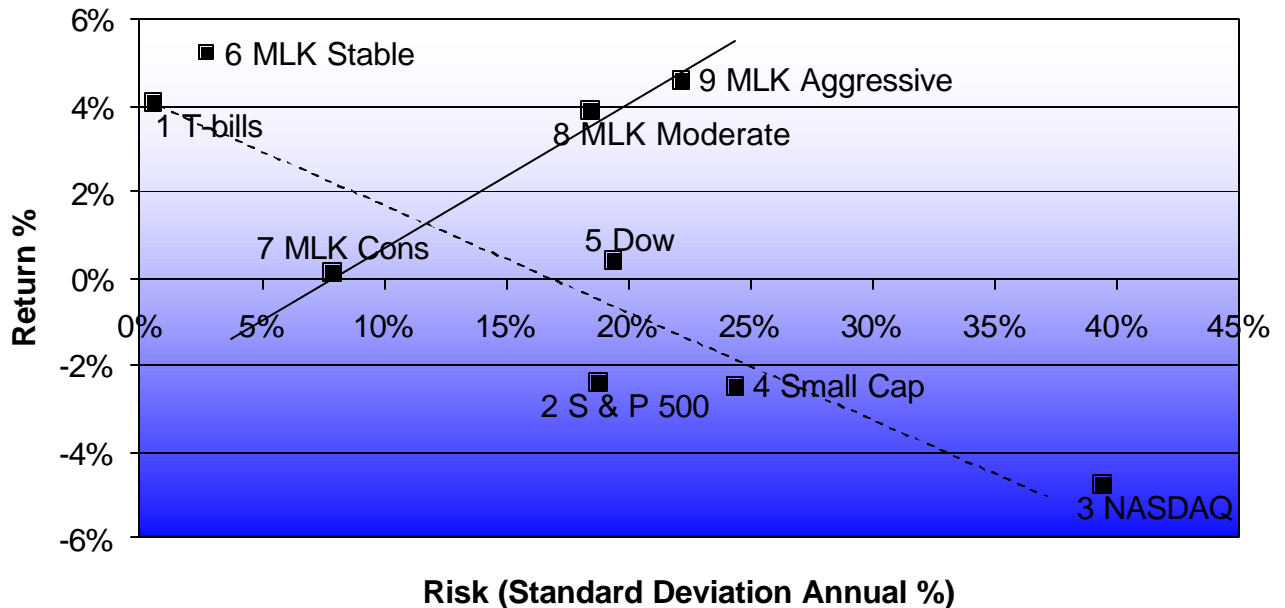
The dashed line shows the relationship of risk and reward over the last 5 years. Look at data points (3) through (5) representing the NASDAQ, Small Cap Russell 2000 and the DOW Jones 30 Industrials. As you can see investors were not rewarded for taking more risk by investing in index funds and pursuing a buy-and-hold strategy in spite of the fact that this period includes two of the better years the market has ever seen!

The dashed line is exactly the opposite of what textbooks on investing will show the long-term relationship between risk and reward should be. In the long run, if investors are not rewarded with higher returns on their money for taking risk– why take the risk? Over longer periods of time – 40 to 50 years, risk has always been rewarded. Unfortunately, I am not willing to wait that long when there is a better way to invest.

When reading the chart –

1. Any data point above the dashed line means higher than market returns for the risk taken. Higher return with less risk is good!
2. If two investments have the same rate of return and one is to the left of the other - that means the left one earned that rate of return with less risk! Compare (7) and (5).
3. Look at data points (6) through (9) representing our Stable, Conservative, Moderate and Aggressive accounts. The solid line represents the risk/reward relationship for our managed equity accounts. Note that - without exception – our accounts have had substantially higher return - for the risk taken - than any of the equity market averages!

RISK AND RETURN RELATIVE TO THE MARKETS (Five Year Period ending 4/30/03)



If You Have Not Retired

If you have not retired there is still time to build wealth. Your company's retirement plan is the best wealth building tool available because it offers after-tax contributions with tax-deferred accumulation - and contribution limits that greatly exceed IRA limits.

To see what this can do for you go to <http://www.401k-investment-advice.com/> and check out the **401(k) Wealth Calculator**. You don't need a password to get into it. After you fill in the blanks and click calculate, go to the bottom and look at **Age 65 Account Value Assuming 8% Growth**. Big number! Right? Now go back to the top of the page and change the growth rate – not the contribution rate - from 8% to 9% (or any other rate you want to see) and click recalculate. Now check the age 65 total again.

The point here (with your numbers) is that just a 1% difference in the growth rate of your portfolio can make a huge difference! By paying better attention to your money – both in and out of your retirement plan - you should be able to get at least 1% better return than if you completely ignore it.

Any investment manager that can not get you at least 1% better return than you can get (even after paying their management fee) should be fired. **Our Moderate Growth account earned 6.32% more compound annual return over the five years ending 4/30/03 than the S&P 500 while taking slightly less risk!** That 6.32% is after subtracting all management and trading fees.

On a \$1,000,000 investment that 6.32% would have represented a **\$210,815 gain verses an \$115,284 loss.**

401(k) Investment Advice

Our <http://www.401k-investment-advice.com/> website is being very well received. It gives users tools that we use in managing client portfolios. Once you log in, go to Investment Advice – Actively Manage. You can also get a view of the Current Market conditions by going to Current Market Conditions. If we do not already do so, we can manage your 401(k) account – as well as your personal and IRA investments.

If the market begins to show weakness again, we will either sell our equity holdings or add back our hedge to offset this market risk by having a portion of our accounts in investments that go **up** when the market goes **down**. This reduces or eliminates the market risk from the equation and allows the relative strength or our other holdings to give us the potential for a positive return with much less risk. When we hedge, we try to balance the hedge against the other holdings of the account so that we hold market neutral positions. Our goal is either a small loss or a big gain – without any big losses.

*Our Stable, Conservative, Moderate and Aggressive models have all **significantly** outperformed the S&P for the last 1, 3 and 5 years.*

We are at a Crossroad

Unlike many Registered Investment Advisors we have not set a high minimum account size. Many fee only investment advisors will not take accounts smaller than \$250,000, \$500,000 or \$1,000,000. Unfortunately this leaves the smaller investor - those who are just getting started, those who started late or those who have had bad luck in the market - out in the cold and on their own. (Or at the mercy of commission-only advisors that get paid to sell and not to manage.)

The problem with accepting smaller accounts is that the minimum trading fees at Schwab disproportionately affect smaller accounts. If we trade when our system dictates that we trade to protect from losses or to trade up to better performing investments, smaller account performance is reduced by the trading fees. (This does not apply to accounts we manage in 401(k) plans.)

Overall performance numbers we quote are a composite of all our accounts - both large and small. Some of you with larger accounts may have noticed that your performance is actually better than the performance numbers we quote – smaller ones less.

We do not want to abandon smaller account holders. We value these account holders equally and some have been with us from the beginning of our firm.

Our alternatives are to:

1. Change from Schwab to a custodian with a more manageable fee arrangement for trading mutual funds.

2. Start trading Exchange Traded Funds. These are all index funds so we lose some of the potential performance added by good managers. This however, could be offset by lower trading fees and much lower management fees than mutual funds.
3. Start our own mutual fund. Then instead of having several hundred trading fees (one each for several hundred client accounts) we would have just one fee per holding divided by several hundred accounts.

I do not know which of the above options we will pursue – it may be a combination. In any event, our clients will have a choice as to whether to participate in any new accounts or stay with the current basis. More later.

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MLK Capital Management, Inc. is a fee based investment advisor. Our income can not grow unless our assets under management grow. We do not make money by trading client's accounts. When we make a trade, it is to keep the account from losing money or to put it in a position to grow more. The success of our firm is tied to the success of our client's investment accounts.

This letter will be published periodically with my views on the market, investing and things that seem important to me at the time. Remember, all of this is filtered through over 40 plus years of experience including a fair amount of both "Good Judgment" and "Bad Judgment". Or, as a friend of mine says, we may not be right - but this is our opinion. Please feel free to share this with anyone you think might be interested. If someone would like to be put on the list just send me an email with his or her email address. You can reach me at:

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