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Election Priorities

Now that the mid-term elections are complete and we have moved to a sure stalemate scenario, what should the lame duck session of Congress try to accomplish. There are a number of issues they should tackle, and the Democrats might feel this is a last chance to pass other initiatives. The annual drumbeat of expiring tax measures is especially strong this year with various versions of the Bush tax cuts reaching the end of their legislated lives. The most important is the estate tax, because of the incentives in place today. In 2010 there would be no estate tax, but in 2011 it will revert to a material event for significantly rich people. I expect $1,000,000 to pass free and then an increasing percentage based on the amount. Many states tie their estate tax rates to the federal law so this will have far reaching implications. If they pass something this fall it needs to have a date that incorporates the 4th quarter of 2010 or else a lot of elderly billionaires will die during December. At this point it looks like the income rates will be extended for all until the next election and it can be a campaign issue in 2012. The economic implications of raising taxes during a high unemployment period are just too negative to comprehend for a politician.

Total Returns for Bonds

Bond rates cycle. If you ladder your bonds with varying maturity dates they will eventually come back to where you started. Today's environment with very low rates is unlikely to end up happy for many investors for many years. Capital gains come when rates fall, but there is little leverage left in a falling rate environment. If rates stay steady the investor receives very low, but positive rates. If rates rise the investor has a capital loss unless the bond is held to maturity. Models need to reflect this in their scenario generators. I recently was asked to comment on a variable annuity that has a 6% roll up with the maximum account value to use for guaranteed living benefits, with the provision that the asset allocation move to bonds when in the money. I am struggling to understand the pricing of this feature since I see no way bonds will earn 6% any time soon.

Asset Allocation

Along the same lines, if bond returns are going to be weak shouldn't asset allocation strategies take this into consideration? Many investors are piling into bonds right now when it seems like a very risky time to do so. There is very limited upside.

Margin of Safety

Value investors often talk of margin of safety, a tool that says you should be very sure of something before investing. It does not eliminate the downside risk but makes sure the likelihood is small. To me this is very similar, if not the same, to an entity that has a robust and structured ERM framework. More on this in 2011.

Retirement Planning: The Number

Books have been written and advertising campaigns focused on “The Number”. If you save this amount you will be able to enter retirement worry-free. Unfortunately all the models I have seen are designed to show this at a certain probability of success. You have a 95% chance of having enough money to make it to 85. Each of the assumptions used are suspect in the future. What if you live past 85? What does your planner tell you to do then? My suggestion – calculate the “number” and double it. It’s simple, and if the market tanks right before you retire you have built in a contingency plan.

Fiduciary Standards

Why are there no fiduciary standards for investment bankers? Would we avoid most financial crises if there were? Bankers will tell you that their clients are sophisticated, but we all know that is not really true. They spend a lot of time name dropping and saying that your competitors are doing this and you had better do it too. Even if it does not stop one crisis, it seems like it would weaken bankers going forward after they are sued for their poor advice.

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