How investors can act on what was learned

Five years after the financial crisis

The five-year anniversary of the stock market bottom in March 2009 may be a good time to look back at what happened and how investors reacted. With the benefit of hindsight, the financial crisis provides an opportunity to learn and apply those insights to help become better investors.
The financial crisis and the journey from perceived security to accountability

Everyone remembers the financial crisis. But think back to how things were before it hit. Everything appeared to be going great. The market was up; housing was booming; lenders were lending; and borrowers were borrowing. Then suddenly everything seemed to go awry, and we all know what followed.

Today, a look at the major market indices will tell you that stocks have come back, and then some. Housing is improving, and banks are lending. But the crisis appears to have left many investors feeling once bitten, twice shy.

What changed

A reason for the lingering uncertainty may be that the stakes for investors are higher now than ever before. Historically, Americans relied to a large extent on defined benefit plans, or traditional pension plans, to fund their retirement. These plans are run by employers, who make contributions and promise employees they will receive a certain benefit in retirement.

The last few decades have seen defined benefit plans decline in favor of defined contribution plans, such as 401(k) and 403(b) plans. With these plans, it’s up to the individual to make contributions (employers may also contribute) and determine how they should be invested.

What’s nice about defined benefit plans is they offer a perceived level of security: Employers promise workers they will receive a certain amount in retirement. Defined contribution plans come with no such promises. The amount contributed, what investments are chosen, how long a worker has until retirement, market activity, inflation, and other factors help determine what kind of retirement an individual may be able to enjoy.
With the crisis, investors may have fully realized the impact of the shift from defined benefit to defined contribution plans. As the market declined, so did their 401(k) account balances and for some, their retirement dreams. There was no defined benefit plan “safety net.” Americans really “got” it: They were fully accountable for their retirement, and the perceived security defined benefit plans once offered their parents and grandparents now has turned out to be a thing of the past for many. Defined contribution plans give employees more control over their retirement savings, but ironically, the crisis left them feeling less in control of their futures.

Other factors compounded matters for investors even further. For example, life expectancies are increasing. In fact, one out of every 10 people who are age 65 today will live past age 95.\(^1\)

This generally means workers today should plan for a longer life in retirement. In addition, the Federal Reserve instituted a number of economic stimulus programs designed to keep interest rates near zero. While these programs have benefitted borrowers and the stock market, they’ve also made it extremely difficult for retirees struggling to live off the interest from their investments. Longer life spans and low interest rates mean investors need to take additional risks to generate an adequate level of income, but they feel, or are, under equipped to handle this.

**Lessons learned**

This report looks at five insights from the crisis and strategies shown below we believe investors should consider now that the worst of the downturn is five years behind us.

<table>
<thead>
<tr>
<th>Defined benefit plans have declined</th>
<th>Defined contribution plans have grown</th>
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<tbody>
<tr>
<td>1980 38%</td>
<td>1980 08%</td>
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<tr>
<td>2013 16%</td>
<td>2013 42%</td>
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Statistics are the proportion of private wage and salary workers with access to defined benefit plans and defined contribution plans.


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<th>Worker confidence is down</th>
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<tr>
<td>1995 72%</td>
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<tr>
<td>2013 51%</td>
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Statistics are the sum of the percentage of worker responses of “very” and “somewhat” to the question, “Overall, how confident are you that you (and your spouse) will have enough money to live comfortably throughout your retirement years?”


1. Know your risk tolerance
2. Use debt strategically
3. Weigh fundamentals versus feelings
4. Establish a cash reserve
5. Exercise good financial habits

\(^1\)Social Security Administration, January 2014
Prior to the financial crisis, many investors enjoyed several years of relatively healthy returns with little downside and modest volatility. They became comfortable with the market’s risk and reward proposition as long as it heavily favored rewards. Living in the shadow of the tech wreck in 2001, many investors’ idea of risk management was to avoid Internet or technology stocks; they did not consider that significant risks could lurk elsewhere in the financial markets.

As markets began to slip in 2008 and later fell precipitously, some investors who thought they were comfortable with their risk tolerance over-estimated their appetite for risk and got out of the market as shown in the chart to the right below. While there were many sleepless nights during the height of the financial crisis, panicking or emotional investing should not be considered part of a rational investment strategy. As the financial crisis subsided, investors who kept a level head, stayed in the market, and adjusted their portfolios accordingly likely exited the financial crisis with portfolios that were in relatively good shape. Investors who panicked and got out of the market may have avoided some of the market’s worst declines, but they may also have missed some of its best advances.

As the stock market declined during the crisis, many investors opted to sell

**Net new cash flow**

<table>
<thead>
<tr>
<th>Year</th>
<th>Bonds</th>
<th>Equity</th>
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<tbody>
<tr>
<td>2006</td>
<td>$400</td>
<td>$300</td>
</tr>
<tr>
<td>2007</td>
<td>$200</td>
<td>$100</td>
</tr>
<tr>
<td>2008</td>
<td>$100</td>
<td>$-100</td>
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<tr>
<td>2009</td>
<td>$-200</td>
<td>$-200</td>
</tr>
<tr>
<td>2010</td>
<td>$-300</td>
<td>$-300</td>
</tr>
</tbody>
</table>

**Source:** Bloomberg and Wells Fargo Advisors

**Source:** Investment Company Institute and Wells Fargo Advisors

*Net new cash flow is the dollar value of new sales minus redemptions combined with net exchanges. Components may not add to the total because of rounding. Note: Data for funds that invest primarily in other mutual funds were excluded from the series.
With the markets and economy back on a more even keel, we believe it is a good time for investors to reassess their tolerance for risk. Too little risk, and your portfolio may not be able to deliver the level of return needed to support your investment goals. Too much risk, with an asset allocation overweighted in stocks, and your portfolio may suffer shocks that could derail your investment goals. It is an important balancing act, and we believe investors should work closely with their Financial Advisor to develop proper risk/return parameters.

Just as an investor’s housing and transportation needs evolve over time, your risk tolerance will too. An investor with many years to retirement or low liquidity needs has more time to ride out equity market volatility and can be invested more aggressively. Conversely an investor nearing retirement or with high liquidity needs likely cannot stomach significant downside risk and should be invested more conservatively. And there may be life events other than retirement that cause an investor’s risk tolerance to change.

Risk tolerance is unique to each investor. Some investors are more comfortable with market volatility than others. As shown in the chart below, a portfolio that assumes less risk and is more diversified may have less of a bumpy ride over time. Wells Fargo Advisors uses a three-tier risk tolerance spectrum with conservative as the least risk tolerant, moderate as more risk tolerant and long-term as the most risk tolerant. The best approach is to have frequent conversations about life events and risk tolerance with your Financial Advisor.

**Diversification can help smooth out a portfolio’s performance**


![Graph showing annual returns of S&P 500 and combined S&P 500/U.S. bond portfolio, 2004–2013.](source: Morningstar and Wells Fargo Advisors)

Effective diversification requires combining assets that behave differently when held during changing economic or market conditions. Moreover, investing in assets that have dissimilar return behavior may insulate your portfolio from major downswings. This chart illustrates the annual returns of a 100% investment in large stocks and a portfolio of 50% large stocks and 50% long-term government bonds. When the stock and bond asset classes were combined into an equally-weighted portfolio, the 50% stock/50% bond portfolio experienced less volatility than stocks alone.

*Past performance is no guarantee of future results. Annual rebalancing is assumed in the 50% stocks/50% bonds portfolio. The return of the portfolio is higher than the returns of the constituent asset classes due to a phenomenon called “the rebalancing bonus,” which occurred due to the unusual behavior of stocks and bonds over the time period analyzed. This information is hypothetical and shown for illustrative purposes only and not indicative of any investment. The data assume reinvestment of all income and do not account for taxes or transaction costs. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Different investments offer different levels of potential return and market risk. While stocks generally have a greater potential return than government bonds, they involve a higher degree of risk. Government bonds, unlike stocks, are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although U.S. government securities are considered free from credit risk, they are subject to interest rate risk. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price.*
Use debt strategically

Over the last five years, the economy has been dealing with the dark-side of leverage. In 2007, cracks began to emerge as over-leveraged consumers began to default on their debt. The demand for loans also slowed, which caused a deceleration in economic activity. In response to the slowing economy and elevated debt burdens, consumers began to deleverage, which deepened the recession and ultimately helped contribute to the financial crisis of 2008 and 2009.

Prior to the financial crisis, many consumers used the refinancing process to extract cash from their homes in an effort to take advantage of the rapid price appreciation. In essence, these consumers were using their homes almost as a “piggy bank” to pay bills, fund purchases, and maintain their lifestyles. Now that home prices have fallen, these borrowers — who had increased their leverage — are making mortgage payments on a house that has depreciated in value.

Homebuyers who took advantage of easy credit, which included low down payments and/or interest-only payments were also affected by the dark side of leverage. Some of these borrowers have since filed for bankruptcy because they were unable to make the payments when the interest rate reset and, in many cases, the house was worth less than what was owed. A bankruptcy filing can severely limit a consumer’s ability to borrow as the event remains on a credit report for 10 years.

The double-edged sword of leverage, of course, cuts both ways as it magnifies returns and also losses. Leverage can have a role in a portfolio if used prudently and strategically. But the roles that leverage plays will be different for every investor’s unique goals. We believe investors need to understand their personal risk tolerance and receive guidance from their Financial Advisors so that they can use leverage appropriately.

Consumer debt has grown substantially over the past 30 years

U.S. household debt in trillions

The U.S. experienced a massive buildup of consumer debt from 1980 to 2008 with mortgage debt growing from $0.9 trillion in 1980 to $10.7 trillion in 2008. Consumers stretched themselves thin with debt-to-income and debt-service-to-income ratios reaching all-time highs in 2008. Rising housing prices meant that the ratio of household debt to assets appeared stable in the years prior to the financial crisis. Instead of naturally building equity as home prices were rising, consumers were actually reducing their equity by taking the cash out of their homes through home equity loans.
Weigh fundamentals versus feelings

Fundamentals and emotions will always play a part in investing. Emotion can take the form of fear, greed, uncertainty, euphoria or any number of other feelings. For investors, allowing emotions to influence portfolio decisions rather than a rationally thought-out investment plan can lessen the probability of reaching long-term goals. Hence, we believe it is critical to have a well thought-out investment plan.

Most market declines, especially large ones, typically end with a significant number of investors selling at or near the bottom. This trait of selling close to the bottom of a market correction is one of the best examples of letting your emotions get the best of you. In this case, fear of further losses pushes the investor to sell out of what are likely good longer-term investments at the wrong time. This type of group behavior has been well documented over the years and can clearly inflict severe negative consequences on your portfolio’s long-term return. Historically, some of the best rally days in the stock market occur in the wake of a big selloff. These robust rebounds often come quickly, giving the shellshocked investor little time to react. Regrettably, those investors who sold near the bottom are often too fearful to get back into the market. As a result they potentially miss the big rally as the panic fades, fundamentals are reconsidered, and clearer heads prevail. Once again, sticking to a well thought-out long-term plan devised with the guidance of a Financial Advisor can help prevent the investor from making rash decisions they may later regret.

The importance of staying invested

Ending values after a market decline in thousands

The chart illustrates the value of a $100,000 investment in the stock market during the period 2007–2013, which included the global financial crisis and the recovery that followed. The value of the investment dropped to $54,381 by February 2009, if an investor remained invested in the stock market over the next 46 months, however, the ending value of the investment could have been $151,671. If the same investor exited the market at the bottom to invest in cash for a year and then reinvested in the market, the ending value of the investment could have been $98,818. An all-cash investment made at the bottom of the market might have yielded only $54,560.

Recession data are from National Bureau of Economic Research (NBER). The market is represented by the Standard & Poor's S&P 500®, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Cash is represented by the 30-day U.S. Treasury bill. Past performance is no guarantee of future results. This information is hypothetical and is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. The data assume reinvestment of income and do not account for taxes or transaction costs.

Source: Morningstar
Establish a cash reserve

Among the primary lessons learned over the past five years is the need to balance both flexibility and discipline in responding to unexpected events. One approach to better maintain both discipline and flexibility is to incorporate prudent levels of cash reserves within an investor’s overall investment and expense funding plans. Cash reserves are intended to provide immediate liquidity for an extended period to help reduce the need to sell depreciated or less liquid assets at inopportune times as well as provide additional means to help fund unexpected expenses. The cash is intended to be there when needed and subsequently replenished as circumstances and market conditions allow. In our opinion, cash should be in the form of bank deposits, money market accounts, or other such instruments that provide both ready access and ongoing stability. While the concept is simple, what level of cash reserves should be maintained is often less clear.

General guidelines, combined with your specific circumstances, can help determine what level may be best for you. The decision is a balancing act between maintaining enough cash/liquidity to help weather potential near-term risks and meet unexpected needs while also guarding against holding too much cash to the detriment of potentially longer-term returns needed to meet future needs and maintain inflation-adjusted purchasing power.

The general rule of thumb for investors in the early-to-mid phase of wealth accumulation is to maintain at least six to 12 months of expenses in cash reserves. For those nearing or in retirement, maintaining anywhere from one to three years of expenses in cash reserves can be prudent. For these investors, substantial market downturns can be particularly punishing given reduced time horizons, larger amounts of money invested, reduced ability to invest

Low interest rates make finding the right amount of cash reserve important

Barclays U.S. 3-month Treasury yield, 1983-2013

Source: Bloomberg and Wells Fargo Advisors
new funds, and limited income sources. This could result in potentially a greater need to sell more at depressed prices to fund expenses. The higher levels of cash reserves are warranted to help maintain investment discipline, avoid ill-timed sales, and further participate in market recoveries.

With the level of cash reserves being largely dictated by spending levels, investors should continue to regularly assess their ongoing spending needs, levels of flexibility, and expense reductions (based on essential vs. discretionary spending) during adverse market periods. Such flexibility cannot only reduce the levels of cash reserves needed, but also help keep more dollars invested for greater participation in potential eventual market rebounds. Coordinating prudent cash reserves and spending plans can help increase investment discipline, allow investors to better prepare for and respond to the unexpected, and ultimately increase the potential for longer-term financial success.

A flexible spending strategy can help investors weather market downturns

Probability of a portfolio lasting 30 years at various withdrawal rates

Flexible spending strategies are designed to temporarily reduce spending during market declines or other adverse circumstances. By reducing spending and required portfolio withdrawals, more money can remain invested should the market eventually rebound.

This chart illustrates the potential impact of a flexible spending strategy. Results are based on the probability of being able to take withdrawals from an investment portfolio over a 30-year period at various rates without running out of money. Using the Envision® planning tool and market simulations, when an Envision plan dropped below the 75% probability for success, spending was reduced until the plan was able to achieve 75% or higher probability based on the original withdrawal rate. At that time, the spending was increased to the original rate.

For example, a portfolio with a 4.5% distribution rate has a 86% chance of providing that level for 30 years. By reducing spending by 5% when the portfolio’s Envision plan falls below its 75% target rate, the probability of success rises to 89% if the lower withdrawal rate is maintained until conditions improve. On the other hand, if spending is reduced 25% until conditions improve, the probability for success rises to 96%.

As the example illustrates, investors should consider adjusting spending in response to periods of major market distress and substantial declines as a way to reduce selling low and further increase income potential over the full course of retirement.

Assumptions: Moderate Growth & Income allocation and Capital Market Assumptions (mean return: 7.7%, standard deviation: 9.0%); monthly returns and distributions; 30-year investment period; 3% inflation rate. This information is hypothetical, and is for illustrative purposes only, and not indicative of any investment.

Source: Wells Fargo Advisors
Exercise good financial habits

As the previous four lessons indicate, it is critical for investors to understand the many behavioral and environmental factors that can either help or hinder the achievement of their goals. It is important for investors to use these lessons to build good financial habits that could weather the stormy days.

Often times, investors will recognize that changing existing habits can be difficult. Sticking with a change can be even harder in the long run given behavioral and market factors that can create uncertainty or anxiety. That is why it is so critical to establish an investment plan and build reasonable goals that can make the plan attainable.

As an example, if an investor is trying to increase savings by the end of 2014, action steps might be “create a budget” or “spend less.” Those might be a good starting point, but the steps themselves are not detailed enough to effectively achieve the goal.

Instead of writing down steps to achieve a goal, we think investors should work with their Financial Advisor to write down the obstacles that might get in the way of achieving their goal and prioritize what is important to them. Afterword, they can build the needed action steps to overcome those obstacles by using a well-crafted plan.

A good financial habit in this case could be setting a goal of “going out to dinner no more than once a week.” An action step to build better habits around this goal might be “cook dinner with the family at least three nights per week, and budget a set amount for dinners out.”

Depending on the type of investor, here are some questions to ask that might build better financial habits. Set a goal to act on two or three of these in 2014, and then connect with your Financial Advisor to begin the plan to help achieve them.

<table>
<thead>
<tr>
<th>Action steps for investors who “delegate” responsibility for their plan to their Financial Advisor:</th>
<th>Action steps for investors who actively “collaborate” with their Financial Advisor on their plan:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Meet annually/semi-annually with Financial Advisor</td>
<td>1. Consider how recent market returns have impacted portfolios</td>
</tr>
<tr>
<td>2. Work with advisor to create an Envision plan</td>
<td>2. Rebalance portfolio regularly and know whether the portfolio is aligned with Envision plan objectives</td>
</tr>
<tr>
<td>3. Regularly revisit the goals laid out in the Envision plan with an advisor</td>
<td>3. Coordinate investments [insurance, pension plans, 401(k), etc.] to work together</td>
</tr>
<tr>
<td>4. Have a comprehensive investment plan drafted for self and loved ones</td>
<td>4. Use insurance (annuities, whole life, deferral of taxable income) within portfolio</td>
</tr>
<tr>
<td>5. Read statements and financial literature to keep current with the market</td>
<td>5. Prepare family members to be financially stable in the long run (e.g., long-term care, elder care, etc.)</td>
</tr>
<tr>
<td>6. Be aware of the two or three most important things that might have a material impact on future financial goals (e.g., trust, 529 college savings plan, budget, etc.)</td>
<td>6. Prepare for the potential escalation of health care costs in the future</td>
</tr>
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An Envision plan provides focus

Unlike other tools you may have experienced, an Envision investment plan from Wells Fargo Advisors can help you uncover goals, determine which are the most (and least) important, and track your progress toward them. And it gives you flexibility to alter your plan to account for changes in your life.

The Envision process begins when you sit down with your Financial Advisor to discuss your goals. These may include the age you want to retire, the income you want in retirement, your plans for major purchases, and your estate and legacy.

One of the Envision tool’s most useful features is a personalized benchmark that lets you track your investments’ performance toward your goals as often as you want.

For more information, contact your Financial Advisor at Wells Fargo Advisors. If you need a Financial Advisor, use the Branch Locator at wellsfargoadvisors.com to find one near you.

Investors who are Delegates

- Value a strong personal relationship
- Prefer advisor drive decision making and present recommendations

Investors who are Collaborators

- Value advice but also enjoy doing their own research
- Prefer to review options and make the final decision
Conclusion

While the financial crisis five years ago was a painful experience for many investors, hopefully some of the lessons learned have put investors in a better position to realize their investment goals. Realize your unique risk tolerance, don’t let emotions take the wheel, have appropriate cash balances, understand the role of leverage in a portfolio, and be intentional with your investing strategy; all things that will potentially help you reach your goals. Wells Fargo Advisors appreciates that investors want to feel more in control of their financial future, and we are here to help you in your effort to succeed financially.

A properly implemented investment plan should be at the core of the investment process. A plan can help balance your risk/reward profile, provide adequate cash reserves and provide flexibility and discipline when emotions become a risk. Your Financial Advisor at Wells Fargo Advisors can create an Envision plan that will provide you a path toward achieving your investment goals.

Standard deviation of return measures the average deviations of a return series from its mean, and is often used as a measure of risk. A large standard deviation implies that there have been large swings in the return series of the manager.

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