



# Quarterly Financial Update

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Fourth Quarter 2011

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## *Part II*

### **The Value of Perspective**



I am deeply ambivalent about the extreme short-termism of contemporary society. It's not that I don't like having real-time access to my bank accounts and investment portfolio – because I do. It's that having real time access to everything from financial data to information about what our friends are currently having for lunch makes me worry about how well we deal with it all. In most cases, I suspect that our natural inclination to be distracted by the chatter and patter of novelty overwhelms our sense of what is important – of what is actually going on over the long term – to our own detriment.

Think of it as one more way in which the modern condition imposes a need for forbearance and discipline on a largely unreflective and highly distractible species. It's a lot like food behavior. For most of human history, people didn't have to think about balancing their caloric intake with their physical activity. They ate when they could get food and learned to be efficient about physical work because food was scarce and the activity required for survival was great. But our eat-a-lot-and-work-as-little-as-possible instincts are now killing us – literally. Similarly, having evolved in an analog world in which changes were largely gradual, our survival instincts cause us to pay close attention to things in the environment that pop and glitter. Yet these days the dancing widget on the web site or the simulated ticker tape on the screen usually serve only to suck our attention away from the fundamentals of the product we're looking to buy or the investment choice we want to evaluate. It's like a denial-of-service attack on our brains. Ironically, our well-being can frequently be best served by doing things that don't come naturally to us: eating less, exercising more, and paying less attention to short-term bling.

#### **The 30-Year Decision**

Most of us are at least familiar with the concept of trying to focus on the big picture when it comes to making investment decisions. Yet there are other aspects of our

financial lives that could be dramatically improved by adopting a longer-term, more holistic approach.

Nowhere is this more true than it is in the case of large, semi-permanent lifestyle choices, such as buying a house. A house purchase isn't really a single event. Instead, it is a series of events that happen over time. Just as buying a laser printer implies the purchase of ink cartridges, buying a house implies dozens of other purchases over time. Yet people routinely fail to take these secondary costs into account when deciding to buy a house. These costs include property taxes, insurance, furnishings, maintenance and utilities – even schooling or other lifestyle costs that may be implied by a choice of neighborhood. The cumulative, long-term impact of these implied purchases adds tens or even hundreds of thousands of dollars to the long-term cost of the house.

Like other long-term commitments, the choice of a house purchase is typically expensive, difficult, time consuming, and emotionally painful to undo. In other words, even if you admit that you've overextended yourself to buy your dream house, it's frequently not worth the financial, social, and psychic costs of change. This helps explain why so many Californians are 'house

poor' – a condition that describes spending so much of one's available resources on a house that there literally is nothing left over for anything else.

The antidote to traditional thinking for such decisions is to reframe the decision *up front* as part of a comprehensive, long-term plan.



Rather than asking how large a mortgage one can "afford" right now – a question only of near-term cash flow and only for the house itself – the question should be: What is the impact of this purchase on my long-term wealth likely to be? By considering the decision *in context* and *over time*, you'll be much more likely to make a choice that is right for you later – as well as right for you now. In

fact, in all the cases I've looked at, there's a "sweet spot" range of house prices for a client, where the benefits of permanent home ownership plus potential tax benefits exceed the expected cash outlay over time. Beyond that range, every dollar you spend on a house decreases your long-term wealth. In the end, if you want to spend more than your target suggests – that is fine – as long as you understand and can manage the long-term implications of your choice.

### **A World in a Grain of Sand**

Details are actually quite important. It's just that when there are so many of them it can be difficult to see how they fit together to form a big picture. It can also be difficult to fully appreciate when small changes in the present can have far-reaching implications.

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Take, for example, the fact that interest rates in the economy are at an all-time low. Short-term rates are at zero (or negative, if you count inflation). Long-term (10-year) rates for US Treasuries are less than 2 percent. They have been at historic lows for some time and, if one is to rely on the intention of the Federal Reserve, they are likely to remain so for the foreseeable future.

As I suggested in my investment review above, a key reason for this is an attempt by the Fed to lessen the burden of excessive debt in the economy, including debt at the federal level. In economics, as in physics, however, where there is an action there is usually an equal and opposite reaction. For every homeowner who is able to refinance a mortgage at more favorable rates – and thus have more money to spend on discretionary purchases in order to presumably ‘stimulate’



the economy – there is a retiree or saver who is now receiving 0% interest on his or her savings. This is a dramatic loss of return on capital for many individuals and may necessitate drawdowns from savings or capital in order to maintain basic spending. Is this good for the economy? Perhaps it does marginally increase discretionary spending in the short term. But it

also forces dis-saving over time, compromising the long-term financial health of retirees and savers specifically and generally destroying capital as a result. The one thing that is certain is that it is politically expedient. The government has decided to curry favor with one group of citizens (the indebted) while penalizing another (the savers). In the long run, however, it seems to me that this policy mortgages everybody’s economic future. It has long been known that, over the long run, capital formation and investment drive economic growth. By forcing dis-saving economy wide, therefore, current Fed policies will tend to dampen the prospects for long-term growth.

If you happen to be among those arguing for a ‘tax’ on wealth, I find it hard to find a better one than this. (There’s also inflation, of course, which works in similarly stealthy ways.) Let’s say you’re hoping to amass enough savings to support a comfortable retirement, for which you estimate that you’ll want income of about \$50,000 a year. If the long-run returns on capital in the economy average 6%, you’ll need to save \$833,333 to be assured of achieving your goal. On the other hand, if the Fed engineers a 1 percentage point decrease in overall returns on capital in the economy – say to 5% – then your savings requirement has suddenly increased to \$1,000,000 – an increase of \$166,667, or 20%! Talk about a tax. Predictably, Federal policymakers do not seem to consider that individuals might counteract their ‘stimulous’ moves by saving more in order to

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maintain their long-term financial prospects. Perhaps they are correct in this assumption for most Americans, though certainly not for all. It seems pretty clear to me, however, that everybody would be better served – both the already rich and the would-be rich – by economic policies that encourage both saving and economic growth rather than capital redistribution.

Isn't this just a problem for 'the rich'? Heck no. Public and private pension funds for millions of moderate-income families are being impacted by lower returns on capital. Over the long run, this will require plan sponsors either to lower their pension promises or to increase contributions to the plan by raising taxes – either on taxpayers or on shareholders. Either way, the loss of growth results in real costs in the economy.

What if you are one of those rare individuals who is aware that a decrease in long-term capital productivity is going to have a real impact on the amount of savings you'll need in retirement? Well, forwarned is forarmed.

### **Many Paths Diverging**

Many decisions, even seemingly innocuous ones, have long-term consequences. Like the poet's two roads diverging in a wood, the path that we choose today inevitably leads to vistas and possibilities and choices that are unique to it. Some of the characteristics of any path will be random and serendipitous, and thank goodness for that. But others are foreseeable, and many of those have financial implications, even if we do not (and should not) think of them primarily in terms of financial outcomes.



A good example of a decision with overlooked long-term implications is the choice of a young couple to locate near immediate family – or not. In most cases, this is a secondary decision, since the primary decision driver is the couple's career aspirations and opportunities. But having been made,

it has consequences for both generations, and it can be helpful to think those things through. Who will pay for occasional visits? How will the arrangement affect the adult children's ability to advocate for their parents as they age? Would it make sense for the older generation to relocate to be closer to at least one child? If so, should they do it earlier or later in retirement? If there are several, geographically dispersed, siblings in the family, how should they share in the responsibilities, financial and otherwise, of dealing with aging parents?

These days, there are more options than ever to help families deal with such choices and challenges, but most work best with a bit of advanced planning.

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- If you choose the right long term care insurance agency, they will be your (or your parents') advocate with the insurance company, relieving family members of an emotional and logistical burden at a critical time.
  - Elder-Advocate Nursing specialists are inventing a new vocation, acting on behalf of adult children who are geographically distant.
  - Do you want your adult children (and grandkids) to visit you more regularly? It might help to build that into your own retirement plan.

### Final Thoughts

As you begin the New Year, take a moment to de-focus on the cacophony and distractions of the moment. Resolve to spend a little bit of time each month considering both your goals and your problems in a long-term light. Where do you really want to be headed? How do you want to get there? Are you currently on the right path? If not, what are you willing to do about it?

If you're considering a big decision, think about it's long-term and secondary consequences, not just its sticker price. Your

health and sanity and marriage are worth as much to you (or more) as your money over the long run. Wherever possible, simplify your life. *Unnecessary* complexity obscures the underlying truths that you face and obscures solutions to problems, all while sapping your time and energy. If things are not as you would wish them to be, consider it a planning opportunity. If you like, you can always talk to us about your thoughts; that's one of the things we're here for.

