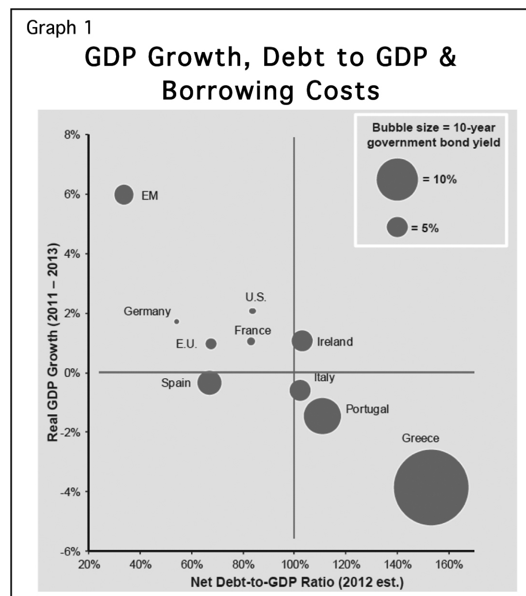
DVI
DAVID VAUGHAN INVESTMENTS

Fall 2012 | Vol. 19 | No. 4

We Simply Do Not Know Yet

Attempting to assist clients to make informed, well thought out estate and financial planning decisions in the current environment is nearly impossible. What we face here at DVI on a day-in/day-out basis is a microcosm of what has to be occurring all over the United States as small, mid-size and large businesses struggle to invest their capital and allocate their enterprise wide resources. With so much uncertainty, who can forecast with any sense of conviction what the future is going to look like on so many key topics? What will be the condition of the U.S. economy 12 months from now? Will Global GDP remain positive and resilient? Will Washington remain in gridlock or will the post election environment change all of that for the better? What will happen at year end; a Fiscal Ladder, Ledge or Cliff? What about tax policy, both individual and corporate? With all of these unknowns, enough to make your head spin, most rational business leaders are taking a wait and see approach and for the most part they are skeptical. A recently released Wall Street Journal survey found only 38% of the respondents confident that we would avoid the tax increases and spending cuts scheduled to take effect at year end.[1]

Graph 1

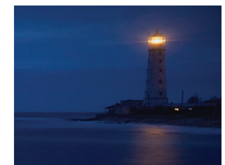


Source: JP Morgan

What We Do Know

- There is a coordinated global effort to provide liquidity at all costs to avoid further economic contraction and to place a floor under the global economy. With debt levels as a percentage of annual GDP at unprecedented levels (see graph 1), the global capital markets would not tolerate a sustained reduction in tax receipts due to a slowdown. In excess of 70%, the U.S. debt to GDP ratio is unhealthy and unsustainable. Those that advocate further Fiscal Spending as our way out of this mess should recognize the correlation between higher debt to GDP ratios and a nation's borrowing costs. When one carries nearly $16 trillion in outstanding debt, we can ill afford higher carrying charges.
- The Fiscal Cliff is no longer a secret and has been discussed and analyzed as much as the prior decade's scare surrounding Y2K. It is widely known

| Continued on Page 4


1 We Simply Do Not Know Yet

2 Should I Buy Long Term Care Insurance?

3 The 4% Rule

Route To:

____

____

____

Should I Buy Long Term Care Insurance?

Stephanie Ricketts, CFP®
Relationship Manager

It is a question we get asked quite frequently in our client meetings: Should I buy Long Term Care (LTC) Insurance? The answer to this question is often not clear cut and almost always fraught with emotion. Each situation is different. Making a sound decision about whether to opt for long term care insurance involves weighing the probabilities. Is it worth paying the premiums for many years – risking premium increases or benefit cutbacks along the way – in exchange for peace of mind? What if you never need long term care? The decision to buy or not buy long term care insurance is a highly personal choice that will revolve around your health and financial wherewithal. Unfortunately, the "right" decision will be evident only in hindsight, but it is certainly worthwhile to educate ourselves about the issues and arm ourselves with the facts in order to decide how best to address this financial concern with our valued clients.

As Backdrop:

The cost of care: In 2012 the median annual rate for a private room in a nursing home was $81,000, and the average length of stay was 2.44 years. Additionally, median nursing home costs increased at a 4.5% annualized rate between 2008 and 2012 (source: Morningstar).

The estimated need: According to the American Association for Long Term Care Insurance (www.altci.org), the estimated years of an individual requiring long term care after turning age 65 breaks down statistically as follows:

More than 5 years: 20%
2 to 5 years: 20%
1 to 2 years: 12%
1 year or less: 17%
None: 31%

The estimated cost of coverage: Cost of insurance varies significantly based upon several factors including age, how much protection is purchased, health status, the insurance company, and even the state in which you live. Comparing virtually identical policies between insurance companies can vary as much as 60 to 90 percent. Providing any sort of an estimate on median cost is impractical because of the individualized nature of coverage needs and the unique condition of the purchaser. There are a dizzying array of options and features one must understand when considering the purchase of a LTC policy; many of which are as follows:

What daily benefit will you need? The higher the daily benefit the higher the premium, and striking a balance between daily benefit and cost must be determined.

How long will the benefits last? As stated above, the typical stay is 2 ½ years. Also, think about your own family's health history. Would it necessitate longer coverage?

What's the elimination period? This is comparable to the deductible on other insurance policies. Medicare typically pays for 20 days and most policies start with a 30 to 90 day elimination period. The longer the elimination period, the cheaper the premium.

Is the benefit inflation protected? With nursing home costs increasing at a rate of approximately 4.5% per year, a policy rider that guarantees inflation increases may be more expensive, but probably worthwhile.

What level of care does the policy cover? Levels of care include skilled (provided by nurses) and unskilled (activities of daily living including assistance with bathing, walking and dressing).

Does the policy cover help at home? Some policies do cover costs of bringing people into your home and others do not. Sometimes the policy may require a prior hospital stay before this benefit is available.

Is the policy tax qualified or nonqualified? A qualified policy allows you to deduct premiums as a medical expense, up to certain limits, (to the extent all medical expenses exceed 7.5% of your adjusted gross income). Benefits from qualified policies are not considered taxable income and the vast majority of policies issued today are qualified. A nonqualified policy does not require a doctor's certification to pay benefits, but rather set their own internal triggers of when to pay out benefits.

How financially stable is the insurer? Research the financial rating of the company offering the policy and check out ratings at A.M. Best's website (www.ambest.com).

With the above questions only being a sampling of features to consider and with insurance costs continually rising, it's no wonder that the next question, or some variation of it, we typically encounter is ,"Do I have enough to self insure?" It seems that the rule of thumb is that individuals with $2 million or more in assets can self insure for the long term as they can utilize their nest eggs to cover costs. Rapidly rising long term care costs, longevity rates and increasing rates of Alzheimer's and dementia among the elderly, however, makes that $2 million not what it once was. In order to make this last, how much should one reasonably set aside to cover such expenses and in what vehicles should you invest the money?

(1) Make sure you are saving enough or have saved enough. Estimates of possible long term care needs can be calculated based upon current age, estimated age at needing long term care, annual cost of care in today's dollars, assumed inflation rate and number of years estimated to need long term care. Once this figure is calculated, one can arrive at a reasonable savings target of dollars that should be earmarked for long term care needs or the savings goal to work towards.

(2) Should you consider ongoing living expenses? Some individuals are of the mindset that if you are in a long term care setting, you won't need to buy your own food, or maintain a household. That may be the case for some, such as single people who enter long term care settings or for those who have outlived their spouses, but in other instances some seniors prefer to receive care in their own homes. This is not uncommon for couples where one spouse needs long term care while the other remains healthy.

(3) Consider earmarking a certain level of assets for long term care expenses. If you feel that long term care expenses will be on the horizon and are going to be in addition to regular living expenses, budget for them separately or view them as segregated from your other retirement assets. These are assets that would be among the last to be depleted during your lifetime and outpacing the long term care inflation rate should be a primary goal. If the assets are not utilized for long term care needs, they become additional money that passes to heirs.

The final question we are often asked is about Medicare and the long term care coverage it provides. Many individuals assume that Medicare will cover their long term care needs, and that since the

benefits are not need based, people do not need to deplete their assets to qualify (as they do with Medicaid). Medicare, however, only covers long term care needs under a limited set of circumstances and for a short period of time. It provides coverage for the first 20 days in a skilled nursing facility following a three day hospital stay, provided the person needs skilled care; for the next 80 days, Medicare picks up a portion of the bill. It may also provide short term home health care for those recovering from an illness or injury as well as hospice care for terminal illness. Medicare does not cover extended, open ended long term care, or custodial care, to help an individual carry out basic activities of daily living. In short, it should not be considered part of a viable long term care plan.

So while we may not be able to succinctly answer yes or no to the "should I buy long term care insurance" question, at DVI we will continually do our best to assist our clients in making a sound decision for their unique needs and goals by staying current on the facts and circumstances of long term care costs.

The 4% Rule

Brian Christensen, CFA

Senior Vice President

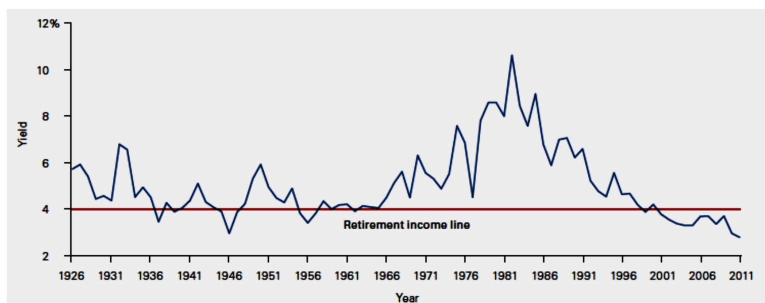
As clients approach or have already entered retirement, there is one question we hear frequently. How much of my retirement savings can be spent each year without eventually running out of money or losing purchasing power to inflation? Opinions and research on the subject are broad with many variables playing into the outcome.

In 1994, William P. Bengen published an article in the *Journal of Financial Planning* titled, "Determining Withdrawal Rates Using Historical Data". While the title doesn't make one want to dash off to Barnes & Noble, the conclusions of the paper have become time tested and recognized as both sound advice and a good place to start your planning.

Bengen's research was based upon financial and market data reaching back to the mid-1920's and assumed a portfolio was invested 50% stocks and 50% bonds. He ran thousands of scenarios reconstructing actual investment results for periods including the Great Depression, World War II, and the high inflation years of the 1970's. Bengen's answer – "If you spend 4.5% of your retirement savings in your first year and increase the annual amount each year by inflation, your assets will last at least 30 years under all the scenarios tested." One caveat, Bengen assumed that retirement savings were all tax-deferred (IRA's, 401(k)'s, etc.). Bengen's conclusion became widely known as the 4% Rule.

In August of this year, Vanguard Investment Research revisited the 4% Rule in recognition of the current low interest rate environment. For the majority of the years from 1926 to 2011, the income return on a 50% stock/50% bond portfolio exceeded 4%. The chart below provides detail.

Clearly investment income has become strained in today's low rate environment bringing question to the appropriateness of the 4% Rule. Aside from interest rates, there are other assumptions that can affect spending levels including retirement horizon and portfolio asset allocation.



Notes Equity returns are represented by a blend of S&P indices, the Wilshire 5000 index, and the MSCI U.S. Broad Market index. Bond market returns are represented by a blend of S&P indices, Citigroup indices, Lehman Brothers indices and Barclays indices.
Source: Vanguard

The factor with the greatest impact on portfolio longevity is retirement horizon. Vanguard proposes that age 95 is a reasonable default, given today's longer life expectancies. Based upon calculations using mortality data from the Society of Actuaries Retirement Participant Table, Vanguard determined that for a 65 year old married couple, there is an 80% chance that at least one spouse will live to age 85, a 55% chance that one will live to age 90, and a 25% chance that one will live to age 95. Intuitively, longer retirement horizons imply lower spending rates.

However, one must also consider the portfolio's investment allocation. A portfolio's long-term rate of return can have a substantial impact on portfolio longevity. A more aggressive investment strategy may be able to support higher spending levels. Vanguard modeled three hypothetical portfolios to test success rates of various scenarios. Vanguard's Conservative Portfolio was 20% Stocks/80% Bonds, the Moderate Portfolio was 50% Stocks/50% Bonds and their Aggressive Portfolio was 80% Stocks/20% Bonds. Vanguard's stock allocations included both international and U.S. stocks. The tables above outline the results of the study.

a. Portfolio withdrawal rates assuming 85% success rate

	Planning horizon (years)						
Portfolio	10	15	20	25	30	35	40
Conservative	9.3%	6.3%	4.8%	4.0%	3.5%	3.1%	2.9%
Moderate	9.6	6.6	5.2	4.4	3.9	3.5	3.3
Aggressive	9.6	6.7	5.3	4.5	4.0	3.7	3.4

b. Portfolio withdrawal rates assuming 75% success rate

	Planning horizon (years)						
Portfolio	10	15	20	25	30	35	40
Conservative	9.7%	6.7%	5.2%	4.4%	3.8%	3.4%	3.2%
Moderate	10.4	7.3	5.9	5.0	4.5	4.1	3.8
Aggressive	10.7	7.7	6.2	5.4	4.9	4.5	4.3

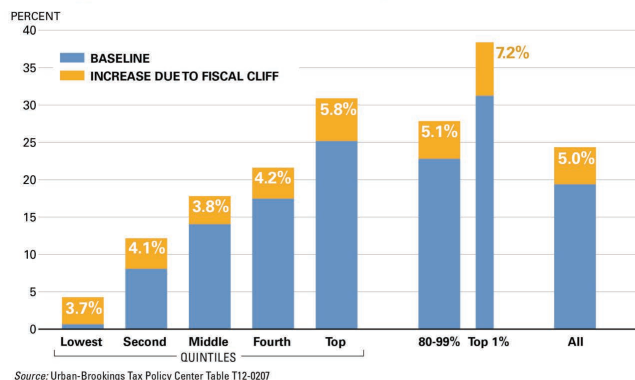
Notes: Results are based on projections of the Vanguard Capital Markets Model as of 12/31/11.
Source: Vanguard

DVI advocates a total return approach when considering retirement income needs. Investment income should not be the sole determinant of a portfolio's ability to support long-term spending. Capital appreciation is a meaningful component of long-term value creation. The DVI team includes Certified Financial Planners and Chartered Financial Analysts all capable of evaluating and building a long-term plan for retirement spending. Our evaluations result in a sound plan for managing your retirement income needs well into the future. You won't receive a sixty page report generated by some computer model that inevitably includes a recommendation for owning more insurance or an annuity contract. You will receive our best thinking and a commitment to execute the plan. The 4% Rule is a great place to start our conversation.

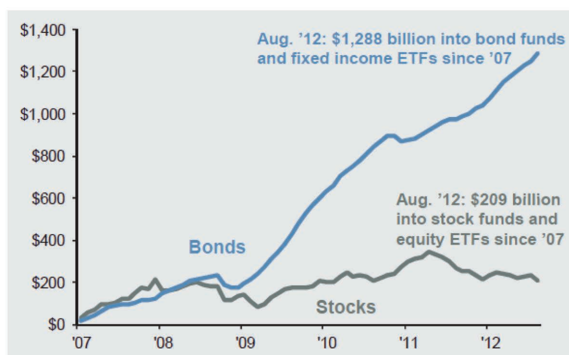
We Simply Do No Know Yet

Continued from Page 1

and understood by both political parties that the nation's economy could not withstand the jolt from sizeable reductions in both fiscal expenditures and across the board tax increases due to the phase out of the Bush tax policies. The Tax Policy Center (see graph 2) has estimated that a complete phase out would result on average in an additional 5% tax rate per household, with the top 1% of income earners gaining an additional 7.2% or a 23% tax increase. With the nation's economy 71% consumer driven, and small business owners being the primary driver of job creation here in the U.S., a shock of this magnitude is simply not realistic. We might not see a "Grand Compromise" between the ideologues of both parties, but in this fragile economy common sense would suggest some movement by both sides to remove the cataclysmic drama from year end.



- Despite the continued rally in the equity market in the month of September, this stealth bull market continues to have very little investor support. Investment flows continue to favor fixed income markets over equity market alternatives. Since 2007, nearly $ 1 trillion of additional dollar flows have gone into an asset class that very likely will experience negative real rates of return into the future and the momentum appears to be gaining steam. Going into November, investors are seeking insurance from financial market volatility and they continue to favor fixed income as their insurance of choice.
- With all of the policy uncertainty that exists in the marketplace, it is becoming increasingly clear that corporate earnings are going to be challenged by the slowing global economy. In the United States, the GDP quarterly growth rate dropped from 2% in the first quarter to 1.3% in the second quarter. We have seen evidence in the third quarter of corporations guiding earnings lower and management teams reducing overhead to attempt to maintain operating margins as revenues have softened. Is this a problematic development? In isolation, maybe, but in tandem with the election and policy uncertainty it is not out of the question that investors will pay more for a dollar's worth of earnings into the future (P/E Multiple Expansion) if we can eliminate some of this uncertainty. For good or bad, November 6th is right around the corner and that uncertainty will be behind us. Of interest, since 1964 67% of election year market highs were reached in November or December according to Standard and Poors.



Sanguine

David Vaughan used to use the term sanguine as he peered over his reading glasses and looked up from his yellow research legal pad to provide me his take on the market. Unfortunately, we have not been able to use that word for sometime as we have faced considerable financial and economic challenges. Since the spring of 2009, we have climbed a wall of worry of epic proportions. Maybe it is too rosy of a scenario that as the dust settles and all of this uncertainty is reduced that the investing public and their hoards of cash might once again see long-term value in the equity market. We Simply Do Not Know Yet.

Will Williams
President

[1]WSJ October 4, 2012

Quarterly Perspective is published quarterly by David Vaughan Investments, Inc. Copyright 2012 by David Vaughan Investments, Inc. All rights reserved.
David Vaughan Investments, Inc. • Peoria, IL • Winter Park, FL • www.dviinc.com