THE RUDD COMMENTARY

{ JULY 2010 }

We are excited to publish this edition of *The Rudd Commentary*, which is a monthly publication designed to bring you a professional opinion on the current investment environment and other important topics. Since we are in the business of managing investments for our clients, we will focus on information and events that we feel are material to that end. We will not comment on opportunities or challenges relating to specific securities as this would undermine the value we provide for our private clients. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

DRILLING ON FIXED RESOURCES

The recent disaster in the Gulf of Mexico has consumed a large amount of media time over the past two months. Watching the live video feed from a mile beneath the ocean's surface is gut-retching as I consider the impact this single event will have on the Gulf Coast environment, the resources that will be spent to clean up the mess, and the knee-jerk legislation that will result. This tragedy should remind us of our inability to accurately forecast and control outcomes with any certainty even when we have a century of data and experience at our disposal. On many fronts, this is very similar to the challenges we face in the current investment environment. The successful management of limited resources is the primary goal of investing whether we are acting for our personal interest or someone else's, such as a pension fund or an endowment. Our biggest challenge moving forward is not just how to manage the known risks by improving our process and efficiency, but also to humbly recognize the limitations we could face as future unknown risks increase our costs to consume these resources and cannibalize our principal.

As a professional who advises both families and businesses, I spend a large amount of time analyzing the challenges investors face when managing a fixed amount of resources. This often reminds me of my thousand mile drive home to western Colorado from Texas when I was in college. If I had worked hard during the year and replenished my cash resources, I could drive without a thought to fuel efficiency or my bald tires. If I didn't contribute enough to my summer "retirement fund", I was very careful to drive at the most fuel efficient speed, air my tires to the correct PSI, and slow down in the small towns. Any unexpected cost, such as a friendly visit with the DPS officers in Decatur, Texas, could force me to spend extra time during the summer working in construction (which my parents were fond of signing me up for when I came home with bills) instead of enjoying all of my three month retirement.

> "This tragedy should remind us of our inability to accurately forecast and control outcomes with any certainty even when we have a century of data and experience at our disposal."

This same type of problem challenges both individual and professional investors alike as they try to calculate the proper withdrawal rate on a fixed investment portfolio. The impact of a major negative event or "blowout" during the distribution phase can be devastating if it occurs at the beginning of one of those long, rough stretches of road such as the last two recessions. In these circumstances, a distribution rate that is too high can cause us to run out of money before we reach our destination and force us to rely on someone else's charity, or worse, Uncle Sam. Therefore, investors should make an effort to understand the big difference between active and fixed investment portfolios. An active portfolio is one where we are making regular contributions and have the resources and time to exploit market set-backs. Fixed investment portfolios are exactly that, they are a fixed amount and in most cases are being depleted by regular withdrawals. When moving from a portfolio that is kept active by our paycheck to one that is fixed and dependant on dividends and interest, selecting an appropriate withdrawal rate should be a primary objective as we consider asset allocation, risk tolerance and our investment objectives.

For a quick example, let's consider a fixed investment portfolio of long-term Treasury bonds with average coupon payments of 5%. According to Ibbotson, the average annual return for long-term Treasuries from 1926 to 2009 has been 5.8%, so it makes sense that a portfolio of long-term U.S. Government guaranteed investments should be able to support a long-term withdrawal rate of 5%, when the average returns for these securities over the last 83 years has been much higher, right? This is wrong and one of the most common mistakes I see investors make in practice. First, even if all bonds are properly laddered and held to maturity, the returns on this portfolio will fluctuate in an unpredictable manner due to the reinvestment of maturing bonds at changing interest rates. Consider the recent low rate of 3.93% offered on 30 year Treasury bonds as of June 29th, 2010. We simply cannot predict where rates will be each year which forces us to prepare for times when we will not have enough income to support our current withdrawal needs. Second, most investors don't consider that inflation will force them to increase their withdrawal rate over time. Our "safe" Treasury bond ladder will not grow in principal value without reinvestment, so what started as a 5% withdrawal rate will increase to 7.8% of the original principal at 3% inflation after 15 years, which is much higher than the historical average return. Finally, we will also bear fees, trading costs, and taxes (directly and indirectly) that will occur all along the investment process. Now, consider if we were to introduce the more volatile returns of the corporate bond or stock markets into this example. These added variables would require an even greater amount of consideration.

The point to consider here is that properly managing a fixed investment portfolio is not as easy as buying CDs at your local bank because of the unpredictability of returns, inflation, and government (taxes and legislation). It requires the effort necessary to establish a proper investment policy, make reasonable expectations about the investment environment, and in some cases; confront the brutal facts of the situation. If you are ever confronted with the challenge of producing a sustainable income on a fixed resource such as your investments, an endowment, or a deep water oil well, it will be necessary to set aside some of these principal resources for production costs, inflation, and Uncle Sam before making your spending or profit projections. If you also want your principal to have its best chance to survive the unknowns out there such as you living to 105, your private equity investments becoming completely illiquid, or a catastrophic deep water oil disaster; it would be wise to set aside some of the annual earnings as well before you take up yacht racing.

Invest Long and Prosper,

Josh Rudd

THOUGHTS » **So how should you consider a withdrawal rate on a fixed amount of investment resources and also account for inflation and the "blowouts" that will occur? To work towards a solution, investors should first break this question down into three parts in the following order.**

What is the time horizon for withdrawals? » This is an important first step for many reasons. If you are on a non-profit board and directing investments to fund a continuous need; your investment strategy will be quite different from an individual investor in retirement who wants the inheritance check to his children to bounce. The retiree can afford a higher withdrawal rate, but has less time to recover in the event of a setback.

What is the maximum real withdrawal rate my portfolio can sustain given my time horizon? » This is the meat of the process and should be discussed with a professional that has a working knowledge of the variables that will affect this rate over the long-term. Some of these are inflation, taxes, asset allocation, risk tolerance and appropriate cash management. He should also have experience managing a static portfolio through at least one complete investment cycle and confronted many "blowouts". I cannot stress how important practical experience is in this process. Projections of success at a particular withdrawal rate should not be based only on the bell curve and college statistics, but also on experience confronting the unexpected "blowouts" and designing strategies to prepare for them.

How much can I accomplish at this maximum withdrawal rate? » This final step is simply to drive home the idea that wants or lifestyle should not drive a portfolio's withdrawal rate. If we place our wants first, we are essentially letting our credit card limit determine our level of expenses. While this may work in the short-term for governments that can run deficits and monetize their debt, we must confront the calculated withdrawal rate for what it is…a maximum. We must then set a goal to withdrawal some amount less than this maximum to prepare for any unknowns we did not consider in our analysis. We call these "unknown unknowns" and they are Deep Water Horizons that will continue to surprise us.

The Rudd Company, LLC is an independent investment management & consulting company. We provide objective investment advice and customized asset management services for individuals, family offices, and institutions. We specialize in serving clients with unique tax needs, liquidity concerns, and a desire to make a positive social impact with their investment choices.

If you are interested in our services, and have $1 million or more in investment assets, we welcome you to contact us at (877) 605-7833 for more information.