BONDS

Scarsdale Investment Group, Ltd.

All Bond Portfolios

The Third Rail of Financial Planning

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Introduction

This article provides an alternative financial strategy for those investors who have a substantial amount of investable funds and are looking for some certainty in an uncertain world. It is based on predictable cash flow from a laddered portfolio of the highest quality individual bonds. Let's call it the Scarsdale Strategy.

The Third Rail

Over the years that we have provided financial planning for individual clients seeking a secure retirement, we have run into what we call the "third rail of financial planning". The third rail is a reference to train tracks run by electricity. You touch it and you die. In our experience, when we provide advice that concludes that a client should size their lifestyle to their predictable cash flow, some clients either think about or actually run out of our office. This is not good for the client or for us – that is why we call it the third rail of financially planning. If a financial planner touches the third rail, the planner may lose the client. If that were to happen, the client loses because the client embraces the belief that you can live the life you love without accepting financial risks. If you invest in risk assets, like Index Annuities, you would then buy a product that would appear to meet your needs, without reading the fine print, which details what you don't want to hear in language you could not possibly understand. Alternatively, you agree to a trading strategy with known costs and uncertain outcomes.

The Problem with the Current Financial Planning Model

Here is the problem as we see it. The financial services industry generally believes that financial planning for retirement should be based on diversification of investments to all major asset classes with the majority of assets allocated to equities and other risk assets. The traditional view is that this allocation will reduce risk and maximize returns. The adviser then runs projections such as Monte Carlo projections, based upon *prior returns* of asset classes and concludes that there is only a ____% chance of the client running out of money before they die.

Does this sound familiar? It should, this is the traditional strategy and thus sounds like the truth. However, we are not persuaded that this is the truth or the best strategy to follow in today's financial environment for retirement planning for the following reasons:

- In the traditional model of financial planning, predictions about the future are based on past performance. We don't believe that the past will predict the future unless you believe that the future will be like the past. The world is changing faster and faster, so we reject betting our financial well-being on past performance.
- When you allocate your assets to risk assets, rather than to high quality bonds, you are increasing your risk rather than reducing it.
- The Scarsdale Strategy results in a predictable cash flow. The diversified strategy is based on trading your portfolio with unpredictable results. Holding risk assets just increases risk over time because eventually there are market adjustments.
- We are living longer and longer. This is one of the major uncertainties of financial planning. Looking at average life spans to determine when you will die is by definition off by 50% and more if you are wealthy.
- The stock market is near an all-time high. Can you predict significant yearly gains from here? If you are putting new money into the market, you are buying in at market highs. This sounds risky to us.

- And then there is “sequence of return” risk. This is the risk that equities will have a poor or negative performance early on in your retirement. In this case, you will withdraw too much from your portfolio at the beginning of your retirement and will have an unsustainable rate of withdrawal, resulting in a shortfall toward the end of your life.
- Don’t forget to take into account, taxes, fees and bad timing in projecting returns, or in evaluating published returns of market performance.

<u>The Scarsdale Strategy</u>

The Scarsdale Strategy provides an alternative model for financial planning for retirement. We believe that projecting gains and losses is too risky to bet your financial life on. We believe that you should base your financial planning on the following strategy:

Size your life style and spending budget to your predictable cash flow (the interest income) from a laddered portfolio of the highest quality individual bonds. Use your principal for emergencies and projected major life events.

There! We touched the third rail. We are suggesting the strategy of reducing your lifestyle (your spending budget) to your predictable cash flow, in order to keep your financial future secure.

The idea of investing in riskier assets to maintain a lifestyle in retirement, when you no longer have earned income, appears very risky and inappropriate for many investors. For conservative investors it looks like a Hail Mary pass.

Next Step

If you wish to understand the Scarsdale Strategy in more detail, please contact us. 215-646-8768; 215-646-7693