

The Quarterly Report

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| INSIDE STORY |

Retiring in A Bear Market

Learn four huge
mistakes to avoid

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Retiring in A Bear Market

Myths die hard. For as long as I can remember, there has been a myth that investors must reduce their exposure to stocks and increase their exposure to bonds as they approach retirement. This advice is based on the fallacy that if one is exposed to the stock market and we have a bear market (as we do today) at or close to one's retirement, then his retirement will be forever impacted. He will have to live on less and suffer for his bad timing.

That is wrong. It is wrong in lots of ways, but most importantly it ignores a far greater risk: outliving one's resources. In the thirty years I have been in the investment business, primarily focused on retirement, I have seen four huge mistakes that need to be avoided at all costs. The first is taking too much risk when one is young, then panicking and selling everything during a bear market. We talk about this often.

The second is retiring without a plan. I am not talking about a financial plan. I mean an action plan. What are you going to do that will take up your time and fill your life with meaning. If you do not know the answer to that question, then you are not ready to retire. Vacations are great, but they are largely great because they are short. If one retires at age 65 today, then she is likely to be in retirement for 25 or 30 years. One can only play so much pickleball. She had better have a plan as to what will keep her active and engaged with others.

The third mistake is outliving one's health. Modern medicine is designed to keep one from dying, and they have gotten really good at it. That, however, is not the same as living. The more I deal with retirees, the less I care how long I live. I just want to really live right up until the end. Even if you have never exercised in your life up to retirement, you had better start exercising because your ability to physically function is a use it or lose it skill.

The fourth mistake is the one we will deal with in this article: becoming too conservative at or in the decade or so before retirement. This leads to outliving one's resources, and if there is anything as horrible as outliving one's health, this is it. The risk of outliving one's resources is the risk that investors should think

about the most. It dwarfs the risk of market volatility, yet that is what most people think of as risk. Most people look at what has happened to the market this year and think, "This is risk; this is the scary part."

It is human nature. We know better, but it is difficult to see the current value of one's investments drop and not be anxious about it. That is a normal reaction, but we have to remind ourselves that this is part of the cycle of life. We see ups and downs, and the ups will outweigh the downs over time as long as we stay the course. Time is on our side. Since 1926, the S&P 500 has been up 72 percent of the time. We get a negative year on average once every four years. This will pass, and the market will go to new highs.

This truth leads to one of the fallacies that causes people to hit the brakes too soon. They say, "If you are young then you have time to recover, but if you are about to retire, then you do not." Wrong! This is the fallacy of the wrong time horizon. An investor who is investing for her retirement does not have a time horizon that ends on her retirement date. Her time horizon is her life expectancy, which today is at least 20 years after retirement. I use 20 because when I was an economics student, we learned that as far as mathematical projections go, 20 years equals infinity. Anything beyond

that time period is pure garbage. In our investment policies the longest time horizon one can have is 20+ years, and one has that time horizon into their 70s.

How did the idea of retirement as an end-date ever get started? Unfortunately, that has to do with the evolution of the investment industry and the incredible difficulty the industry has in serving investors through retirement. Many years ago, investors either did it themselves or they hired an investment adviser to manage their money for them. Either way, all the actual transactions had to go through a broker. In fact, to simply know what was happening in the market that day one had to go to a "wire house" brokerage firm. These were the large New York-based broker-dealers who would pay the expense of having a wire service run to their regional offices around the country.

*Myth:
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These firms had brokers in all of these offices because the only way to transact was in person. Technology has replaced that entire system. If your phone has a cell signal, then you can know what is happening and can trade stocks. In most businesses this would have meant the end of the broker, and in my opinion it should have. However, in the investment business, the broker transformed himself into the financial adviser. The broker's historical role was that of a salesperson. If his broker-dealer had stock of GE, then he would be selling GE that day.

The next day they might have a bond from GM, and he would sell that.

The role has not really changed, but most people today are not interested in paying the high cost of buying a stock or bond from the salesperson when they can do it far more efficiently online. Today the financial adviser sells money management; unfortunately, he isn't a money manager. However, this works for most money managers, because they frankly are more comfortable looking at spreadsheets than talking to people. They can manage money the way they want and turn it into a product that gets sold by financial advisers, who are generally good with people.

Hence, the money management industry evolved from a service profession to a product manufacturing business. The brokerage business evolved from selling stock and bonds to selling managed products. This is far from ideal in our opinion, but it does work for accumulating resources. The vast majority of the products sold by advisers are geared toward growing one's investments, so while a truly tailored approach is not possible, it is possible to build a portfolio of products that will grow in value over time.

The problem comes when one retires and transitions to producing income. While everyone who is still in the accumulation phase can be oversimplified as needing to make money, each person in the income phase has a truly unique situation. Designing a product for that is like trying to fit a square peg into a round hole – it simply will not work.

It also leads to this idea that when one retires, she must take all her money and put it into an income-producing product. If one did that, then the balance of the portfolio on the day of retirement becomes extremely important. If the investment industry is just a product-pushing business, then the timing of switching products becomes much more important than it should be.

At Iron Capital we do not believe that the industry should be about pushing products. We believe it is supposed to be a professional service. As such, we build each income-producing portfolio from the bottom-up, tailored to each client's needs. Our philosophy is simple: Build a portfolio that generates the income needed while taking as little risk as the market will allow.

We have been in a historically low interest rate environment for most of the last 20 years, certainly since the financial crisis in 2008. This hurts most income-focused products because they primarily invest in bonds. Bonds, after all, are simply loans. The loans are paid back plus interest, which produces income. The industry has really struggled in trying to

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The 2nd quarter 2022 GDP growth came in down 0.6 percent, which means we are in a recession. Many pundits are arguing that this isn't a recession because employment has held up, as have corporate earnings, but words have definitions for a reason. Regardless of labels, there is no doubt that activity has slowed.

The official unemployment rate rose to 3.7 percent through August. The labor market remains tight with almost two job openings for every unemployed person. This has become the Fed's fixation. They seemingly will not stop until unemployment rises.

Inflation is 8.3 percent based on the latest consumer price index report. It has leveled off and there are signs it could be cracking. The producer price index, which tracks wholesale prices, is up 8.7 percent over the last 12 months and actually declined month over month in August. +

REVIEW of ECONOMY

The market tried to rally but failed in the end. For the quarter the S&P 500 finished down 4.88 percent, and small company stocks represented by the Russell 2000 index were down 2.19 percent. Growth outperformed with the Russell 1000 Growth index down 3.6 percent while the Value index was down 5.62 percent. For small companies the value index was down 4.61 percent and the growth index was actually up 0.24 percent.

Bonds continued their steep decline. The Barclays U.S. Aggregate Bond index ended down 4.75 percent. High yield bonds dropped 0.68 percent. Bond yields are actually attractive once more.

International stocks dropped as well. The EAFE index finished down 9.29 percent and the MSCI Emerging Markets index ended the quarter down 11.42 percent. +

REVIEW of MARKET

MARKET *forecast*

Pessimism remains very high right now, and we believe it is overdone. Stocks are the best long-term hedge against inflation which is the biggest economic issue. We are in a conundrum, corporate earnings are likely to hold up better than expected, but this will anger the Fed who seems to just want a severe recession no matter what inflation does. What should be good news may actually be bad news.

In the longer-term value stocks and small company stocks still look more attractive. International stocks look more attractive than domestic but the strengthening dollar is hurting U.S. investors.

Bonds are actually looking worthwhile once more. Time is near to go back to normal long-term allocations in bonds. +

» *Continued –*

solve the retirement income puzzle in this environment. For the most part, they just gave up and started telling their clients that they would have to live on less.

Article after article preached the demise of the so-called 4 percent rule – the “rule” that one could only take 4 percent of their portfolio as income if they wished to preserve the capital. In the meantime, most of our clients need closer to 6 percent. The product-based solutions are no solution at all. We have delivered the income our clients’ need through taking the best income sources available at the time. For most of the last 20 years that has meant dividend-paying stocks, preferred stocks, and higher-yielding bonds.

The good news is that while we have more in stock, the stocks we were investing in for these clients are more conservative. They tend to hold up extremely well during market downturns. The one exception to that rule was the Covid shutdown. These conservative companies that pay dividends tend to do well in thick or thin, but not when the government says you have to shut down. So, what did we do?

We put enough in safe places to pay the income needs for a few years, and then took advantage of the silver lining of the downturn. Every bear market creates opportunity. We took advantage of that opportunity to rebuild our client’s income portfolios. This is also what one should do when retiring in, or shortly after, a bear market.

When producing the needed income is a professional service and not a product, one gains flexibility. There is no need to have a one-time flip of the switch; the transition into retirement is exactly that – a transition. There is no rush, as we are going to be managing the income production for 20 to 30 years, if not longer. There is no need for a bear market at one’s retirement to be any different than a bear market at any other time.

Today we are in a bear market, and it is creating opportunities. For the income-needing client, those opportunities are now in bonds. For the first time in a very long time, bonds are paying enough interest to be a meaningful portion of an income strategy. This, however, is not going to help the product-pushers. Bonds are simple: One loans his money to a company or government, and the borrower promises to pay it back plus interest. If one buys a bond, then she will get interest payments, and at maturity, the return of her principal. There is a risk that a borrower will not be able to pay it back, but that risk can be judged up front.

Bond funds, i.e. the products, do not work that way. What one is really doing is buying shares in a mutual fund. The fund then invests in bonds. Should interest rates rise further, the bonds will lose value in the market. A bondholder who isn’t selling doesn’t care, because she will continue to get what she agreed to from the beginning. The bond fund, however, will lose value. It does not behave like an actual bond; it behaves like a mutual fund that happens to invest in securities with lower return potential.

Retirement is a personal experience. It is a stage of life, not something one buys from a store. Managing one’s investment portfolio to produce the needed income is just as personal and just as unique. If one wishes to go the product route, then he had better have saved a lot of money and avoided the last-minute downfall. On the other hand, if one goes the route of professional service, then she will be able to navigate life’s ups and downs with far more flexibility. Bear markets are horrible to endure, but they do produce opportunities – even for those about to retire.

Warm Regards,



CHUCK OSBORNE, CFA *Managing Director*