



## Nesting an Investment Strategy within a Financial Plan

### Summary

- Most of the investment material we produce relates to current economic views and market opportunities. Once a year, it is worthwhile to step back and focus on more strategic issues.
- For an individual investor, the most important topic is setting a long-term asset allocation strategy. We published, about a year ago, a piece in Glenmede's *Perspectives* which discussed the importance of nesting an investment strategy within a long-term financial plan.
- The following is an updated version of the article, with the addition of two case studies which attempt to bring this topic to life. The individuals discussed are, of course, fictional. Any resemblance to family members, clients, or former college girlfriends is purely coincidental.
- Our new Director of Investment Strategy, Jason Pride, and I are in the process of updating our economic and market outlook; our latest views will be published shortly.

### Financial Planning and Investment Strategy

Investing and financial planning are often treated as separate disciplines when, in fact, they are closely linked. On its own, investing is the art of maximizing return and minimizing risk. Financial planning, in part, is the process of defining objectives and developing a strategy that best achieves these objectives. When combined, these disciplines address the question, "What is the investment strategy that will best achieve my financial planning goals and objectives?"

At Glenmede, we firmly believe an asset allocation and investment strategy should wrap around a very clear understanding of a client's financial plans. Given our outlook for fairly volatile markets, we recommend that clients consult with their relationship management team to review their investment strategy and, if necessary, revise their financial plan.

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## A Very Volatile Market Outlook

By most historical measures, many stocks are selling at acceptable valuation levels. For long-term investors, this can be a good time to invest in under-valued risk assets. Having said this, we continue to face extraordinary economic conditions and it is quite possible we will see either further market decline, or a sustained period of flat performance. While it would be nice if we could foretell the coming years' markets with certainty, we can offer advice based on what is likely to happen.

Investing without planning for the possibility of a significant downturn is a bit like living in a house without fire insurance. Hopefully, in both cases, your worst fears go unrealized and caution is merely a cost. Even so, sleeping may be a little difficult. By designing an investment strategy within a financial plan, while you may not eliminate portfolio volatility, you actively manage to optimize the outcome and, more importantly, reach your goals.

## Knowing Your Objectives

The first step in creating a financial plan is actually the most important: knowing your financial goals. Financial planning goals are often broken down into three general categories:

1. Personal Spending: How much do you plan to spend per year?
2. Legacy: How much of your estate will you leave to family members and other beneficiaries?
3. Charitable: How much will you give to charitable causes, and at what point will these gifts be made?

The first case-study walks through a sample set of financial goals for a hypothetical couple. With these considerations (along with some basic information concerning assets, liabilities, and estate planning), we outline a financial plan. From this financial plan we develop an investment plan.

## Investing with an Eye Toward Meeting Financial Goals

So, how do we determine whether your investment strategy is able to support your financial goals? In a comprehensive financial plan, we project your spending, examine your assets, and estimate the probability of meeting these goals. For most clients, this is a worthwhile exercise every two or three years, or following significant personal developments or changes in the financial markets. There are, however, some simple ways to approach this issue, particularly as it relates to whether you will have sufficient capital to cover personal spending goals.

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Traditionally, financial planning and investing have been linked through the development of an asset mix which produces the required income to meet your personal spending needs. This approach has its advantages:

- First, if you have a diversified portfolio, the interest and dividend income produced will probably be fairly stable even though market values may swing quite significantly.
- Second, this approach, which allowed many investors to ride through the downturn, can enable you to withstand difficult periods and benefit from stock market growth over time.

The disadvantage of this approach is that it may encourage an inappropriately high allocation to fixed income securities. Bonds are wonderful investments when equity markets decline. It is not likely, however, that they will appreciate enough to compensate for the loss of purchasing power due to inflation.

The more modern, alternative approach is to identify an asset mix with an expected total-return (income plus capital appreciation). For example, if we determine your spending rate (spending divided by assets) and estimate for inflation, this sum equals the expected return you will need to meet your current spending needs as they grow with inflation and the inflation-adjusted value of the assets you plan to bequeath.

For instance, if you spend 4% of your assets annually, and inflation is 3%, you will need to earn a 7% rate-of-return over time. At present, we estimate a mix that includes 56% or more in equities will achieve this return.

A more complex analysis may be required if you spend more than your estimated total-return. In this scenario your assets will be reduced over time. At this point, financial analysis can help determine the probability that you will outlive your assets.

The critical problem with the "total return" approach is that it assumes portfolios will not just produce income but also see capital appreciation. This is usually true, but is certainly not the case over exceptional periods like the last ten years. If markets decline, it is possible that either your personal spending will need to decrease or, if you don't adjust your spending, you will have to liquidate a greater percentage of your assets at a time when stocks are relatively cheap. The second case study discusses how one couple selected an asset allocation based upon their financial plan.

Many people find it makes sense to marry the two approaches. For example, you may choose to invest from a total-return perspective for the long term, but set aside the estimated short-term spending needs in cash or short-term fixed income securities. Regardless of the selected approach, it is prudent to update your financial plan once every two or three years and evaluate whether your investment strategy supports your financial goals.

Please contact your relationship manager to discuss whether your current asset allocation aligns with your financial plan (or to develop a plan if one does not exist).

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## Appendix A

### Case Study: Wealth Objectives

#### Personal Objectives

Peter and Katherine want to enjoy the rewards of their hard work. They believe annually they will spend approximately \$500,000 (after tax). Peter will continue to consult (\$6,000/day) with his former company through his S Corp, Lockhaven. Lockhaven will provide “hobby money” for Peter to invest in his kids’ entrepreneurial ideas and “other” investments.

#### Legacy Objectives

With an unexpected increase in their wealth from a private equity transaction, Peter and Katherine feel they have new responsibilities. Prior to the transaction they thought their estates would pass along a maximum of \$2 million for each of their sons. They still want to provide both sons and their families with certain life advantages, but they do not want to overindulge them or adversely affect their lives. As a result, the couple revised their estate plans to include a family foundation. They may also leave \$1 million in assets to other deserving family members who are in need.

#### Charitable Objectives

In 2008, Peter and Katherine’s new sense of responsibility for their “additional” wealth led them to establish a family foundation with \$5 million. This decision was reaffirmed by their son and daughter-in-law’s (Ernest and Allison) decision to begin their own family foundation. Peter and Katherine are in the early stages of realizing how a family foundation can also provide a multi-generational family bond. For instance, Katherine wants the foundation to focus on social welfare, education, preserving modern architecture and the performing arts.

#### Other

Peter and Katherine would like to review their financial plan in either 2010 or if/when the market value of their assets changes significantly.

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## Appendix B

### Case Study: Spending and Asset Allocation

From Miriam's perspective a portfolio review with her husband (Elliot) has its pluses and minuses. Before the meeting she has a good excuse to browse the stores selling mid-century modern furniture and artifacts. Miriam enjoys this period of art and by her reckoning, has made a series of well-timed art and antique purchases that have appreciated well over the last decade.

Elliot also enjoys these sessions, particularly if the Chief Investment Officer participates. Elliot has a knack for succinctly recalling each of the CIO's failed predictions while the CIO suffers selective memory loss and can only recall his successes. The CIO has explained this disability enhances his personal job satisfaction. Elliot, however, cannot stand to see his friend suffer and seeks earnestly to heal him.

There was, though, a tendency for these conversations to get a little lost in the trees so on this day Miriam asked the rather pointed question, "Are we going to outlive our money?"

Elliot, who had just cornered the CIO into an uncomfortable rhetorical position, tried quickly to dispense with the interruption so he could return to the relevant task - eviscerating his adversary's pride and logic. "Well sweetheart, if we successfully pick investments which earn a high return rate we will not run out of money."

"Elliot, you are not listening."

After having worked together in a small business for over 50 years, Miriam and Elliot had recently retired with approximately \$8 million in investable assets. They were considering whether to sell their current house for a mid-century modern house in Palm Springs, California. The house in Palm Springs, a classic period piece, will require extensive renovations in order for it to serve as a showcase for the couple's extensive furniture and mid-century modern art collections purchased over the years from auctions.

In addition to their existing assets, Elliot and Miriam will receive the proceeds from the sale of their existing house, which they estimate will net \$1.3 million. However, given the state of the real estate market, they might not get close to the asking price. As well, they are uncertain if they want to relinquish a residence close to their children.

The couple anticipates they will need about \$400,000 to cover spending and taxes in a normal year. In the coming year they believe they will need closer to \$1 million to cover both their annual needs and renovation expenses.

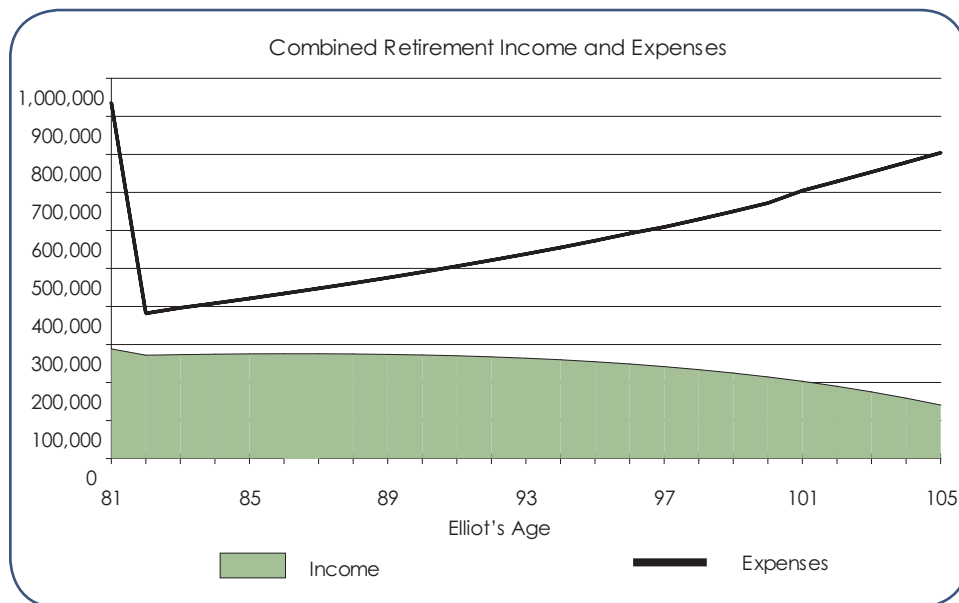
Elliot has traditionally favored a portfolio with about 70% in equities. In more recent years, his portfolio manager tilted to a lower equity weighting over concern with equity market valuations and the potential need for cash associated with the Palm Springs purchase. In light of Elliot and Miriam's recent retirement and the market volatility, their relationship manager suggested they test whether different asset allocations may make sense.

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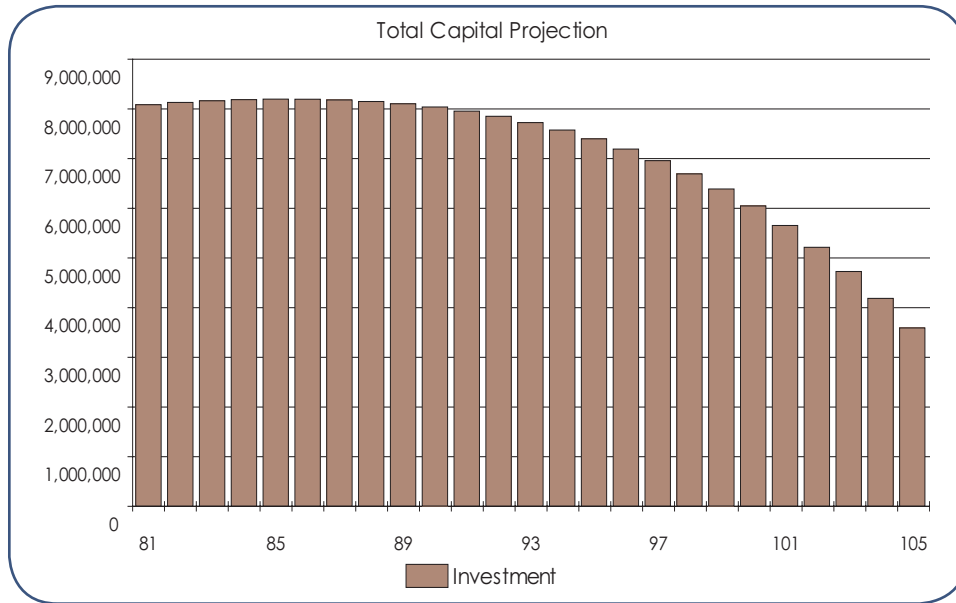
As a result, the couple's administrative officer created a complete financial plan starting with a family balance sheet. The balance sheet consolidated their bank accounts, 401k assets, investment assets at Glenmede, and an old trust account at a Manhattan bank currently receiving government funds, as well as the relatively small mortgage on the Palm Springs house. Utilizing reasonable market return and tax rate estimates, the administrator projected the couple's total expenses. In making the projections the administrator assumed their expenses would grow at an inflation rate of 3% per annum. The administrator also assumed they will keep their current residence, foregoing sale proceeds.

The following two graphs illustrate the family's projected expenses, as well as their income and remaining capital after spending and taxes.

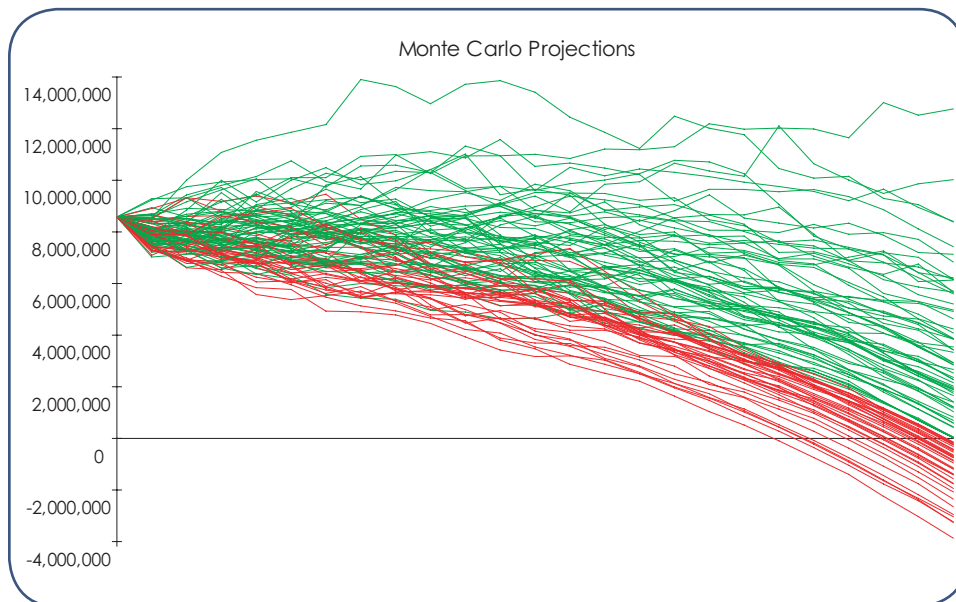


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The couple's administrator then performed a Monte Carlo simulation of portfolio returns. A Monte Carlo simulation is actually multiple simulations of the couple's spending and assets assuming different return outcomes ranging from a bull market to a bear market. These simulations represent the varying results that could occur over their lifetimes. In the following chart, the green lines represent scenarios where enough money remains at the end of their life expectancies, while the red lines represent scenarios where they will run out of money by age 100.



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According to this analysis, there is a 67% and greater than 95% probability the couple will not run out of money by ages 100 and 90, respectively, assuming current spending patterns plus inflation growth. The administrator then ran another Monte Carlo projection assuming the couple sold their house and reinvested the money. In this case, there was an 88% and greater than 95% probability the couple will not run out of money by ages 100 and 90, respectively.

To meet their goals with a higher probability, the portfolio manager suggested the couple consider a portfolio with more fixed income. Another set of analysis was run assuming a reduction in the portfolio's equity exposure from 70% to 50%, and an increase in fixed income from 30% to 50%. As it turned out, the higher fixed income weighting increased the probability the couple will not exhaust their assets. The family liked this outcome. They also liked the fact that the higher fixed income amount produced more income and that the dividends from stocks and the income from bonds covered 73% of their spending and taxes rather than just 63%. This meant the couple was slightly less dependent on capital appreciation to fund their ongoing needs. They were relatively unconcerned by the fact their portfolio would not appreciate as much if stock markets rallied significantly.

	% Equities	Portfolio Value		Probability of Success*	
		Starting Value	Values at Age 100 assuming normal market returns	Age 90	Age 100
Keep the House	50%	8,579,084	8,508,785	>95.0%	72%
	69%	8,579,084	8,662,227	>95.0%	67%
Sell the House	50%	9,879,084	12,879,825	>95.0%	94%
	69%	9,879,084	13,228,489	>95.0%	88%

\*Probability of Success = Probability of not running out of money at the age specified

As a result, they decided to immediately increase their fixed income allocation by 10% and subsequently transition the final 10% by mid-year. If their portfolio manager felt market conditions might warrant either moving slower or faster, the timing of the switch could be altered.

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