

# Capital Financial Planners, LLC

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## What Historically Follows Severe Economic Crises

**W**hat if U.S. home prices dropped by more than a third, and didn't recover for six years? Or if stocks slid by 56% in a three-year bear market? Consider what would happen if the unemployment rate rose by seven percentage points, or per capita economic output fell more than 9%, and didn't recover for two years.

While parts of that scenario may seem extreme, in fact it's just average for almost a score of banking-led financial crises around the world since World War II. In a recent paper, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University put the current U.S. downturn in global and historical perspective. They considered 18 postwar financial crises around the world, including what they dub the big five: Spain in 1977, Norway in 1987, Finland and Sweden, both in 1991, and Japan in 1992. Add to that group the U.S. upheaval that began in 2007—which is “now beyond contention...severe by any metric,” they write. They also factored in famous emerging market crises, including Asia in 1997-1998, Colombia in 1998, and Argentina in 2001, and incorporated data from the Great Depression. In all of these cases, banking system meltdowns triggered major recessions. The Reinhart-Rogoff paper maps the fallout in several areas and charts how long it took before conditions improved.

By late 2008, when the paper was written, U.S. real housing prices had fallen by almost 28% from their peak—

more than twice the decline during the Great Depression. And though many countries have suffered much worse setbacks, including drops of more than 50% in Finland, Colombia, the Philippines, and Hong Kong, the U.S.

retreat has approached the 35.5% average noted by Reinhart and Rogoff, who found that the average recovery time for home prices is almost six years.

The U.S. stock market retreated further since Reinhart and

Rogoff compiled their data, and prices dipped close to the 55.9% average loss noted in their paper. Here, too, some equity markets have fared much worse, with stock prices in Iceland collapsing by more than 90% during the current crisis and Thai equities sliding about 85% after 1997. Though the average recovery time has been 3.4 years, several markets have taken more than half a decade to bounce back.

Job losses always come with recessions, but when banking crises lead to downturns, the rise in unemployment rates tend to be particularly jarring. The worst was a more than 20 percentage point increase during the Great Depression, a catastrophic result that no postwar recession has approached. Still, the seven percentage point average spike in unemployment that Reinhart and Rogoff observed amounts to an enormous drag on any economy, and the 9.5% U.S. rate in June 2009 was already more than five points above the

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## Back To School

**W**elcome autumn, and welcome to our new clients and readers.

One of our recent work-related activities included a presentation at Willamette University titled “Taking Control of your Financial Future.” We encouraged participants not to focus on the unpredictable markets, but on variables they can control: asset allocation, diversification, and the tax and estate planning consequences of their investment actions.

Willamette has kept us busy, as both Judy and Barry participated in career-oriented events at the school's Atkinson Graduate School of Management and College of Liberal Arts.

In this issue, you will find an article of particular interest to those nearing retirement. Planning and developing a retirement roadmap is a large part of what we do, both before and after “the big day.” We very much enjoy helping clients realize this dream!

With cooler days and back-to-school excitement, many of us feel more energized, perhaps even ready to tackle things we put off over the summer. If you've been putting off a review of your financial situation and retirement roadmap, it may be time. We always have time to meet with you, so give us a call.

Judy:

# Key Questions For Those Nearing Retirement

**L**ife may begin at 40, but the countdown to retirement starts at age 55. Now is the time to take stock of your savings, goals, and timetable for moving into a phase of life that may last 30 years. These questions can help you gauge how you're doing.

When do you want to retire? This is a crucial variable. If you're planning to retire early—say, at age 55 instead of 65—you'll not only have to save more, sooner; you'll also need to have the money last an extra decade. On the other hand, if you expect to work well past normal retirement age, that reduces the burden on your nest egg. Another reason to keep working: While you normally can begin penalty-free withdrawals from an employer's qualified retirement plan at age 55, distributions from an IRA before age 59½ may result in a 10% penalty.

How is your money invested? Though there are no guarantees, a portfolio with most holdings in stocks holds the potential to grow more quickly than one emphasizing bonds or cash. But at this point, you won't have much time to recover from market losses and may need to reduce your allocation to equities. That, in turn, could affect when you'll have sufficient savings to leave the

work force.

What will you get from Social Security? Government payments may make up only a small percentage of your retirement income, but this variable, too, needs to be part of your retirement calculations. How much you receive depends on several factors, including when you were born and when you apply for benefits. Payments could start as early as age 62, but if you begin then, your checks will be smaller. Wait a couple more years (if you were born between 1943 and 1954, full retirement age is 66), and your checks will be larger. If you live a long time, the bigger monthly checks will more than make up for the few years you did not collect up front.

How's your contingency planning? An unexpected job loss or serious illness could hurt your retirement plans, draining savings just when you need to be putting away as much as possible. If you have a cash

cushion you can draw on in emergencies, it could stem the damage—but if you don't, build your reserves now. And you may want to invest in long-term care insurance.

How much will you need during retirement? Though rules of thumb suggest you'll need 70% to 80% of your current income to live comfortably after you leave the work force, the amount you should set aside depends on several factors, including the age when you expect to retire, your anticipated housing costs and other living expenses, and



how healthy you are. To be effective, your retirement plan needs to take into account many interrelated variables. We can help you evaluate many possible scenarios, and if you're in danger of falling short of your goals, we can work with you to get on track before it's too late. ●

## Red Flags Raised By Madoff's Scheme

**T**he recent revelations concerning Bernard Madoff's "Ponzi scheme" have put the fear of fraud in investors. Even if you never came anywhere near Madoff Securities, you may sympathize with those who reportedly were bilked out of billions of dollars. And you'll probably wonder whether something similar could happen to you.

According to Madoff's indictment, his truly was a scandal for the rich and famous, who were drawn in not by a chance to make a quick killing but by rock-steady annual returns of 10% to 12% regardless of the state of the markets. Although there are no

guarantees that any financial manager is on the up-and-up, a closer examination of Madoff's operation would have revealed several "red flags," giving investors pause.

The mere fact that he had an unwavering track record should have been the first and biggest warning sign. Normally, even the best-diversified portfolios will rise and fall with the markets; the hope is merely for a smoother-than-normal ride and better-than-average results. In addition, Madoff took the unusual step of assuming full custody of client assets, rather than using a nationally recognized custodian. That, too, should

have set off alarm bells. But there were also other problems.

**Madoff's books were audited by a little-known accounting firm.**

That's extremely unusual for such a major investment company. Normally, big investment managers use a Big Four national accountant or at least a prominent regional firm—and investors thinking about entrusting Madoff with millions of dollars in assets should have been wary.

**The lack of information on Madoff's website and in his brochures was telling.** There was nothing about the qualifications or designations of the firm's money

# A Mixed Record On U.S. Government Bailouts

**T**he final cost of the U.S. government's still-evolving rescue plan for the nation's financial institutions may be impossible to tally. Beyond parceling out the \$700 billion of the Troubled Asset Relief Program (TARP), the U.S. Treasury Department and the Federal Reserve are providing wide-ranging financing, loan guarantees, and foreclosure relief for homeowners. But whatever the price tag, and however much or little of its investment the government eventually recoups, the plan will ultimately be judged on whether it accomplished what it set out to do—avoid massive bank failures, thaw frozen credit markets, stabilize home prices, and just generally pull the nation out of its economic tailspin.

Those are ambitious goals, but this is hardly the first time the government has attempted to save threatened industries or companies. ProPublica, a public interest news organization, recently compiled a list of 15 U.S. bailouts that begins with the 1970 rescue of the Penn Central Railroad and continues through today's multiple efforts. Though some initiatives managed to stabilize important American institutions, the overall record has been decidedly mixed.

Typically, the government steps in only after its hand has been forced. In the

case of Penn Central, for example, the railroad was nearly bankrupt when it asked for help from the Federal Reserve, arguing that support was vital because the railroad transported goods essential for national defense. But Congress balked and Penn Central, which had placed large bets on real estate and other non-railroad investments, declared bankruptcy to avoid repaying debts owed to numerous commercial banks. Fearing a chain reaction of bank failures, the Fed in 1971 provided almost \$700 million in loan guarantees. In 1976, the U.S. merged Penn Central with five other rail carriers into Conrail, a national freight railroad company, and later sold the company to private investors. All told, the government spent almost \$20 billion to keep Conrail running, then recouped about \$4 billion on the sale.

Other transportation industries have needed their own bailouts. Defense contractor Lockheed, which made military aircraft, wanted to produce commercial jets as well, but problems with its first passenger plane left the company in dire financial straits. In August 1971, Congress passed the Emergency Loan Guarantee Act, and to

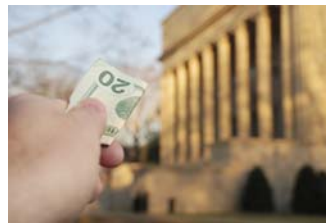
save 60,000 jobs in California and avoid a threat to national defense, the government guaranteed \$250 million in financing (more than \$1.3 billion in 2008 dollars). Lockheed repaid the loans by 1976, according to ProPublica, and the U.S. actually made money on the deal, receiving \$112 million in loan fees.

New York City and Chrysler Corp., in 1975 and 1980, respectively, also asked for and received federal bailouts.

President Gerald Ford at first refused to help the insolvent city, but once New York had made efforts to save itself, he signed legislation that provided billions of dollars in loans and loan guarantees, all of which was eventually repaid. In 1979, Chrysler lost \$1.1 billion and was on the verge of bankruptcy. Once again, Congress acted, and \$1.5 billion in government loans, matched by commercial lending, saved the company. According to ProPublica, the U.S. netted more than \$600 million on its bailout investments.

Several past bailouts involved financial institutions, including Franklin National Bank in 1974 and Continental Illinois National Bank and Trust Company in 1984. But by far the biggest previous rescue involved the savings and loan industry in 1989. In what was then the greatest collapse of financial companies since the Great Depression, more than 1,000 S&Ls failed. The Resolution Trust Corporation, formed as part of legislation passed in 1989, took over failed institutions and sold assets at an ultimate cost to taxpayers of \$293 billion, according to ProPublica.

Current government efforts dwarf anything it has done before. Already, hundreds of billions of dollars have been spent to arrange for the sale of Bear Stearns, guarantee the solvency of Fannie Mae and Freddie Mac, rescue American International Group, Citigroup, and automakers General Motors and Chrysler, and inject capital into banks through TARP. It may take years to judge the success or failure—and add up the total cost—of this latest, greatest government bailout. ●



managers, and scant information about Madoff's process for managing assets. If investors had compared these marketing materials to those of other, more forthcoming investment firms, they might have been more inclined to question Madoff's apparently remarkable results. Those who did try to decipher how Madoff worked his magic found they couldn't replicate his results—it just seemed impossible to deliver that kind of performance. It was.

**There was no evidence of diversification.** The kind of



astonishingly steady returns Madoff used to attract investors, if feasible at all, should require broadly spreading assets over many kinds of investments and regularly rebalancing to keep investment risks under control.

As more details about Madoff's dealings emerge, investors may get a clearer picture of what went wrong. In the meantime, the scandal reminds everyone that there are no shortcuts to investment success, and that when results seem too good to be true, they almost always are. ●



## Severe Economic Crisis

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low recorded in March 2007. On average, it has taken nearly five years for employment to rebound to pre-crisis levels.

The bottom-line impact of a recession is the decline in a nation's economic output, and by that measure, banking-led crises have also been unusually severe, according to Reinhart and Rogoff. Emerging economies have suffered most, probably because they depend on external credit sources that may dry up when times get tough. Per capita gross domestic product (GDP) dropped by more than 20% in Argentina after 2001 and by almost 15% in Indonesia after the 1997 financial crisis. Much worse, of course,

was the nearly 30% plunge during the U.S. Great Depression. But developed countries have also seen economic output drop sharply in more recent times, and on average, recovery takes almost two years.

And the cost to governments of trying to coax their economies back to life? The average rise in public debt during the three years following banking crises has been 86%, according to Reinhart and Rogoff. "Even recessions sparked by financial crises do eventually end, albeit almost invariably accompanied by massive increases in government debt," they write.

It's not certain, of course, that the

current crisis will follow the pattern of past upheavals, and the authors note that some central banks have been particularly aggressive this time in promoting economic recovery. Still,

they write, "one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and

limit the risk of financial contagion." They hardly needed to add that the limits of that hypothesis have become painfully clear. ●



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