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Half-Baked Investment Concepts for Retirees

Are we trying to help retirees make wise financial decisions, or are we trying to save the future of equity funds? If retirees follow the advice many investment professionals are giving them today, the markets will prosper, but the retirees probably will not.

New wisdom, or new foolishness?

It used to be common wisdom that people should invest more conservatively after they retire. But increasingly, and with near unanimity, this message has changed in the past decade or so. Now, various reasons and schemes are offered to promote equity investment by retirees. Has the world really changed that much?

Actually, it hasn't. While life expectancies have increased considerably in the last century, little of this increase has occurred in the last decade. Meanwhile, inflation – another oft-cited threat to retirees – has been low or moderate for a quarter century, and seems much less a danger now than it did to retirees back in the '80s.

What *has* changed is the sheer number of retirees, the proportion of their own income they control (e.g., through 401(k) accounts, in place of traditional pensions), and the financial industry's awareness of these factors. If Baby Boomers turn conservative when they retire, there is a potentially large threat to the equity markets, and to people who make their money from those markets.

Perhaps our fear of this makes us too ready to accept ideas that legitimize retiree risk-taking. But our uncritical approach is resulting in advice that is harmful for retirees. It is time to step back and reconsider.

Half-baked concept #1: Investing for growth during retirement

Here's the argument: as a retiree, you could face a longer life than you expect, maybe a much longer life. Furthermore, you'll have to deal with two or three or even four decades of inflation. So you need to invest for growth to cope with inflation, and you can do it successfully because you have a long-term investment horizon.

This message has become predominant, because it sounds so right. Yet it isn't. Here's what it really says: You, as a retiree, face increasing financial risk: both mortality risk (living too long) and economic risk (inflating expenses) – *and therefore you should pile* *on additional risk* (in your investment portfolio). This doesn't make sense.

There are several points that proponents of this half-baked idea fail to take into account:

- Some – and in some cases most – retiree income is already adjusted for inflation.
- Inflation is usually not a big factor for retirees in their eighties and older, because increases in some expenses (housing, utilities, medical) are offset by decreases in others (travel, food, entertainment, clothing, purchases of hard goods, etc.).
- In a fund that is being amortized, most of the original principal is spent in the earlier years (the opposite of a mortgage, where most of the principal is paid off in the later years). This means that the investment horizon for the lion's share of a retiree's nest-egg is short-to-medium term, not long-term, even if they expect to live another thirty years or more.

But there are two much more serious problems with the concept:

> **Since non-affluent retirees have much less to gain on the reward side and much more to lose on the risk side, the only place where the market's risk/return trade-off is the same for them as for other investors is at the zero-risk point.**

- ***<u>Successful</u> risk-taking pays off less for retirees than it does for savers.*** That's because the "miracle of compound interest" can indeed work wonders when you are accumulating a fund over a long period of time, but it doesn't do nearly as much good if you are amortizing an account. Here's an example: if you *save* a level amount annually for 30 years, and earn 10% instead of 7%, your final balance, and any withdrawals you then choose to take from it, will be *79% higher*. But if you *amortize* a fund with level withdrawals over 30 years, and your fund earns 10% instead of 7%, your withdrawals can be only *32% higher*.
- ***<u>Unsuccessful</u> risk-taking hurts retirees more than it hurts savers.*** That's because retirees have fewer ways to recover from investment catastrophe. Younger people can redouble efforts to get a promotion, or can moonlight, or can maybe get a non-working spouse to take a job, or, if all else fails, can postpone retirement. But once people are already retired, they can rarely go back to their old jobs or even to comparable jobs. And if it takes, say, five or ten years to realize that an aggressive investment strategy is failing to the point where recovery is unlikely, the retiree's credentials are completely stale by then. Finding more than a minimum-pay job is unlikely. Or, because of health issues – either the retiree's or a spouse's – the retiree may not be able to return to work at all. What is a misfortune for a younger saver, therefore, is likely to be a calamity for a retiree.

Taking these last two points together, we can make a stronger argument: investment risk is almost always a bad bargain for non-affluent retirees, *because the market is rigged against people with the risk/reward profile of the typical retiree.* This is true because investment risk is priced by a market dominated by institutions, wealthy individuals, and middle class families still saving for the future. The market trade-off between risk and return is rational, maybe even beneficial, for those players. But because non-affluent retirees have much less to gain on the reward side (because they are amortizing) and much more to lose on the risk side (because the consequences of losses are more catastrophic), the only place where the market's risk/return trade-off is the same for them as for other investors is at the zero-risk point. Now, depending on the financial vulnerability and the risk tolerance of the individual, it might be rational for some of them to move incrementally off the zero-risk point, but a large move would be foolish for the typical retiree.

Of course, these latter points do not apply to retirees who don't have to spend down their savings, and who could absorb losses without catastrophe. But retirees with this much money also don't need to worry about the longevity and inflation issues that fuel the "Invest for Growth" concept. Sadly, the very people this concept is intended to influence are the ones who should not follow it.

Half-baked concept #2: Asset allocation that includes guaranteed income sources

This concept, unlike the first one, is based on meritorious principles – but it is flawed in its execution. The basic idea is that if one receives Social Security, pension or annuity income in retirement, the present value of such income streams can be considered an asset. Furthermore, it is a conservative asset – a very conservative one, if payments are strongly guaranteed. Having this conservative "asset" means the allocation of one's other assets, one's true assets, can be more aggressive – i.e., can include more stocks.

We can admire this concept for recognizing that assets are not the whole story when it comes to retiree finances. In general, the financial industry has been way too focused on asset management – understandably so, since this is what the industry knows about, and where it gets paid. But retirees need to manage their entire cash flow, not just their assets, because as everyone agrees, the object is to avoid running out of funds while one is still alive. Achieving this goal, obviously, means more than managing assets, but also managing debts, income, and expenses, in all their forms.

It is interesting – and perhaps just a coincidence – that of all these other items, the one thing that proponents of half-baked concept #2 have decided to include is the element that will most *increase* the retiree's ability to invest in equities. But they fail to include the equally valid items that would tend to *reduce* investment in equities:

- ***Non-guaranteed income.*** Where income is received from *uncertain* sources – a family business, part-time work, contributions from family members, pensions that are shaky in their financing, rents, royalties, and the like (including Social Security, in some people's opinion) – the assumed present value of such income should be added to the existing *higher-risk* component of the asset allocation, for the same reasons guaranteed income is added to the lower-risk component.
- ***Debts.*** Mortgages and other persisting debts are roughly the negative equivalent of bonds and CDs. When retirees have such debts (and most, these days, do still have a mortgage when they retire), these should offset (reduce) the current conservative investment total, and therefore tend to boost the conservative (and reduce the equity) components in any reallocation of assets.

- ***Expenses.*** Expenses are pretty much guaranteed. Even discretionary expenses need to exist at some level. So the present value of future expenses should also be used to offset one's actual allocation to conservative assets – though, to be fair, some portion could probably be used to offset equity investments.

Of course, taking these other elements into account will complicate the investment models currently being promoted. But if the purpose of these models is prudent asset allocation, the bias they currently contain by taking guaranteed income sources into account but omitting financial elements having the opposite impact, makes the models worse than worthless for their stated purpose. It makes them dangerously inappropriate.

The models were actually less biased, and therefore more useful, in their older form, before the one-sided inclusion of guaranteed income sources was added to them.

Half-baked concept #3: Creating separate portfolios to support different age-periods in retirement

This third concept, though difficult to express in ten words or less, is actually the simplest. Since, as noted earlier, part of one's savings as of retirement age are really long-term, why not invest that portion more aggressively, and invest the short-term part conservatively, and invest the middle part in a middling fashion?

Like the other half-baked ideas, this one looks sensible on its face, and it has the "merit," as they all do, of justifying an investment in equities. And it is probably not as highly objectionable as the other two. But it contains some serious practical problems:

- Doing this properly actually doesn't change things very much. To use an appropriate, but simple scheme: suppose someone retires at age 64 and decides to split her assets into three buckets, each to support one 12-year period. This covers her to age 100. It would be incorrect to simply divide the three buckets evenly, because the first one will have little time to grow and the last one a great deal of time. To the extent that investment return exceeds inflation, this matters. So, to illustrate, let's suppose 3% inflation, 5% return on the short-term portfolio, 6% return on the middle portfolio, and 7% return on the long-term portfolio. The correct initial allocation among the three portfolios would then be, roughly: 60% to the conservative portfolio, 29% to the middle portfolio, and 11% to the more aggressive portfolio. If the middle portfolio is, say, 40% equities and the aggressive one is 80% (and the conservative one 0%), only about 20% of the total assets would be in equities. Models with vastly higher equity percentages are suspect.

- This scheme assumes that cash flow requirements increase steadily and predictably over the years. But there are dozens of reasons why this might be false (the presence of a mortgage that is paid off at some point; the death of one member of a retired couple; etc., etc., etc.). A very sophisticated analysis is needed to split the three (or however many) portfolios appropriately. But even the most sophisticated of us cannot accurately project cash needs 30 years out, or even 20 years out. And if you can't, the whole concept is founded on sand.

- If the retiree household is not affluent, the investment portfolio is not very large. Dividing it into pieces makes each piece even smaller, which in turn makes it difficult to diversify each portfolio appropriately and manage it cost-effectively.
- Since home equity is the largest asset most people own, this asset has to be included in the portfolio. But home equity usually cannot be tapped effectively until the later years of retirement, so the house has to go into the longest-term portfolio. This leaves little or (commonly) no space for equities. Ideally, of course, one would simply leave the house out of the equation, but families who can afford to do so aren't typical and don't require this kind of scheme anyway.
- Perhaps most seriously of all, this plan implicitly assumes that the only serious risk retirees face is investment risk. Essentially all of the assets are geared toward optimizing a response to that risk. But investment risk is only one – and far from the most important – risk that retirees face. We have already mentioned longevity risk and inflation risk, but there is also the risk of contracting an expensive disease, of needing long-term nursing care, of losing pension benefits, of having to take care of a parent or child, and so on. A scheme that optimizes one's handling of investment risk sub-optimizes one's handling of other risks. Setting aside 11% of your funds to cover yourself in your nineties, for example, means a big hit to your income and lifestyle in the meantime – yet odds are you won't live long enough to use those savings. There are better ways of doing this.

The multiple-portfolio concept is appealing for its simplicity, but that is the same reason it isn't very suitable for the average retiree. It doesn't take account of the enormous variety of surprises that can be thrown our way *outside* of the financial markets.

Where do we go from here?

It may be too much to ask for, but if we are going to give financial advice to retirees, we need to make sure we are giving them good advice. This is the right thing to do, even more so than for other clients, because, as we've seen, retirees are much more vulnerable. Our half-baked concepts can mean ruin and despair for real people.

Whether society and/or the courts will punish us for our incomplete (yet mysteriously self-serving) thought processes remains to be seen. But speaking of retirement risks, this may be a risk *you* shouldn't be taking!

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