

# The Three Stages of Individual Investing Are like a Journey into Space

## Retirement Orbits Are Unique and Personal

By Ron Surz, CIMA®

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:

**Accumulation or savings.** Solid rocket boosters (SRBs) lift the spacecraft 28 miles above the Earth, fueled by ammonium perchlorate, which is powdered aluminum mixed with 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.

**Transition.** 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. The events of 2008 were more devastating to those near retirement than they were to the very young or very old. During this critical transition phase, the investor decides between self-insurance (custom-built portfolio) and purchased insurance (annuities). The transition phase covers the span from roughly five years before retirement to five years after retirement.

**Retirement or distribution.** 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 is not high on the list of adjustment alternatives. 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 three 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 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, investors can plan carefully how they will secure the remainder of their lifetimes with 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 until this time arrives.

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 standards 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 such as annuities and guaranteed-payout funds may serve these investors best.

No one answer 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 because the majority of participants withdraw their accumulated stage 1 savings at retirement. Importantly, a failure to throttle down during transition can, and has (e.g., in 2008), shattered many lives.

### Mission Critical: Transitioning from Accumulation to Distribution

There is a "risk zone" in saving for retirement. It's the period five to 10



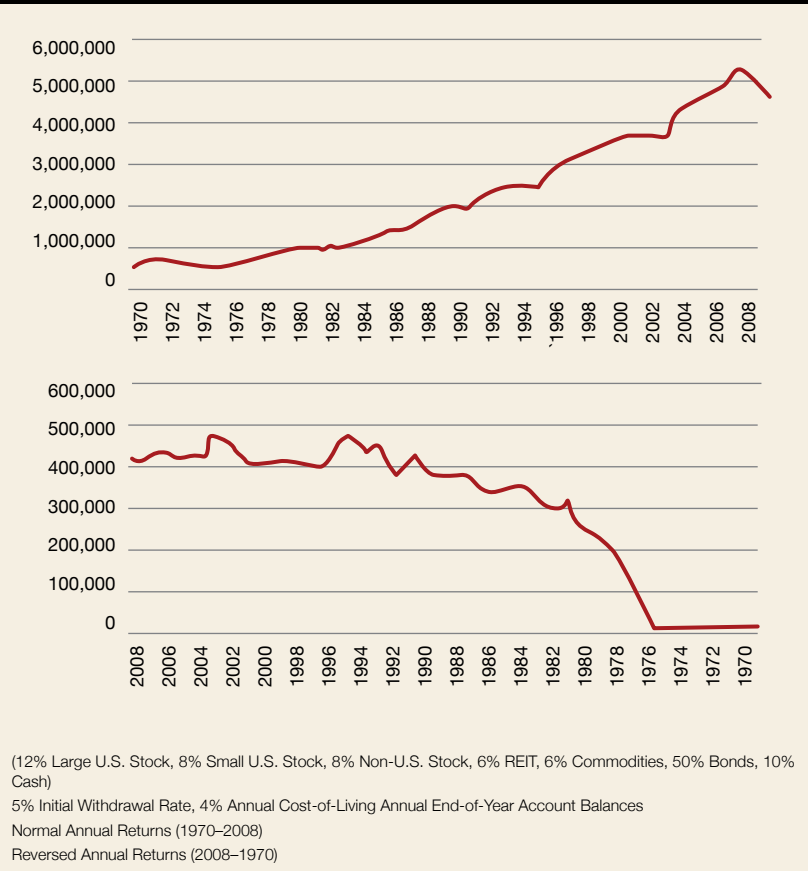
years leading up to retirement and the five to 10 years immediately following retirement. Those are the years your account is most susceptible to lifestyle risk. This is the period when savings generally are at their highest level and your only available response to loss is a reduced standard of living because going back to work generally is not an option. This is why, when the Securities and Exchange Commission (SEC) and the Department of Labor (DOL) held joint hearings on target date funds (TDFs) in 2009, the focus was on 2010 funds: The market meltdown showed the dire impact of large equity allocations.

Target-date funds have a wide range of equity exposures in the risk zone, from a low of 20 percent to a high of 70 percent. They differ about the appropriate level of risk. Prior to this dangerous period or risk zone, most TDFs are allocated in a narrow range, roughly 70 percent to 90 percent in equities. When viewed over the continuum of their lives, TDFs look deceptively similar; their hidden risk is visible only when one examines the risk-zone allocations.

The risk zone is also critical from the plan sponsor's perspective. Older, more-senior employees are more likely to sue, or at least make their voices heard, than are younger employees with smaller account balances. Employers should fear the risk zone for both its litigation threat and its importance to employee morale. Enlightened fiduciaries should focus on the risk zone in their TDF selection. Fiduciaries eventually will develop objectives for the risk zone, and it is likely to be safety first. Then the TDF industry will provide a consistently safer product. Until then, advisors can best help their clients by focusing on the level of equity allocation during the risk zone.

Here is proof of the criticality of the risk zone. Our research shows that an individual saving \$2,000 per year over the 39 years 1970–2008 (\$78,000) would have grown that savings to \$800,000.

**FIGURE 1: 40/60 DISTRIBUTION PORTFOLIO—\$500,000 INITIAL BALANCE**



But if we “Benjamin Button” the return series and run it in reverse, starting in 2008, this same participant enters retirement with \$1.2 million, which is 50 percent more. This difference is because of 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 percent, which may or may not look like the next 39 years.

Now let’s repeat this exercise for an individual in retirement. As shown in figure 1, an individual who retired in 1970 with \$500,000 saw his nominal account balances grow almost 10-fold over the ensuing 39 years despite 2008’s loss (figure 1, top). But if we run the

return stream backwards, starting with 2008’s loss, this same individual went broke in 30 years—that’s a huge \$5-million difference (figure 1, bottom).

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

### Conclusion

The DOL and SEC June 18, 2009, hearings on 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

*Continued on page 56*






---

## Surz

Continued from page 49

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. 

*Ron Surz, CIMA®, is president of PPCA Inc. and its division, Target Date Solutions. He earned an MBA in finance from the University of Chicago and an MS in applied mathematics from the University of Illinois. Contact him at [ron@ppca-inc.com](mailto:ron@ppca-inc.com).*