

# A COMPENDIUM ON ACHIEVING FINANCIAL INDEPENDENCE



**EnRich** Financial  
PARTNERS  
ALIGNING YOUR MONEY WITH YOUR LIFE

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## Lifeboat Drills

by Christopher D. Rich, CFP®

When the Titanic sank back in 1912, it became tragically clear that there were too few lifeboats and no organized plan for all passengers to exit the ship before it sank. As a result, whenever you board a passenger ship today, the crew performs a lifeboat drill with the passengers. The drill is intended to “teach” everyone how to quickly get to their assigned lifeboat in the event the ship experiences serious difficulties, even though the likelihood of running into an extreme difficulty is remote.

### The Background:

The financial “seas” of the last few years have certainly been rough. Longtime readers know, we have communicated how historically the U.S. stock market has declined 20% or more about every five years followed by a recovery period. And with considerably less frequency, markets have occasionally declined 30-50% followed by more prolonged recovery periods. The unusual occurrences of two market declines in excess of 40% within the past decade have caused many investors to believe the risks of owning stocks are much higher than they thought.

During periods of extreme turbulence and uncertain economic forecasts, the tendency of many investors is to hunker down and wait for calmer “seas.” The problem most investors face is that the impulse to reduce their exposure to stocks and replace them with “safer” holdings like bonds may be offset by an equal risk of not maintaining your purchasing power over time. In the near term, the effects of inflation are negligible, but in the long-run, the constant pressure of inflation almost never subsides. People generally underestimate the way prices rise and every year everything seems to cost more. On average over

a 25 to 30 year retirement, consumer prices in the United States will triple given historical long-term inflation rates. Therefore, people need to own investments whose income also has the potential to triple. That means most people should (and hopefully will) own equities, whose dividend growth normally offsets inflation over long periods of time.

The problem most of us face is that we are unable to evaluate our newfound desire for “less” risk and balance that with our desire to maintain our lifestyle over a 25 to 30 year retirement. In previous newsletters we communicated that we are near-term cautious and long-term optimists. Specifically, we talked over the past year about the uncertainties our economy faces and how we expect there to be periods of optimism followed by disappointment, but eventually we expected our markets and economy to reach a new

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“equilibrium” from which to grow. Free market economies that have experienced a pro-

longed period of excess in one area are always followed by a period of correction and adjustment as capital flows out of the over allocated areas and into the areas of more opportunity. To somewhat simplify the situation, we (as a collective society of consumers) behaved our way into this economic malaise by spending on credit and devoting economic capital to financial “gimmickry” rather than staying within our means and investing capital in the production of real things. We expect that we are now in a period where we, as a society, must behave ourselves *out* of this

- Equities growth normally offsets inflation over long periods of time..
- We must behave ourselves out of this situation.
- The best opportunities are born out of periods of financial stress.

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situation. It took roughly seven years to get to the extreme overextended state we were in by late 2007, so we think it is a reasonable possibility to expect a prolonged period where we (as a collective society of consumers) reduce our personal debt and redeploy capital toward more productive economic endeavors. We know this is frustrating. It doesn't seem fair that financially prudent people like you (our clients), should have to pay for other people's poor financial management and judgment. However, we find it helpful to keep in mind that some of the best opportunities are born out of periods of financial stress, and bad economic situations do not last forever. Warren Buffett recently said the following in a September 23rd interview on CNBC Squawk Box.

*"I think the most important factor in getting out of the recession actually is just the regenerative capacity of American capitalism. And we [have] had many recessions in the history of this country when nobody even heard of fiscal policy or monetary policy. The country always comes back. There are 309 million people out there that are trying to improve their lot in life. And we've got a system that allows them to do it. It doesn't allow things to get changed overnight, though."*

While we give the above belief statement about a prolonged economic recovery the highest probability out of the potential outcomes we see, it is by no way a guarantee this will be the case. The U.S. economy has a tendency to surprise us. In most periods of financial dislocation, the healing of past misallocation of resources and the redeployment of capital has happened more quickly than most anticipated. We would greatly appreciate a similar outcome this time; we are just uncertain the current economic data supports a normal V-shaped typical post-WWII recovery.

### Future Opportunities:

To assume our above statements are a strong sign of pessimism would be a mistake, though. We see many opportunities for our country to regain its footing more quickly. Strong businesses are able to borrow money at extremely low rates and can redeploy that capital for better potential returns by buying back shares, snapping up competitors, increasing their global reach, and enhancing their business franchises. In addition, we think a concerted effort by our country to embrace alternative and green energy could have tremendous effects on our economy. With focused effort, we could be a global leader in this area. We could reduce our importation of foreign oil, reduce our trade deficit, and stem the export of U.S. dollars to the tune of \$300+ billion annually. Those dollars would stay here in our economy to create jobs, be recirculated, increase our GDP, and support a strong U.S. dollar. Adopting alternative energy could also create millions of much needed jobs here at home. Economists are saying they don't see any transformative economic change that could help drive our economy over the next decade like

the internet did over the past 10 years. We feel adoption of more domestic natural gas based energy use in the near term, while we develop alternative and green based energy production for the long-run, could put us well onto a strong track to recovery.

### Employing EnRich Lifeboat Drills:

Uncertainty is definitely running rampant these days, although a review of history reminds us that uncertainty has always existed—we just ebb and flow in our experience of it. However, given the various possibilities of different economic recovery levels, we have been practicing our own version of lifeboat drills. As with a real lifeboat drill, the intention of the drill is not to imply that we think you will encounter serious financial difficulty, rather the intention is to evaluate the strength of your financial plan in the event it does happen. During annual client review meetings we have been illustrating two potential scenarios of your specific financial plan and then stress testing each of them for market variability.

Scenario one assumes that the bulk of the market and economic pain is behind us and our economy is healing in a manner similar to all post-WWII recessions. This scenario assumes the stock and bond returns over the next decade and longer will move toward their long-term average, albeit with the normal annual variation in returns one can expect.

Scenario two assumes we are in for a period of healing before we move back toward a more normalized economic and market condition. Specifically, we have been illustrating Four Lean Years, where we assume zero percent portfolio returns over the next four years followed by a return to more normal stock and bond returns. We have further stress tested this scenario by applying normal market variability over the entire illustration period including the four lean years. While we are more than hopeful that returns will be significantly above zero over the next four years, we felt illustrating four years with no net growth provided a very conservative "difficult case" scenario.

Our intention by illustrating both scenarios is to give you a basis of potential outcomes on which to evaluate your decision, rather than just reacting emotionally from a place of uncertainty. There are always a variety of ways to adjust a financial plan to increase its probability of success. We can do this by reducing our spending, working longer, foregoing lower priority financial goals, increasing our investment exposure to higher expected return assets like stocks, and in other ways. By having a "difficult case" lifeboat drill presented alongside a "normal case" lifeboat drill, we hope clients will make more informed decisions and achieve better financial outcomes than they might have by just reacting to the gut level fears that run rampant in the marketplace today. Essentially, we can help you determine what the expected long-term implications are to

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lowering your stock exposure within your plan, and then help you evaluate whether the trade-offs you might need to make—such as lower income, a later retirement date, and/or goal priority adjustments—are worth the peace of mind you may achieve in order to avoid the higher uncertainties associated with owning a higher exposure to stocks. In addition, we hope the shift in focus, from short-term investment outcomes to what the real life probabilities of your financial plan success are, will provide much needed peace of mind during times like these.

We have been diligently meeting with our clients over the past year to review financial plans, illustrate these scenarios, and discuss any adjustments that may be ap-

propriate. As you might imagine this has been a considerable undertaking, but one that we feel is extremely important and has been well received. We are also pleased that our new client site, EnVision, allows us to track your financial plan in real time. As we move forward, we expect the ability for you to monitor the health of your plan to be easier and more up to date. We know there are a few of you for whom we haven't had a chance to perform a full financial plan review, yet. Please know, our intention is to review all clients by year-end.

As always, if you are experiencing any concerns or would like to review your situation sooner, please do not hesitate to call.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value-weighted index. The Russell 2000 Index measures the total return of small capitalization U.S. stocks and is a market value-weighted index of the 2,000 smallest stocks in the broad-market Russell Index. The MSCI EAFE is a Morgan Stanley Capital International Index designed to measure the total return of the developed stock markets in Europe, Australasia, and the Far East. The S&P 500, Russell 2000, and EAFE are unmanaged indexes. One cannot invest directly in an index. Past performance does not guarantee future results.

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