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Staying Rich

As I write this, the financial markets are performing as expected: still waging a war between the boomers and the bears. Meanwhile, we are continuing with our long-term investment agenda, which we will detail more deeply in the June 30th Quarterly Review. Meanwhile, here is our meditation for the month.

As a successful investor, you will someday face a golden moment wherein your life will change. Perhaps this moment has already happened, or perhaps it is years away. You will realize, perhaps suddenly, that you have accumulated enough financial assets. Your financial emphasis will change from accumulating and growing net worth to judicious spending.

But what is the right amount to spend? Spend too much and you will run out of money before you run out of lifetime. That is not a happy prospect, yet it happens all too often. However, spend too little and you will needlessly limit your life. Finding the middle ground is the joyful challenge. The whole world should have such troubles.

The good news is that this is a long-term process. Unless a sudden need for a yacht or an insatiable craving for foie gras seizes you, it is OK to spend a little too much or a bit too little for a month or two. Your long-term pattern and agenda is the key. Before you can even hope to calculate your monthly or annual spending potential, you must understand why you are spending.

What are your dreams and goals? Are you planning on leaving an estate to your heirs or do you wish to run out of money when you run out of life? Deciding these questions can be a bit thorny. Who likes to review their mortality? I don't. But you need to know what you wish to accomplish with your money before you attempt to spend it.



At this point I need to make a confession. Budgeting fills me with terror. To my irrational mind, it seems like an exercise in scarcity. Like mine, your irrational subconscious is likely to rear up and make itself known when you start delving into your financial belief system about money.

In fact, it is an exercise in abundance. It is all about making choices. Even if you do it like me, on the back of a napkin or a used paper plate, you will be better off in the process. I suppose that it is educational, and character building, like watching an appendectomy. If necessary, paying for a professional to walk you through the process is probably worth it.

Your next step, after you have budgeted, is to ask us to prepare an amortization for you. An amortization is a written spreadsheet analysis (a whole bunch of numbers) of how monthly or annual fixed payments will impact the portfolio that we manage for you. In fact, an amortization is a key method to discover if you are spending too much. It is also immensely comforting to confirm that your spending is reasonably in line with your lifetime goals.

When you read your amortization, you need to keep a couple of caveats firmly in mind. *These numbers are only estimates!* The reality of the financial markets will be different from projecting a fixed rate of performance for your portfolio. Any amortization also makes guesses about the rate of inflation and your need for money. You will want to be sure that your amortization calculations employ reasonable, conservative numbers for investment performance and inflation. When in doubt, you want to err on the side of keeping yourself rich. Please remember that any amortization is still an educated guess.

But what if you do not like the answers? What if your amortization reveals that you will run out of money in six years...and you have no intention of going back to work?

Faced with this rude reality, the time-honored tradition is to do nothing, and then to act surprised when your financial assets drain away. This is not a very effective response, yet we see it all the time.

A more effective response begins with re-examining the amortization and making sure that the assumptions and the numbers are accurate. Then, if your amortization is reasonably correct, you should begin an iterative process of paring your spending (via budgeting and planning), and searching for additional income through other investments, such as real estate. Quite often, you will easily find an answer.

Often we find that the client's projected income is inadequate because the client has built up off-budget debt via refinancing or credit cards. To stay on budget you will want to avoid this insidious and gradual trap prior to relying on your investments for income. In other words, you will be required to exercise spending discipline well in advance of retirement.

Once you begin to rely upon your investments for income, it is also important not to confuse the sources of your portfolio's gains. Many investors seek cash flow from bonds and mortgages to such an extent that they neglect the risk exposure and growth of their portfolio. As a result, they tend to gravitate towards a portfolio of high income garbage such as junk bonds and limited partnerships. These often fail unexpectedly. Result: their spending power does not keep up with inflation.

Portfolio gains occur in two different ways. Cash flow, otherwise known as income, and capital gains. Together, these make the total return of the portfolio.

As a mathematical equation, it looks like this:

$$TR = I + CG$$

(Total Return equals Income plus Capital Change)

For long-term portfolio success, you must focus on total return. If you emphasize income and neglect the value of your underlying principal, then you will often find that the value of your selected investments has actually declined over time. This is why it is profoundly important to focus your long-term investment goals on total return, not cash flow. In addition, realizing capital gains in your portfolio often results in substantial tax savings.

The key is diversification, with both reasonable risk and reasonable gains to meet long-term total return goals.

As I have mentioned, this is an iterative process. That is, you do it again and again: you budget, you get an annual amortization, you spend, and you review it all again next year. In the process, you will be able to live richly and serenely all the days of your life.

If you are now relying upon income from the portfolio which we manage, or if you are planning to do so in the future, please call us to request a free amortization.

Administrative note: Pete will be out of the office intermittently between June 10th and June 21st. Please contact us early if you foresee any special needs for our services.

