CLIFFORD SWAN
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WISDOM *for* GENERATIONS

PLANNED GIVING TOOLS FOR MEETING YOUR PHILANTHROPIC GOALS

By Kenneth H. Dike
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"Planned giving" is a broad term for charitable gifts made in conjunction with an individual's financial or estate plan. These gifts are usually infrequent and relatively large. They can be outright gifts that are made available to the charity immediately, or they can be deferred to be used by the charity at a future date. Deferred gifts are a current decision to make a gift in the future and can be *irrevocable*, in the form of a gift annuity or charitable trust, or *revocable*, as in a will bequest or beneficiary designation in a life insurance or retirement plan.

As a donor's uncertainty about his or her future financial needs and resources increases, the most appropriate form of gift generally moves from an outright gift to an irrevocable deferred gift, and finally to a revocable deferred gift. In all but an outright gift, the donor retains some right. The retained interest may be the right to periodic payments from a gift annuity or charitable remainder trust, or what remains when a charitable lead trust terminates. In a *revocable* gift, the donor retains the right to remove the charitable disposition in his or her will or change the charitable beneficiary in an insurance or retirement plan.

This article will focus on the intermediate stage of the planned giving continuum, *irrevocable deferred giving*. This includes various types of planned giving arrangements, each with unique characteristics that have evolved to address specific donor needs. A future article will address how the charitable deduction is calculated for each of these planned gifts and how the beneficiary (oftentimes, the donor) reports the payments he or she receives on a personal tax return.

IRREVOCABLE DEFERRED GIFTS

1) **Charitable Gift Annuities**
2) **Charitable Remainder Trusts**
   - 2.1) Charitable Remainder Annuity Trusts
   - 2.2) Charitable Remainder Unitrusts
     - 2.2a) Standard (no net income limitation)
     - 2.2b) Net Income (with or without makeup provision)
     - 2.2c) Flip (from net income to standard)
3) **Charitable Lead Trusts (annuity trusts and unitrusts)**

1) CHARITABLE GIFT ANNUITIES

Like annuity trusts, the periodic payments to the beneficiary are fixed and do not change over the life of the payments. Unlike annuity trusts, gift annuity payments are not subject to the availability of trust assets since the payments are a general obligation of the charity. For these reasons, gift annuities appeal to donors who are looking for certainty in the periodic payments they receive from the charity that assumes all the risk inherent in these life-term payment obligations.

Unlike annuity trusts and unitrusts, charitable gift annuities do not require a trust agreement or trustee. Reporting to the beneficiary on the taxability of the payments he or she receives does not involve annual calculations incorporating the types and timing of the income earned by the underlying investments. In addition, there are no annual tax returns that must be filed. Overall, the cost of creating and administering a charitable gift annuity is significantly less than other types of planned gifts, making charitable gift annuities most appropriate for smaller and more frequent giving.

2) CHARITABLE REMAINDER TRUSTS

In a charitable remainder trust, the periodic beneficiary distributions (income interest) are made to a non-charitable beneficiary, and whatever remains in the trust upon its termination (remainder interest) goes to charity. The beneficiary payments can be fixed in amount, as in a charitable remainder *annuity* trust, or vary each year based on the trust's market value, as in a charitable remainder *unitrust*.

A charitable remainder trust is a separate legal entity created by the transfer of assets to a trust governed by the terms of a trust agreement that is

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administered by a trustee. Annual trust tax returns are required that produce a K–1 for the beneficiary income reporting based on the type and timing of the trust income. Due to the administrative burden of a charitable remainder trust, these types of arrangements typically involve larger, less frequent gifts than a charitable gift annuity.

2.1) CHARITABLE REMAINDER ANNUITY TRUSTS

Periodic beneficiary distributions of a fixed amount are made from a charitable remainder annuity trust. Like gift annuities, the fixed nature of the beneficiary distributions appeal to donors looking for predictability. Unlike gift annuities, the charity is protected since the obligation to make the beneficiary distributions only continues as long as there are sufficient assets in the trust to make the payments. Unlike unitrusts, the beneficiary distributions will not increase as the trust grows nor will they decrease if the trust assets decline in value.

2.2) CHARITABLE REMAINDER UNITRUSTS

Additional contributions may be made to a *unitrust* but not an *annuity* trust. A *unitrust* is therefore the only trust arrangement for donors who intend to make additional gifts of the same type and want to avoid creating additional trusts.

Unlike gift annuities and annuity trusts, the amount paid to unitrust beneficiaries changes each year based on the change in the value of the trust assets. Unitrust beneficiaries share in any appreciation of trust assets since their distributions will increase in conjunction with the value of the underlying trust investments. Conversely, the beneficiaries share the investment risk with the charitable remainder since the beneficiary distributions will decline if the value of the trust assets decline. Donors who are able to accept this uncertainty in the amount distributed to the beneficiaries yet appreciate the long-term potential of increased distributions find unitrusts appealing.

There are three basic types of unitrusts, each designed to accommodate unique donor situations; standard, net income, and flip unitrusts.

2.2A) STANDARD UNITRUSTS

A standard unitrust makes periodic payments to an income beneficiary based on a percentage (*payout rate*) of the trust's value. The unitrust must be revalued, and the income beneficiary distributions recalculated, at least annually. The amount paid from a standard unitrust does not depend on the amount, or type, of income earned by the trust investments. These trusts are used where cash or readily marketable securities are transferred into the trust by the donor.

2.2B) NET INCOME UNITRUSTS

A net income unitrust is an arrangement where the amount distributed to the beneficiaries is the lessor of (1) the *payout rate* applied to the trust's assets computed at least annually (*percent limitation*), or (2) the *distributable trust income* for the calendar year. The unitrust agreement will specify the *payout rate* and define *distributable trust income*. The net income unitrust agreement may include a *makeup* provision that takes into consideration the *cumulative shortfall*, or the amount by which the prior years' *percent limitations* exceeded the *distributable trust income*. The *cumulative shortfall* is added to the current year's *percent limitation* to determine the maximum amount payable to the beneficiaries subject to the current year's *distributable trust income*.

Net income unitrusts present additional issues and opportunities. Since distributions are limited to *distributable income* and the trust can define *distributable income*, the donor is given more tools to deal with their unique circumstances. Funding a unitrust with unmarketable securities would present a liquidity problem in making the beneficiary distributions. Also, the donor may not want the trust to make beneficiary distributions until some later date as in a retirement plan equivalent.

Distributable income could include only interest, dividends, rents, and royalties received by unitrust investments. This would solve the liquidity problem of unmarketable assets since the beneficiary distributions would be limited to the liquid assets received as interest, dividends, rents, and royalties. Equities and their low dividends could satisfy the retirement plan motive in the early years of the unitrust followed by a movement into bonds thereby increasing the *distributable income* paid to the beneficiary in the later years of the unitrust when the beneficiary's other sources of income may be diminishing.

2.2C) FLIP UNITRUSTS

A *flip unitrust* is an arrangement that begins as a net income unitrust then converts (flips) to a standard unitrust at a pre-determined time or upon the occurrence of an event, such as the sale of unmarketable securities.

Flip unitrusts eliminate the burden of earning the right type of income at the right time after the reasons for the net income limitation no longer exist. A flip unitrust could be created that drops the net income limitation and converts to a standard unitrust when the unmarketable assets are sold or when the beneficiary reaches a certain age.

3) CHARITABLE LEAD TRUSTS

In a charitable *lead* trust, the periodic beneficiary distributions (income interest) are made to a charity and whatever remains in the trust upon its termination (remainder interest) goes to a noncharitable beneficiary such as the donor, the donor's family, or a noncharitable trust. This is a mirror image of the charitable *remainder* trust where a noncharitable beneficiary holds the income interest and a charity holds the remainder interest. The lead trust income beneficiary payments to charity can be fixed in amount, as in a charitable lead *annuity* trust, or vary each year based on the trust's market value, as in a charitable lead *unitrust*.

In a *grantor* charitable lead trust, the donor (or spouse) receives whatever remains in the trust when it terminates.

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In a *non-grantor* charitable lead trust, a noncharitable beneficiary other than the donor (or spouse) receives whatever remains in the trust when it terminates. The assets remaining when a non-grantor charitable lead trust terminates are often given to a member of the donor's family as in a "*Family* Lead Trust."

Charitable lead trusts are complicated arrangements and should only be entered into after consulting with a professional. This article is only meant to introduce the world of charitable lead trusts and does not provide an exhaustive explanation of the tax rules and other considerations that may be encountered in this area.

> "It takes careful consideration to determine which methods will be of the greatest benefit to both you and the charity whose mission you want to support."

Charitable lead trusts are, however, generating more interest as the *IRS discount rate* enters historically low levels resulting in historically high present value estimates of the charitable income interest.

The vehicles for irrevocable deferred gifts are varied and nuanced. It takes careful consideration to determine which methods will be of the greatest benefit to both you and the charity whose mission you want to support. If you are interested in giving—or re-evaluating your gifting strategy—your investment counselor would welcome a conversation to consider your options. ◆

SUMMER INTERNSHIP PROGRAM SUCCESSFULLY COMPLETES SIXTH YEAR

John Galbreath and Abigail Gilliland were selected from a competitive pool of over 150 applicants for the sixth year of Clifford Swan's summer internship program. Abby is a rising junior at Claremont McKenna College where she is pursuing a degree in Economics and Philosophy and a minor in Financial Economics. Also a rising junior, John is majoring in Business Administration at the University of Southern California.

In the spirit of the Clifford Swan mission to instill *Wisdom for Generations*, the summer internship program aims to provide undergraduate students seeking a career in investment and wealth management a fundamental educational experience and opportunity to develop skills in the field.

Clifford Swan colleagues Jennifer Maqueda, David Lin, and Dan Mintz conducted the interviews and selected the successful candidates. Over the course of two months, John and Abby learned about several aspects of the firm, including portfolio management, securities analysis and research, trading and execution, client service, compliance, marketing, and operations. Learning was hands-on, with the interns working directly with Clifford Swan colleagues who served as teachers and mentors for targeted projects.

Abby shared that she was attracted to the internship because she admires the firm's holistic, multigenerational approach to wealth management and emphasis on achieving clients' goals. John appreciated that the internship framed a career in wealth management within the context of the many career paths available in the financial industry. Both John and Abby look forward to sharing their new financial knowledge and skills with their peers in the undergraduate investment associations to which they belong.

Of the internship, Jennifer commented, "Through their intellectual curiosity, insights, and high-quality work, John and Abby contributed meaningfully to the firm. Without question, wisdom was shared across generations." ◆

CLIFFORD SWAN
INVESTMENT COUNSELORS

John Galbreath and Abigail Gilliland

MARKET OUTLOOK

By Daniel J. Mintz

Uncertainty works well as a theme for any stock market outlook written at any time. It always exists, as the economy, geopolitics, and many other key market drivers are inherently difficult to predict. Uncertainty seems to rise and fall constantly, though there is no formal way to quantify the sentiment.

A chart published by Bloomberg in June may be a good proxy for the level of stock market uncertainty (see the chart below). The author looked at the Russell 1000 Index, which contains the largest U.S. stocks, and measured the median difference between Wall Street analysts' high and low price targets. The gap is at the highest level in 10 years. As price targets are derived from predictions about the future, it follows that consensus about events that will drive stocks is less certain now than at any previous point in the recovery.

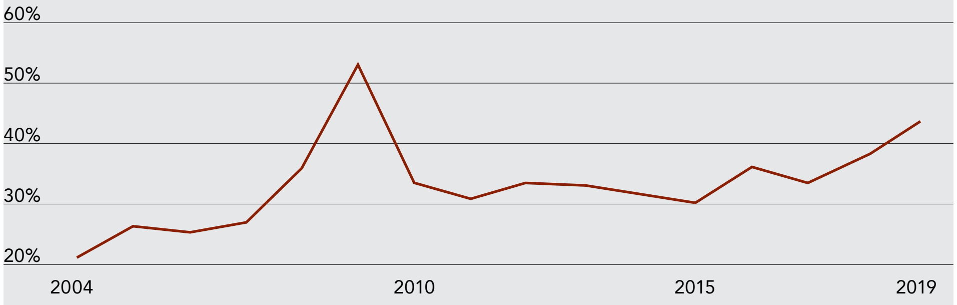
In an interview with CNBC in May, renowned investor Warren Buffett observed, "No economics textbook I know that was written in the first couple thousand years...discussed even the possibility that you could have this sort of situation continue and have all the variables stay more or less the same." Buffett is referring to the dichotomy of full employment combined with persistently low inflation and interest rates. Consider a few data points: consumer confidence is at its highest level since 2000; household debt-to-GDP is the lowest since the early 2000s; and the unemployment rate is below 4% (a "generational low"). Yet, signs of a hot economy—inflation and higher interest rates—are not present. In fact, this summer, the amount of "negative yielding" debt outstanding globally reached $12.5 trillion, surpassing the previous record set in early 2016 during the energy-driven industrial slowdown. The implication is that, in the near term, investors expect a low-growth environment with central bank interest rate cuts, a condition that tends to exist when the economic backdrop looks particularly poor.

Despite a consumer financial profile that appears healthy enough to point to strong spending, there are signs that the ongoing trade dispute as well as economic softening in Europe and China are causing jitters on the supply side. Economic data points like the Purchasing Managers Index (PMI), private construction spending, and shippers' 6–12 month freight demand outlook are at multi-year lows. These are leading indicators; the PMI, for instance, is based on surveys of data about orders, inventories, production levels, and backlogs. As the chart on the following page shows, the PMI today is moving closer to 50, a level that represents the inflection point between contraction and expansion, after hovering close to 60 in 2017 and 2018.

> "When planning for the near term, company management teams want more certainty, not less, regarding trade and demand from international customers."

Stock Market Uncertainty

Measured by the Median Difference Between Analysts' High and Low Price Targets for the Russell 1000 Index



Source: Bloomberg

When planning for the near term, company management teams want more certainty, not less, regarding trade and demand from international customers. That is why charts such as the PMI and freight demand forecasts line up so well with the CEO confidence index (see the chart on the following page). And, since management teams that are confident about the direction of the economy tend to invest more in anticipation of future demand, then clearly the current economic and geopolitical uncertainty has the potential to be self-fulfilling when it comes to the duration of the current expansion.

Before giving up on the recovery that the media has been calling the "longest ever," it is important to note that we have been here before at least twice since 2008. The PMI and CEO confidence charts in this article overlay rather nicely with each other, showing troughs in 2012 and 2016. Other leading indicators, such as the freight demand outlook and orders for durable goods, show similar troughs in 2012 and 2016—dips that turned out to be temporary.

In the face of uncertainty and conflicting market signals, there are several considerations for long-term investors like us:

1. THE RETURNS OF STOCKS OVER THE PAST SEVERAL YEARS SHOW HOW DIFFICULT IT IS TO TIME THE MARKET. 2012 and 2016 would have been terrible

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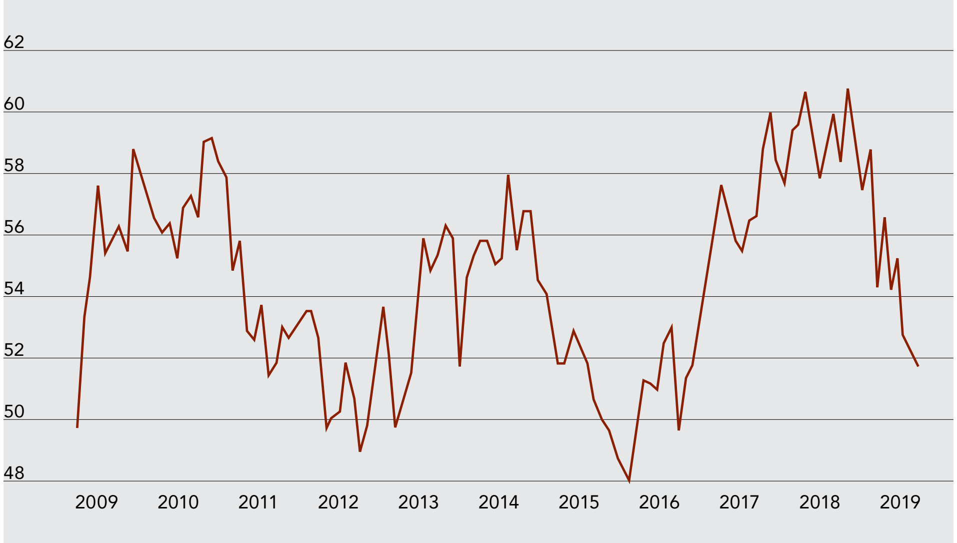
The Purchasing Managers Index (PMI)

Levels Below 50 Indicate Contraction



Source: Thomson Reuters Eikon

times to shift asset allocations meaningfully away from equities for the sake of trying to get out ahead of a market downturn. As of this writing in late-July, the total return of the S&P 500 is 14.4% annualized since the beginning of 2013 and 14.6% compounded since the start of 2017. No one knows whether today's situation will be similar. The best time to make broad shifts in how much to invest in stocks is and always will be when one's long-term goals change.

2. THE ECONOMY AND THE STOCK MARKET EXPERIENCE NORMAL, CYCLICAL FLUCTUATIONS OVER TIME.

Not every correction, or even every recession, signals the death knell of a portfolio. In contrast with 10 years ago, the financial system is healthy. Banks have been passing stress tests with ease this year. To be fair, there are signs of elevated risk-taking in the current environment—examples include positive receptions for IPOs without a path to profitability and strong demand for risky debt—but excesses like those found in the housing and credit markets circa 2006 are not present.

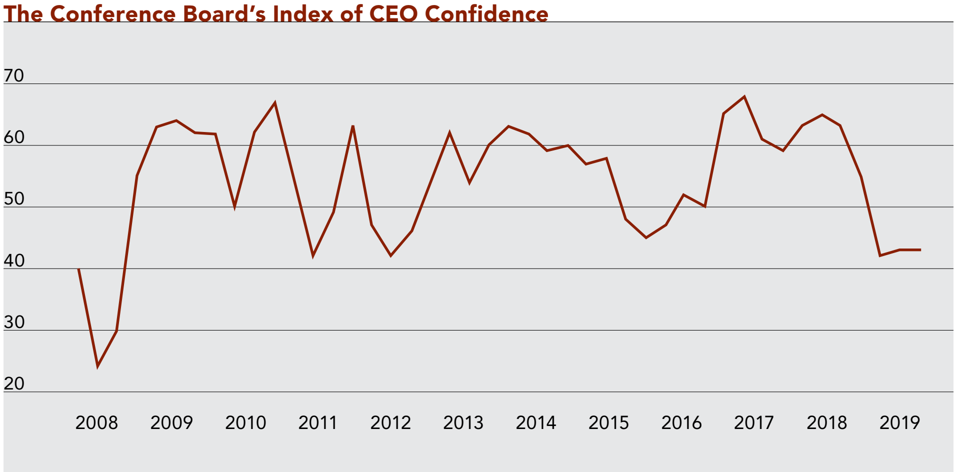
3. DESPITE A HIGH LEVEL OF UNCERTAINTY, A MACROECONOMIC BACKDROP CHARACTERIZED BY LOW INTEREST RATES CAN MAKE STOCKS LOOK RELATIVELY ATTRACTIVE, BOOSTING UNDERLYING DEMAND.

Simply put, when fixed income yields are low, investors seeking reasonable returns often boost their allocation to stocks. This would be a red flag if stock valuations were particularly elevated. Buying overvalued securities for reasons unrelated to their fundamentals would not be a sign of healthy capital markets. However, with the P/E ratio of the S&P 500 just under 18x as of this writing, valuations do not appear extended.

From an investment selection perspective, the current environment illustrates an advantage of Clifford Swan's focus on quality companies. One of the pillars of our strategy is buying companies with durable business models. That is not to say that these companies' earnings and stock prices will rise in all economic conditions. Rather, we target businesses with strong balance sheets and abundant growth prospects built to be able to turn a profit notwithstanding the macroeconomic picture. We are confident that portfolios constructed this way will achieve higher highs and higher lows over long periods, making the market downside case only relevant in the short term. ◆

> "...we target businesses with strong balance sheets and abundant growth prospects built to be able to turn a profit notwithstanding the macroeconomic picture."

The Conference Board's Index of CEO Confidence



Source: Thomson Reuters Eikon

RISK IN RETIREMENT

By Kathleen Gilmore
CFP®

We all define "risk" to our financial well-being in very personalized ways. For some, this risk is not being healthy enough to enjoy the retirements we saved for; for others, it's based in providing for family members who may not be able to provide for themselves; for many, it's a fear (sometimes irrational) of running out of money during our lifetimes. For most, it's the chance of not being able to live our lives as we hoped.

However our clients define financial risk, our work is to plan a long-term course of investment to mitigate this risk. While your investments obviously can't solve health issues, or change family dynamics, they can be a sustainable resource to help ease these concerns and to live happily in retirement. Part of almost every conversation we have with nearly or newly retired clients is determining "how much" can be taken from investment portfolios on an annual basis to make sure the money is there when needed, and for as long as necessary.

THE 4% RULE

There are several rules of thumb used by our industry to provide guidance in answering this question. Perhaps the most widely known is "the 4% rule," originally researched and presented by Bill Bengen about 25 years ago. This rule relies on historical market returns for U.S. large cap stocks and intermediate government bonds, assuming a 60% stock/40% bond portfolio needing to last 30 years. The rule suggests that 4% of the portfolio's value is the "safe" initial annual spending amount, increased each subsequent year by the rate of inflation. Historically, a portfolio invested in this way, with this kind of annual draw, never depleted in less than 30 years.

As the popular saying goes, however, "no plan survives its contact with reality." The future 30 years we will each experience as investors are almost guaranteed to be unlike any 30-year period that's come before. While we may know when we are planning to retire, or have already entered that phase of our life, we have no real knowledge of how long we will live, or if historical average market returns will be what we experience in our future. In fact, one of the greatest factors impacting the sustainability of portfolio withdrawals is the *sequence of returns* we experience, not the actual long-term return itself.

> "…one of the greatest factors impacting the sustainability of portfolio withdrawals is the *sequence of returns* we experience, not the actual long-term return itself."

SEQUENCE OF RETURNS RISK

To understand what we mean by sequence of return risk, consider the table below, which describes two hypothetical $1 million all stock portfolios for two individuals who retired June 30, 1999.

Value of $1 Million Invested in the S&P 500 Index on June 30, 1999
With an Initial 4% Withdrawal Rate Increased by 3% Inflation Annually

	S&P 500 Index		A	B
12-Months Trailing, Ending On	Actual Trailing 12-Month Index Returns	Inversed Trailing 12-Month Index Returns	Portfolio Value *Actual Index Returns*	Portfolio Value *Inversed Index Returns*
June 30, 1999	-	-	$1,000,000	$1,000,000
June 30, 2000	7.2%	10.4%	$1,029,589	$1,060,007
June 30, 2001	-14.8%	14.4%	$841,808	$1,165,251
June 30, 2002	-18.0%	17.9%	$655,579	$1,323,756
June 30, 2003	0.3%	4.0%	$613,408	$1,331,154
June 30, 2004	19.1%	7.4%	$677,005	$1,381,600
June 30, 2005	6.3%	24.6%	$670,513	$1,663,816
June 30, 2006	8.6%	20.6%	$676,495	$1,948,916
June 30, 2007	20.6%	5.4%	$756,450	$2,003,218
June 30, 2008	-13.1%	30.7%	$613,182	$2,551,817
June 30, 2009	-26.2%	14.4%	$413,932	$2,860,317
June 30, 2010	14.4%	-26.2%	$412,147	$2,070,843
June 30, 2011	30.7%	-13.1%	$466,279	$1,751,045
June 30, 2012	5.4%	20.6%	$431,545	$2,042,782
June 30, 2013	20.6%	8.6%	$449,590	$2,155,265
June 30, 2014	24.6%	6.3%	$484,837	$2,227,226
June 30, 2015	7.4%	19.1%	$453,881	$2,578,617
June 30, 2016	4.0%	0.3%	$405,252	$2,520,750
June 30, 2017	17.9%	-18.0%	$399,830	$2,013,089
June 30, 2018	14.4%	-14.8%	$379,417	$1,656,543
June 30, 2019	10.4%	7.2%	$341,495	$1,701,400

Sources: Clifford Swan; Thomson Reuters Eikon (for SPX Total Return Buy/Sell at Close)

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The sequence of returns in Column A reflects actual returns for the S&P 500 Index for the trailing twelve months ending on the dates noted. For simplicity, assume an initial 4% withdrawal amount ($40,000) to cover retirement expenses and increase this by 3% inflation each year. These withdrawals are taken out of the portfolios before we calculated the annual returns for the portfolio. The retiree in Column B begins with the same $1 million, and 4% initial annual withdrawal, increased by 3% inflation each year. However, Column B retiree's market returns are exactly the reverse of Column A. Twenty years later, the difference between these two portfolios is over $1.3 million. Of course, the average return for both of these portfolios over this 20-year period is identical at 7.0%.

In general, compounding interest (interest on interest) creates the most long-term value on larger capital bases, or starting amounts. If we retire into an investment environment that initially erodes the value of our savings, we reduce our capital base at the outset, and hamper our plan moving forward. If, however, we retire into a strong market environment and our retirement savings are able to compound for several years until the inevitable bear market rears its head, then we are able to retain a larger base to sustain ourselves through the ups and downs to come. Given all this, the 4% rule, or any other rule of thumb for long-term retirement spending, may or may not be an appropriate guideline depending upon the market experience of our early retirement years. For distributing portfolios, the journey matters.

> "For distributing portfolios, the journey matters."

STRATEGIES

When assessing sequence of return risk, the first place to start, always, is with the individual client's circumstances. Not everyone is subject to this risk, and many are entering retirement with a base that requires less than a 4% draw from their investment portfolios to support their lifetime goals, and beyond. It is important to remember that the 4% rule was established as the "safe" withdrawal amount to "never" deplete a portfolio within a 30-year time frame based on historical averages. If an investor experiences a favorable sequence of returns, the ability to withdraw more than 4% in a sustainable manner may be possible.

While we have no control over the sequence of returns in the market, there are some strategies to help mitigate this risk if we are concerned about its impact over our lifespan. There are several "levers" that each of us can pull, and some combination of the strategies presented below may be appropriate for you. A conversation with your investment counselor is a great place to start.

BUILD BUFFERS INTO YOUR SPENDING PLAN

Differentiating between our lifestyle "must-haves" and our "wants" is a sound exercise for all of us, and one that can inform how vulnerable we may be to sequence of return risk. The probability of remaining financially stable throughout our lives is reduced when we push the limits of what has to go right in order to keep the "must-haves" in place. In addition, emergency funds and appropriate insurance should be in place to guard against "what could go wrong."

The more flexibility that can be built into a retirement spending plan, the more the retiree can take advantage of good markets while still maintaining a financial base to weather the inevitable tough times. Flexibility may come in the form of downsizing your primary residence or continuing to work part-time in retirement to reduce the initial draw on the portfolios. Turning non-income producing assets into income producing assets, such as renting a vacation home, may also be an option, even on a temporary basis.

MANAGE PORTFOLIO VOLATILITY

With stock markets at all-time highs as of this writing, sequence of return risk may be a heightened worry for those entering retirement in the near-term. This has been a long bull market and investors are understandably concerned about how much longer it can continue. The probability of having 10 more years as strong as the last 10 feels more and more remote.

From an investment perspective, one technique we can use to dampen sequence of return risk is to manage portfolio volatility (the up and down swings in value). While volatility is not equal to risk when investing, it can have negative consequences in portfolios that must provide cash on a regular basis (more on this below). In the chart on the previous page, the portfolios used to illustrate sequence of return risk were invested 100% in the stock market as represented by the S&P 500. By using uncorrelated asset classes within a portfolio like this, such as fixed income, we can reduce the wide swings in returns, and therefore, the risks associated with the sequence of those returns. A portfolio designed, in this manner, to protect capital in down markets may give up some of the return in strong markets in order to preserve a larger investment base that can compound over the long-term to provide steady cash flows for sustainable lifestyle spending.

> "With stock markets at all-time highs as of this writing, sequence of return risk may be a heightened worry for those entering retirement in the near-term."

At Clifford Swan, we manage portfolio volatility by diversifying our invest-

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ments in asset classes appropriate to our clients' goals and time horizons, and by maintaining a strict quality discipline within each asset class we own. We expect the businesses we own to not only create wealth for us, but to do so in any economic environment by maintaining strong balance sheets, executing on their business plans, and exercising control of their destinies. Our valuation work provides an additional margin of safety, enabling us to buy great companies at reasonable prices. We expect our fixed income investments to provide stability during volatile times, preserving the purchasing power of our clients' capital. This philosophical approach to fixed income becomes a critical piece of another technique for managing sequence of return risk in our retired clients' portfolios.

DIVERSIFYING YOUR SOURCE OF RETIREMENT CASH FLOWS

A corollary to "no plan survives its contact with reality," may be that the best plans embrace flexibility. We've already discussed flexibility in spending, and this final strategy is about building diverse sources of cash for that spending into your plan.

Sequence of return risk is directly related to the time frame within which cash is required from the portfolio. If you are in retirement, and you need distributions from your investments at regular intervals within the year, your investment timeframe for the assets producing that cash is very short. By contrast, if you are 20 years from retirement, the investment time horizon for the assets that will ultimately produce the cash you will need in retirement is very long. According to the chart below, the returns for the S&P 500 since 1926 were never negative, if the investment time horizon was 20 years or more. It is easy to see from this chart that if we relied only on the S&P 500 for *monthly* cash flows over the last 93 years, over one third of the time we would be selling stocks in a down market. Of course, this is exactly the erosion of our capital base that feeds into sequence of return risk.

By managing volatility in our portfolios through the introduction of diversified asset classes, we also introduce the concept of sources of cash that are uncorrelated to the stock market. At Clifford Swan, we call these "reserves." The idea is that during downturns in the equity markets, assets such as bonds, which are uncorrelated to stocks, should preserve their value and can be used as a source of cash. Indeed, for retirees who may be particularly sensitive to sequence of return risk, we generally build enough reserves in their portfolios to provide retirement income for several years. These reserves allow us to protect equity portfolios from losing permanent value because we don't become forced sellers of stocks during tough times.

Each of these strategies requires the discipline to balance your plan between: (1) controlling what can be controlled (portfolio diversification, establishing reserves); and (2) managing what needs to remain flexible (retirement spending, deployment of cash flows). What retirement looks like for you is a combination of your lifestyle, your net worth, and the future of the investment markets. With a reasonable lifestyle, a compounding base of wealth, and an "all weather" approach to managing investments, we can plan for the unknown and manage our exposure to risk. ◆

U.S. Stock Market Historical Probabilities

S&P 500 Index: 1926-2018

	Positive	Negative
Daily	54%	46%
Monthly	63%	37%
Yearly	73%	27%
5 Years	88%	12%
10 Years	95%	5%
20 Years	100%	0%

Source: Ben Carlson, *A Wealth of Common Sense*

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