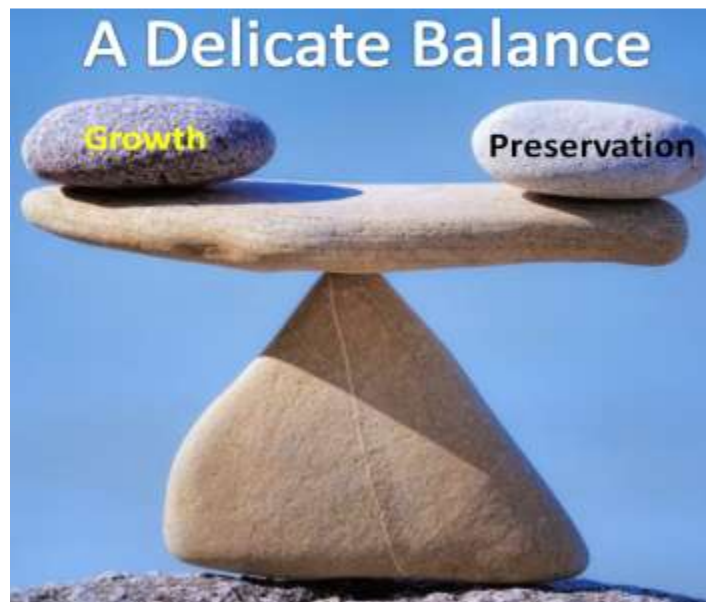
The Delicate Balance Between
Growing Wealth and Not Losing It

- We all strive to save enough, and to protect it. Risking “enough” is a bad gamble.
- Knowing when to take investment risk and when to play it safe is a matter of defining “Enough.” This is “risk management” as opposed to market timing.
- When our working life comes to an end, “Enough” is whatever we have saved. At that point, “Enough” is all we have to live on.
- There are lessons in a solid target date fund design that can be used to achieve this delicate balance.



“Save and Protect” is the correct mantra for retiring with dignity. We all work hard and save what we can. Throughout our lives we have a trade-off between growing our savings and protecting them. One thing is certain: losing a lifetime of savings when we enter retirement is devastating because there’s no coming back. That’s why thoughtful retirement professionals warn about “Sequence of Return Risk” and the “Risk Zone.” Taking risk in the Risk Zone is a bad gamble.

Lessons from a target date fund design

Target date fund (TDF) glide paths attempt to balance the need to grow wealth with the need to protect it. A solid design opts to emphasize protection over growth in the Risk Zone, although there is only one TDF that currently does so. It's a better fiduciary choice because it's better for beneficiaries. Fiduciaries have a higher duty to defaulted beneficiaries because fiduciaries make an investment choice on their behalf.

The best TDF design views the liability of the TDF as the beneficiary's account balance at any point in time, and uses asset-liability management (ALM) to protect that account balance. The disciplines of ALM start the move to safety gradually and increase the move as the protection date (target date) nears.

As described in "*Why Target Date Fund Glide Paths Should Land Safely, But Don't*," the two key decisions that a target date fund glide path designer must make are (1) when to start applying the brakes, and (2) how forcefully. In brief, a well designed glide path looks something like the following, where the move to defend starts 15 years from the target date and importantly it ends in very safe investments like Treasury bills and intermediate term TIPS.

Unfortunately, only one TDF currently follows this enlightened glide path, but that will change as TDFs evolve. TDFs are still in their infancy, having effectively been born just 10 years ago.

Applying TDF glide path design

We can benefit from the disciplines in this TDF glide path. Here are some checklists to use in three phases of our life.

- *Working life.*
  - ✓ Save as much as you can without sacrificing basic needs.
  - ✓ Have an objective for what you'll need to retire with dignity. A simple rule of thumb is that you'll need 22 times your anticipated annual spending. For example, if you want to spend $50,000 per year in retirement you'll need to save $1.1 million (22 X $50,000).
  - ✓ Monitor progress toward achieving your savings goal by conducting adequacy testing. The Department of Labor provides a free calculator that helps.
- *At 15 years before your retirement date, and continuing to five years past retirement*
  - ✓ Protect your savings by moving along the glide path shown above into safe assets over time
  - ✓ **If you're in a target date fund, get out**, because they are not safe for those nearing retirement. The 2010 funds lost 30% in 2008 and have become riskier since then.
  - ✓ If you have assets outside your 401(k) plan, move to protect those too.
  - ✓ Adjust spending plans up or down as retirement nears and your actual savings become known. Redefine "Enough."
- *In retirement*
  - ✓ Use a spending budget that will last a lifetime. The 4% Spending Rule is popular but there are other disciplines like the process described by Siegel and Waring.
  - ✓ Re-risk your savings, moving gradually from very little in equities to about 50% over 30 years. This approach is described in Kitces and Pfau and Fullmer.

Conclusion

We work hard for 40 to 50 years and save what we can for a retirement that lasts another 30 to 40 years. Retirement is the end game. The big problem is that the savings of those in the Risk Zone are not protected. These savings are precious. Losses incurred in the Risk Zone force serious reductions in lifestyle.

Other than the TDF described above, target date funds are 55% in equities at the target date with the balance in (risky) long term bonds. This is riskier than the mix that lost 30% in 2008. Similarly, the average IRA is 55% in equities for all ages – no effort is made to protect those near retirement.

75 million Baby Boomers are in the Risk Zone and are exposed to way too much risk. They need to take control now and shift the balance to safety before it is too late. The World Economic Forum has identified 30 threats to our stock markets. There will be another market crash sometime during the next 30 years as Boomers pass through the Risk Zone.