

The Three Stages of Individual Investing are like a Journey into Space:

Retirement Orbits are Unique and Personal



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It is well understood that individuals travel through three distinct investment stages during their lifetimes: (1) Accumulation, or savings, (2) Transition, and (3) Retirement, or distribution. These three stages are analogous to space travel:

1. Solid Rocket Boosters (SRBs) lift the spacecraft 28 miles above the earth, fueled by liquid hydrogen and liquid oxygen. In the accumulation stage of life the investor fuels his future with savings and investment earnings on those savings. The goal (at 28 miles) is to accumulate a nest egg that will last a lifetime.
2. The SRBs are jettisoned and the main engines are throttled down to keep acceleration below 3g's so that the spacecraft does not break apart as it leaves earth's atmosphere. As retirement nears, the investor throttles down from aggression to conservation. The most critical years in the accumulation phase are those near the end because savings are the greatest at that point. Similarly, the most critical years in the distribution phase are the earliest years because a loss early on significantly shortens the expected length of time that can be supported by the remaining savings. 2008 was more devastating to those near retirement than it was to the very young or very old. It is during this critical transition phase that the investor decides between self-insurance (custom built portfolio) and purchased insurance (annuities). The transition phase covers the span from roughly 5 years before retirement to 5 years after retirement.
3. The Orbital Maneuvering System (OMS) positions the spacecraft for sustainable orbit around the earth. The investor implements his retirement plan, and expects that adjustments may be

necessary as life brings its usual surprises, but these changes are limited to adjustments in lifestyle and fine tuning of the investment approach. Each individual selects a unique plan, or orbit, based on individual circumstance. Collisions with space debris, i.e. unacceptable setbacks, are avoided in this way. Re-entering the workforce is a consideration for some, but not high on the adjustment list. Re-entry can cause burnout.

Some have argued for “set-it-and-forget-it” asset allocation patterns called “glidepaths” (yes, like a rocket) that serve throughout all 3 of life’s investment phases. **This “Lifetime Allocation” approach is a mistake** because the issues that face each investor are different between accumulation and distribution, and each investor has very unique circumstances, especially in retirement. No one glidepath can serve investors from cradle to grave; it’s simply not possible. Rather, the investor is best served by a glidepath that actually reaches the point of transition from stage 1 to stage 3 (that is, from the accumulation phase to the distribution phase) with all of the investor’s accumulated savings intact, plus reasonable growth in those savings.

Then, at entry into retirement, the investor can carefully plan how he or she will secure the remainder of their lifetime in dignity. It is **only** at this point of transition (exiting the workforce and entering into retirement) that enough information is available (amount of accumulated savings, health status of investor [and spouse and/or children], amount of debt, and a host of other in-flight variables) to properly construct the appropriate OMS. The design of the appropriate OMS for each individual cannot be known 30-40 years prior.

Some retirees will, and should, opt for a very conservative OMS. For example, those fortunate enough to have ample savings should not play games with those savings. Academics argue that these fortunate individuals should set aside lock boxes into the future to support their desired standard of living. Other less fortunate retirees will be confronted with the usual trade-offs between risk and return. This is a complicated and individual decision that may be served by some form of glidepath, but other considerations like annuities and guaranteed payout funds may serve the investor best.

There is no one answer that spans these complex stages that we all must pass through. Those who say otherwise are promoting product. A safe and reliable generic SRB will work for nearly everyone, but the OMS is mission-specific based on the differences inherent in each individual’s

travel through time. Retirement orbits are unique and personal. Participant behavior supports this belief since the majority of participants withdraw their accumulated stage 1 savings at retirement. Importantly, a failure to throttle down during transition can, and recently has, shattered many lives.

Mission Critical: Transitioning from Accumulation to Distribution

Here is proof of the criticality of the transition period. Our research shows that an individual saving \$2000 per year over the last 39 years (\$78,000) would have grown to \$800,000 today, but if we “Benjamin Button” the return series and run it in reverse, starting in 2008, this same participant enters retirement with \$1,200,000, which is 50% more. This difference is due to the timing of the 2008 loss; early matters much less than later. Note that if there were no cash flows, other than some initial account value, the ending account balances would be identical; that’s just a mathematical fact. Note also that the average annualized return during this 39-year period was 9.3%, which may or may look like the next 39 years.

Now let’s repeat this exercise for an individual in retirement. As you can see in the exhibit below, an individual who retired in 1970 with \$500,000 has seen his nominal account balances grow almost 10-fold over the past 39 years despite 2008’s loss. But if we run the return stream backwards, starting with 2008’s loss, this same individual went broke 8 years ago – that’s a huge \$5 Million difference!

In summary, we propose that the transition from the accumulation phase to the distribution phase is a particularly sensitive 10-year period: 5 years before transition to 5 years after transition. Accordingly, we believe that the current designs of most so-called target date funds do not properly account for this critical period. The year 2008 is all the evidence we need.

Conclusion

The DOL and SEC June 18 hearings on target date funds (TDFs) make one thing clear: the only entity clearly on the hook for TDF selection and monitoring is the plan sponsor. The problem though is that

there are no generally accepted standards to guide these decisions. Without standards we cannot differentiate between good and bad. Accordingly, plan sponsors need to adopt TDF standards, and in our opinion these standards should emphasize safety, especially during the critical transition period. Plan sponsors need to drive this rocket ship during the accumulation phase.

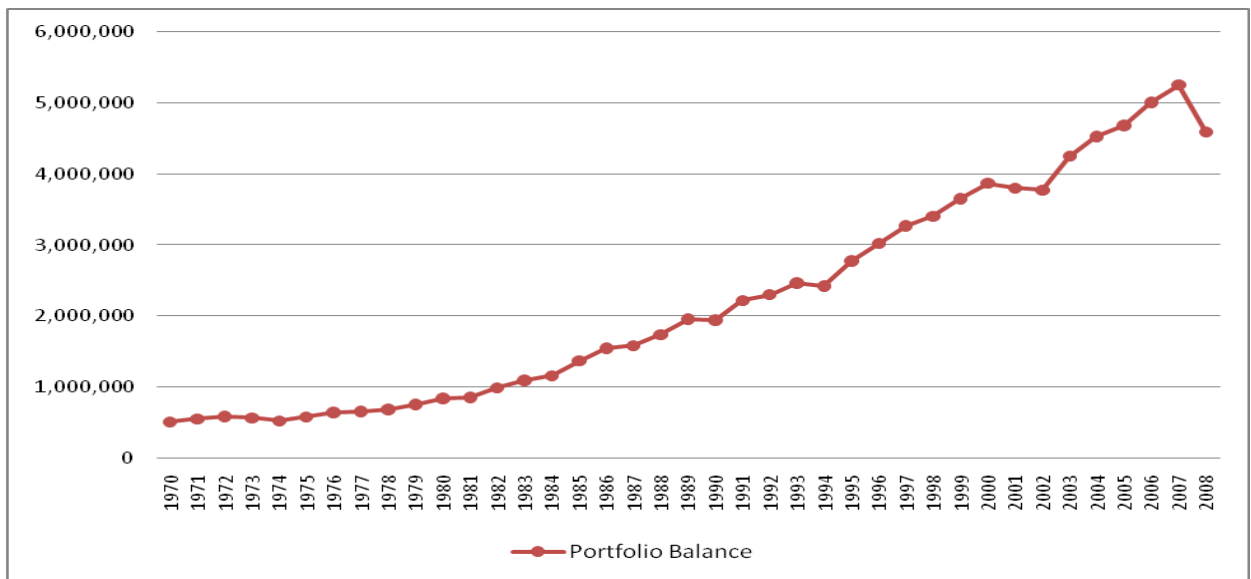
40/60 Distribution Portfolio

(12% Large US Stock, 8% Small US Stock, 8% Non-US Stock, 6% REIT, 6% Commodities, 50% Bonds, 10% Cash)

5% Initial Withdrawal Rate, 4% Annual COLA

Annual End-of-Year Account Balances

Normal Annual Returns (1970 - 2008)



Reversed Annual Returns (2008 - 1970)

