PART I

REGAIN YOUR BALANCE

CHAPTER 1

Adapt to the Changing Landscape

In cartoons, when a boulder falls and drives a character into the ground, he's briefly stunned. We laugh at his frazzled look and empathize with his despair. But soon he shakes off the hurt, his flattened head returns to normal, and all is well. So we laugh some more. Trouble is, I don't think this last recession is like that.

The boulder that fell on us in 2007–2008 is likely to change the face of investing and retirement planning for a long time, perhaps forever. The market meltdown and the ensuing government response are reshaping the financial landscape. Old ways of thinking about retirement are going out the window. New ideas are called for.

In this chapter, I'm going to outline some of the changes we've seen, or are likely to see, and explain how I think they'll affect retirement planning in general. In the following chapter, I'll get more specific about how this could, or should, affect *your* planning.

The End of Easy

Whatever else you call the recent economic convulsion—the "Great Recession," a "severe downturn," or "the worst financial crisis since 1929"—it's what many have labeled "the End of Easy." The end of getting a mortgage without having to show you can repay it. The end of inflation that's so low it's barely perceptible. The end of government that takes a hands-off stance toward business. The end of relentlessly soaring home prices that make houses into virtual ATMs. And probably pretty much the end of the idea that you're going to be able to get by on a guaranteed company pension and Social Security.

A new reality has been brewing for several decades and has accelerated during the recent unpleasantness. And here's the bottom line: *More than ever, you're going to be on your own.* Being on your own and acting wisely on financial matters isn't the easiest thing to do, especially if you have a job, a family, and a mortgage. And, of course, for those who've lost their jobs, the challenge is of a whole other order of magnitude. So more than ever, you'll need to do some hard thinking about the future.

Let's look at some of these tectonic shifts in the economic landscape as they affect retirement:

- **Houses aren't what they used to be.** Until recently, about the only qualifying test for getting a home loan was the ability to fog a mirror. If you could breathe, you could probably get the money. Even if the monthly payment was more than you could afford, that would be okay because the market value presumably would soon soar, then you could refinance, take on an even bigger debt and end up with a wad of cash in your pocket and bragging rights about your house's astronomical value.

  It was like musical chairs. Everyone was moving on and moving up . . . but then the music stopped. Suddenly, almost anyone who'd bought a house in the past few years owed more than it was worth. Foreclosures and short sales soared. The home-building industry collapsed. Millions of people lost their homes. Many preretirees who'd been counting on their home equity to fund their sunset years were dealt a huge blow.
- **Many investors lost confidence in stocks.** From its peak in October 2007 to early March 2009, the Standard & Poor's 500–stock index fell more than 56 percent. The decline was so severe that it brought down long-term performance figures, too. In fact, Ibbotson Associates' figures show that the market's horrific performance in 2008 and early 2009, coming on top of the 2000–2002 downturn, makes this one of the worst decades ever for stocks. Annualized total return after inflation actually was worse (–5.8 percent) for the 10-year period ending in February 2009 than the annualized total return (–5.0 percent) for the 10 years ending in August 1939.

Even with the stunning stock-market rally beginning in March 2009, the S&P 500 still posted a negative return for the decade.

Net *inflows* into stock funds in February 2007, before equities peaked, were $27 billion. Two years later, the net *outflow* for February 2009 was $25 billion, according to the Investment Company Institute, a mutual-fund trade group.

So investors can be forgiven for feeling a bit bewildered. All the oft-recited statistics about stocks averaging 8 to 10 percent annual gains long-term proved, at least for the past decade, to be a cruel joke. (As I've stated many times, "long term" should mean 15 to 25 years. That's because every so often, we have "a lost decade" in which stocks go nowhere. Of course, no one knows when that next will happen.) So while some investors are looking for beaten-down stocks in order to take advantage of a hoped-for rally, many others are unlikely to shake off the recent collapse so quickly: The mind-set that they'd worked under for the past 20 or so years has been dented.

- **Feelings of economic insecurity are rampant.** Confusion reigns. The sharp drop in equities has made even the wealthy feel more pessimistic and risk-averse, according to recent surveys. Fidelity polled some 1,000 millionaires and found 46 percent of them were less than comfortable with their financial positions. And in its tenth year, the Phoenix Wealth Survey, conducted by Harris Interactive, found that of 1,700 respondents, 30 percent were downbeat, six times the proportion who felt that way in 2000.

  Some 50 percent of the millionaires talking to Phoenix said they were unsure exactly how to invest. That compares with 32 percent in 2008 and 26 percent in 2007 who felt that way.
- **"Defined-benefit" pensions are on the way out.** Our parents and grandparents worked decades for the same companies because their pension plans promised a secure retirement. Those days are largely over.

  As recently as 1985, according to the Labor Department, about 80 percent of employees in medium-sized and large companies had such plans, which promise a lifetime stipend. But by 2000, defined-benefit recipients had dwindled to just 36 percent. What's happened is that employees were saddled with the investment and actuarial risks as their employers shifted to "defined contribution" formulas. The result is that many employers now contribute to 401(k) plans that are managed by the employees. Unfortunately, as we'll soon see, workers often don't do a very good job of managing those investments.

What's more, with the recession slamming profits, many of the remaining company pension plans are underfunded. The Pension Benefit Guaranty Corp., which underwrites private pensions, recently reported its largest deficit ever. And Congress, seeking to prevent retirees from draining badly needed cash from the plans, is requiring pension plans to restrict lump-sum payouts when any plan is less than 80 percent funded. At that point, workers can receive only half of the amount in a lump sum, with the other half as an annuity. Plans that are less than 60 percent funded can provide no lump sums, only annuities. That adds up to another curveball tossed at soon-to-be retirees who were counting on a big windfall.

- **Meanwhile, "defined contribution" plans have lost some of their luster.** Many 401(k) and similar plans suffered a loss of nearly 50 percent in value—peak to trough—over the past year or two. This has imperiled retirement for older workers and led some younger workers to wonder whether they should participate at all.

When 401(k)-type plans came on the scene in the early 1980s, they were viewed mainly as supplements to employer-funded pension and profit-sharing plans. Because 401(k) participants were presumed to have their basic retirement-income security needs covered by an employer-funded plan and Social Security, they were given substantial discretion over 401(k) choices. In a sense, everyone was encouraged to become an investment expert.

Now, many firms are cutting back—at least temporarily—on their contributions.

And because of the recession and the fact that many 401(k)s haven't been well-managed by their holders, the balances in those plans likely will be insufficient as the sole supplement to Social Security.

In fact, the Congressional Research Service (CRS) did a study on consumer finances and found that for the 53 percent of households that hold at least one retirement account, the median combined balance was $45,000. Of course, that includes younger workers who haven't yet started saving a lot.

But for households headed by persons between the ages of 55 and 64, the median value of all retirement accounts was just $100,000. Better, huh? Well, sure, but that amount would buy an annuity paying perhaps $700 a month for life, based on current interest rates. And how many lattes is that going to buy you in, say, 20 years?

To make matters worse, the CRS study was based on consumer-finance figures gathered by the Federal Reserve in 2007—*before* the market meltdown. So the median account balances likely are a good deal lower now.

- **Our savings and investing habits have been slow to change.** In recent decades, Americans have become the consummate consumers. Savers, not so much. According to the Commerce Department's Bureau of Economic Analysis, the national savings rate was about 11 percent in 1981. Before the recent meltdown, it fell to about 1.7 percent and has since rebounded to roughly 3 percent. Personal bankruptcies are rising. We're still credit-card addicts.

  Hewitt Associates recently released a study showing that despite record losses in 401(k) accounts in 2008, savings and investing habits barely budged. The median 401(k) plan balance dropped from $79,600 in 2007 to $57,200 by the end of 2008. Yet the vast majority of workers continued to save in their plan at roughly the same rate. Fewer than one in five workers, Hewitt said, made any trade in their 401(k) in 2008.

  Fidelity didn't do a survey but instead relied on actual behavior among the more than 11 million participants in the pension programs it runs. Fidelity's numbers indicated that only about one of every 29 plans participants traded out of one fund and into another in their plan. Such a low level of activity suggests that investors for the most part are sticking with the investment strategy they started with, which may well be a plan that's no longer suitable or appropriate.

  Active trading rarely makes sense. But adjusting the amount you save or rebalancing your portfolio from time to time is prudent and advisable.

- **Credit is getting a lot harder to get.** Banks have put the squeeze on all kinds of consumer loans. The bar has been raised on who gets the very best rates. Lenders are ratcheting up minimum credit scores, requiring bigger down payments, and upping interest rates for borrowers with less-than-perfect credit histories. In other words, to get a loan you now need to be financially fit and have the documents to prove it.

  As far as mortgages are concerned, lenders are eying an overall debt-to-gross income ratio that falls below 40 percent—that's down from the 55 percent or 60 percent that some lenders would approve before the mortgage meltdown. Even if a lender does not hold you to this standard, you'd be smart to do so yourself. Plus, down payments are back in vogue. Plan on putting down at least 10 percent, though 20 percent will get you a better rate. And you'll need the paperwork to prove your income, assets, and overall balance sheet.

  Also, expect tougher financing for cars and say good-bye to no-cash-down deals. Lenders are also restricting the lengths of auto loans. So signing up for a loan that's longer than five years—a common practice until recently—may not be an option.

  Credit-card companies are reducing credit limits, raising interest rates and fees, and closing idle accounts in response to rising business costs and charge-offs, which occur when banks treat delinquent accounts as a loss. Days of a $25,000 credit limit based on a credit score in the 600s are largely gone. And getting approved for a new credit card is definitely getting more difficult.
- **Tax hikes—maybe really big ones—are in the offing.** Total federal debt almost doubled during President George W. Bush's administration, and as much as we needed stimulus spending by the Obama administration to boost the economy, the nonpartisan Congressional Budget Office now estimates total debt levels could almost double again over the next eight years, with our "tax bill doubling over time." Excessive debt virtually guarantees our taxes are going up, way up.

  Funding for Medicare and Social Security, as you've probably read, present real challenges. Those two trust funds already eat up more than a third of the federal budget and increase by $2 trillion each year. Medicare surpluses will run out in 2016. Social Security will be spending more than it takes in by 2017 and will be broke by 2037.

- **Inflation predicted.** Inflation rose an average of 3.3 percent over the past 25 years, according to the Bureau of Labor Statistics index that tracks the cost of living for those age 62 or older. (That index weighs prices for medical care and shelter more heavily than does the overall inflation index.) But, pessimists warn, printing a lot of money will lead to runaway inflation.

The Lessons

What are we to draw from all this? What does this most recent grizzly bear of the market tell us? It tells us that when markets go down as much as they did in 2008–2009, it's easy to:

- **Suffer paralysis by analysis . . . and end up doing nothing.** Just keep doing what you've always been doing, and you'll probably end up with the same results.

  The research firm Dalbar, Inc., has found that while the S&P 500 index earned an average of 8.4 percent during the 20 years through 2008, the average individual investor earned an annual return of just 1.9 percent. That's because many investors followed their emotions and tended to jump in and out of stocks.
- **Get mad, point fingers, and swear off investing forever.** Nor is this a very good strategy. Those investors who will survive and thrive will be those who can keep their heads and also use those heads. In other words, you don't want to overreact, but you also don't want to hide your head in the sand and refuse to adapt to the new reality. You want to figure out what you did wrong and fix it.

  Clearly, Americans are going to need to try harder to live within their means. That entails creating a budget and sticking with it. It means calculating retirement expenses as carefully as possible. It means rebuilding your savings, rethinking your retirement years, and retooling your retirement-savings plans, all of which will be covered in the next chapter. You've also got to invest differently, which I'll explain after that.

A Final Word

The recent "Great Recession" revealed some major changes in our economic landscape. People came to see that their homes can't be infinite sources of income, for example, that the economic security that their parents or grandparents may have enjoyed may be a thing of the past, and that our savings and investing habits need to change. The question then becomes this: What can you do about that? In the next chapter we'll talk about how you can adjust your individual situation to make the most of these new realities.