Prudent Asset Allocation Advisor User Guide

January 31, 2022

Introduction

The Prudent Asset Allocation ("PAA") process is designed to make an annual determination of the need to transfer assets from a Growth class into a Protected class or vice versa. There is no attempt at investment selection or market timing but instead optimizes needs and availability of assets to determine the value of assets that must be protected from risk. (See the paper, "*Arbitrary versus Prudent Asset Allocation*" for more details.)

The Worksheet that is used requires only a limited amount of information.

PAA Process

PAA is based on the historical observation that the longest equity market recovery time is five years. The foundational principle of PAA is that assets that are to be used within five years should not be exposed to market forces. These five year assets are held in very low risk vehicles such as deposits, government bonds, guaranteed investments, etc. Remaining assets can be invested as aggressively as the investor desires, with the knowledge that cash needs are protected for a rolling five years into the future.

The allocation determination is made based on current Protected assets, expected additions and spending requirements. The net total for five years will show either a shortfall or an excess of Protected assets.

Completing the Worksheet

The process begins with inviting investors to provide the information (or to complete the Worksheet themselves). By completing the Worksheet, an advisor and investor learns whether the risk is excessive or potential returns are being forfeited. Worksheet information consists of three broad categories:

- **Beginning**. This contains all cash and cash equivalents currently available to the investor, regardless of where/how they are held. Investors desiring privacy need not reveal any details of where/how these assets are held.
- **Additions**. Expected net cash receipts for each of the succeeding five years. Cash receipts net income, social security, annuity payments, investment distributions and interest paid in cash, debt repayments, inheritance, gifts, refunds and other cash payments. These are estimates that can be revised each time the Worksheet is completed. Investors need only provide totals if privacy is desired.
- **Usage**. The cash that will be needed for each of the next five years is reported here. After seeing results, investors may choose to cut back on spending as needed.

Interpreting the PAA Worksheet

The process of completing the PAA Worksheet can reveal highly important information. Results should be checked for the following conditions and if found, the next step is to review the estimates and approximations that are being used. After establishing that the estimates and approximations are reasonable, the related curative actions should be considered and prioritized.

Investor Is Financially Able to Retire

This is indicated when the value of Growth component is greater than the "**Required Growth Component for Retirement".** Conversely, retirement is not suggested when Growth component is substantially less than required.

Growth Assets Are Improperly Allocated

A mistake is indicated when the Growth component holds cash or other conservative assets. If accessible, these assets should be transferred to the Preservative component. If inaccessible, the conservative assets should be converted to assets that are suitable for the Growth component. If more Preservative assets are needed, accessible Growth assets should be transferred to the Preservative component.

The consequence of this miss-allocation is potentially reduced returns for the investor.

Preservative Assets Are Inaccessible

Preservative assets must be held in the form of payouts or in accessible investments. Preservative assets should not be held in accounts where there are restrictions on withdrawals. Inaccessible accounts may include retirement plans, education plans or certificates of deposit.

Insufficient Growth Assets

The PAA Worksheet can indicate a "**Transfer from Growth**" that requires more funds than are available in the Growth component. Such shortfalls can occur at any of three life stages, early, midlife or late.

Early stage shortfalls are primarily because the investor has not yet accumulated sufficient assets to cover contingencies. This is normal in early stages and is cured by diligent savings efforts to build the Preservative assets and lower the demand to transfer from Growth.

Midlife stage shortfalls occur most often because the investor is planning to spend more than the income can support. The cure is to reduce or delay purchases into the future.

Late stage shortfalls are normal and are due to the draw down of assets for retirement. The "**Required Growth Component for Retirement"** should be checked annually to ensure that the drawdown is not too rapid.

Investor is Unprepared for Emergencies

Up to five years of spending are held in the Preservative component that may be used in an emergency. Immediately after the emergency is funded, the PAA Worksheet should be updated and any necessary changes made.

Current Year Spending May Not Be Sustainable

If a "Transfer from Growth" is indicated because of an item(s) that will be repeated in the future, other changes are necessary for financial security.

Shortfall is Forecasted

When the "**Usage"** in any of the five years exceeds the "**Additions"** for the corresponding year a possible shortfall is indicated. This indicates that in the shortfall year, the investor is relying on accumulated assets to fund the activity. This is not problematic unless the magnitude and/or frequency of the shortfall is excessive.

The issue is most easily addressed by "borrowing" from a future year. If this is not desirable or feasible, the cure in the case for excessive shortfalls is to consider reducing expenses, delaying retirement or seeking additional employment.

Lifestyle Changes Are Necessary

If there are one or more indicators that the forecasts need to be revised, it may be necessary to make major changes to increase income or reduce expenses that will affect lifestyle. This process should begin with the largest expenditures since small changes here can produce significant results. Planned major purchases can be deferred or avoided entirely to achieve financial security.

Investor Is Unable to Retire in the Near Future

If Growth component is significantly lower than the amount shown in "**Required Growth Component for Retirement",** retirement needs to be postponed or lifestyle changes planned.

If the investor is uncomfortable with the PAA Worksheet results, several actions can be taken to make adjustments:

- Increase or decrease the "**Additions"** for the next five years
- Increase or decrease the "**Usage"** for any of the next five years
- Delay taking action until after the next review when facts or market conditions are clearer

How Often Is PAA Worksheet Used

The Worksheet process is repeated every year and at any time an unforeseen event occurs. These reviews permit the investor to make adjustments that reflect changes in personal situation and market conditions that occurred since the previous review.

Reacting to Worksheet Results

Several key decisions are driven by the PAA Worksheet review:

- **Preservative Asset Deployment**. To the extent possible, the suitability of the Preservative assets is determined and changes made to ensure liquidity and stability. For example, these cash or other conservative assets are considered unsuitable for Preservative purposes:
  - Retirement plans subject to withdrawal penalties
  - Investments (funds) from which cash cannot be withdrawn without liquidating non-conservative assets
  - Deposit instruments with maturity of more than five years
  - Bond funds with maturity of more than five years
  - Balanced funds
  - Target date funds
- **Preservative Asset Withdrawal**. Withdrawals occur as scheduled usage on the PAA Worksheet. If withdrawals exceed the planned usage, the investor borrows from assets put aside for future years. These “loans” are paid back at the next PAA Worksheet review.
- **Growth Asset Deployment**. The Growth assets are examined and any conservative assets removed. After funding usage, any cash from these conservative assets as well as any excess cash from the PAA worksheet are invested with the single goal of long term growth.
- **Growth Asset Withdrawal**. Withdrawals are made from Growth assets only when market conditions are favorable. This may involve waiting for up to five years before making a withdrawal. Unfavorable conditions for withdrawals exist following a market decline until there is a full recovery.

Business Enhancement through PAA

Add Value for Clients

There are two common beliefs regarding asset allocation that have been proven false. First is that asset allocation is free and the second is that asset allocation is good protection from loss.

- The holding of Preservative Assets is not free, it costs investors between 2.3% and 9.3% of appreciation every year compared to the typical Growth Asset (S&P 500).
- Protection at the 40% level reduces the number of significant declines from 8 to 6 over an 81 year period! The cost for such an arrangement is 4.6% annually.

Debunking these beliefs opens the door to higher returns (up to 9.3% more) and better protection (protecting only short term assets).

Higher Returns

Removing low earning assets from the client's growth portfolio produces the most visible economic benefit a client will see.

The decision to replace the low earning asset starts with the compelling argument that average investors derived no net benefit during the Modern Era. Even under the most extreme conditions (2008) returns forfeited (9.3% annually) produced only 8.8% benefit in that one year.

If not convincing enough, a comparison of the value of a client's own portfolio with and without the Preservative Asset should make an indisputable economic argument.

Tolerate Market Shocks

The argument here is that asset allocations are necessary in the event that funds are needed when the market is depressed. While this is true, it is only applicable to assets that are withdrawn before the market recovers. With PAA this is a five year window that is covered by Preservative assets.

Investors will immediately understand that assets designated for use before the market recovers must be protected. It then becomes a straightforward process of identifying the funds needed while waiting for the market to recover. In the worst case in the Modern Era, this recovery period was five years (2001 to 2004). The second worst was four years (1973 to 1977).

It becomes clear that protecting assets needed during the next five years affords prudent protection.

Additional Investor Benefits of PAA:

- PAA allocations are based on funding the needs of the investor and on changes in those needs.
- PAA sets allocations based on the markets historical ability to recover from severe declines.
- PAA calculates and protects the needs of each investor.
- PAA releases unnecessary low yielding assets to be invested in a Growth component.
- PAA changes the allocation after needs are met and when changes occur in the investor's situation.
- PAA anticipates usage and maintains funds to meet future needs, independent of the allocation percentage.

- PAA permits the investor to borrow from future needs for emergencies without disruption of the long term Growth component. Borrowed funds are replenished in a non-disruptive way.
- PAA relies on greater long term persistency for the Growth component and takes advantage of superior short term consistency for the Preservative component.
- PAA protects the investor from disappointment by clear delineation of Growth from Preservative components. Growth is not diluted by Preservative assets and preservation is not compromised by a volatile Growth component.
- PAA requires the consideration, evaluation and possible restructuring of Preservative assets.

Add Value for Advisor

Earn More from Existing Portfolio

Advisors benefit directly by the uncoupling of Growth and Preservative assets in a portfolio. Since PAA incorporate assets that are not in the traditional investment portfolio (CDs, money market funds, GICs, fixed annuities and other cash equivalents) the Preservative component that may exist in the investment portfolio is often excessive. These excessive Preservative assets can be transferred to more aggressive investments. and therefore, be more lucrative for the investor and advisor.

Activate Preservative Assets

By opening the discussion of Preservative Assets, the advisor has the opportunity to win the management of these assets.

Enhance Relationship with Clients

The economic advantage, superior protection and personal attention from PAA enhances the client relationship.

Action Items

The first step is for the investor to complete a Prudent Asset Allocation Worksheet.

There are three possible actions that can be taken with Worksheet results:

1. If there is an excess of Protected assets, the difference is transferred to the Growth class.
2. If there is a shortfall of Protected assets and sufficient assets exist in the Growth class, the required assets are transferred from the Growth to Protected component.
3. If there are insufficient Growth assets to fund the shortfall, spending or income must be adjusted until a balance is achieved.

FAQs

The following types of questions can be expected after presenting PAA to a client:

What happens if PAA does not work as described?

- There are three points in time that you will know how well PPA is working for you:
    1. When you see better returns from your Growth portfolio.
    2. When there is a market event and you realize that you can afford to wait until the market recovers.
    3. When your situation changes and you need to know what to do.

Why didn’t you show this to me before?

- The PAA method has been developed, thoroughly researched and tested and is only now being made available.

Does PAA consider the tax implications of the actions taken?

- PAA includes the ability to plan for tax payments and refunds but does not calculate or estimate taxes.

What are the risks of taking the PAA approach?

- PAA is a method of managing risk. The actual risks taken are the investments and other products that the investor holds.

Can I try it with a small portion of my assets?

- Yes.

Is this worth the time and effort?

- It is very worthwhile to investors who are concerned about market risk and managing that risk.

How will I know if this is working?

- The good news is that you will know if it is working as soon as you complete the Worksheet. You will learn whether you are overprotected, overexposed or underfunded.

Can the PAA worksheet interface with my tax/financial records?

- This is a consideration for future releases but is not currently available.

What kind of reporting will I receive?

- Reporting you receive does not change.

Example

Prudent Asset Allocation Worksheet

For:	*Charlie Fontuli*					
For Year:	2022	2022	2023	2024	2025	2026
	Enter approximate or estimated amounts in thousands for the years they are most likely to take place					
Beginning						
Bank Deposits	$25					Includes checking, saving and CDs
Government Bonds	$100					All US bond funds and other US bonds
Other Protected Assets	$10					Other forms of low risk assets
Additions						
Income	$45	$47	$50	$52	$54	Take home pay, distributions or other
Expected Payments	$80	$80	$80	$80	$80	Annuity payments, inheritance, refunds, etc.
OtherAdditions	$0	$55	$0	$0	$0	Any payments not included above
Usage						
Living Expenses	$97	$101	$105	$107	$109	All routine expenses
Major Purchases	$0	$65	$0	$0	$0	Additional outlays planned
Taxes	$17	$17	$17	$17	$17	Taxes owed in excess of withholding
Other Expenditures	$0	$0	$0	$0	$0	Any expenses not included above
Recap						
Beginning Balance	$135					
Additions	$125	$182	$130	$132	$134	
Usage	$114	$183	$122	$124	$126	
Actions						
Transfer from Growth						
Addition to Growth	**$169**					

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