When is the Best Time to Suffer a Negative Investment Return?

Of course there's never a good time to lose money, but if you could choose just one time to suffer a negative investment return when would that be? I think most of us would choose a time when we had the least amount of money, which would likely be when we were young. Losing $30 of a $100 portfolio is no fun, but that pain should go away quickly.

Or asking the question a little differently, when would you least like to suffer a negative investment return? Again, the answer for most of us would be when we have the most money, which is likely to be at the end of our working lives, as we move into retirement. Losing some of our life savings at a time when we have little prospect of getting them back is a big kick in the head.

As basic and obvious as these choices seem, there is disagreement about something very closely related, namely sequence of return risk. Some, including reasonably smart and respected individuals, just don't get it, despite the fact that examples like the following abound on the internet; just Google "Sequence of Return Risk."

It won't happen to me

So what is there to not understand? While most acknowledge that bad luck like that shown in the example above can and has happened, they view it as unlikely because stock and bond markets usually go up, as they have in the past 9 years.

More to the point, critics contend that protecting against sequence of return risk is a waste of money. The best way to defend is to be very conservatively invested during the "Risk Zone" that spans the 5 years before and after retirement. This is not the common practice. Target Date Funds (TDFs) and Individual Retirement Accounts (IRAs) do not defend in the Risk Zone. The view in practice is that there is no risk, but common practice in the good old days regarding smoking demonstrates how wrong common practice can be.

The choice to defend is a classic insurance issue. Buying flood insurance for the house on the mountain is a waste of money, but buying it for beach homes may be a good idea. Such is the case with protecting against sequence of return risk. We each need to assess the risks and the costs. The costs of defending are lost opportunities if markets go up while we're defending. No one knows if this 9-year market will continue to run up, but we do know with virtual certainty that someday target date funds and IRAs will be devastated with losses because someday markets will decline and these savings accounts do not protect those near retirement.

I'll try to help you make the insurance decision in the following. Since I can't tell you what opportunity costs lie ahead, I'll describe the risks in the Risk Zone when it comes to retirement savings. There's the financial risk in ignoring the basic principle of "Save and Protect" and the emotional risk of re-planning the rest of your life. You can decide if the insurance (playing it safe in the Risk Zone) is worth the cost.

Save and Protect

The keys to a successful retirement are to (1) save enough, and (2) keep it. These facts are largely ignored when it comes to target date funds (TDFs), the most popular choice of qualified default investment alternative (QDIA). Specifically, target date funds are designed to make up for inadequate savings by earning substantial investment returns through high equity exposure, even at the retirement date. The typical target date fund

is invested 50% in equities at the target date. This is the allocation that lost 30% in 2008. This practice simply does not stand up to scrutiny in light of known truths, as described in the following. Similarly, the typical IRA is 55% in equities for those between the ages 55 and 75.

In this Working Paper (*Pension Research Council Working Paper*, The Wharton School, University of Pennsylvania, August, 2012), authors Alicia H. Munnell, Natalia Orlova, and Anthony Webb, using real-world data, prove that savings are far more important than asset allocation. To summarize, all cash is a fine investment strategy if you save enough.

This is of course common sense but you'd think otherwise when you read the sales literature for target date funds (TDFs). The stated objectives of TDFs are to replace pay and manage longevity risk, but that's just the hype that lets fund providers sell product rather than solution. Please note that you will not find these objectives in prospectuses or factsheets – they're just in sales materials.

Capital preservation for those near retirement should be the number one objective of TDFs and IRAs. The presumption should be that participants have saved enough to support a lifestyle that is acceptable to them. Some may plan for a life in a modest shack while others see a yacht in their future. It's all the same. A plan is a plan.

Prior to the Pension Protection Act of 2006, the most common investment default was very safe cash and stable value, which was probably too safe for younger employees but just right for those nearing retirement. But now the risk pendulum has swung too far for those nearing retirement. 2008 is all the proof we need.

The human face of retirement savings

In the Fall, 2013 issue of the ***Journal of Retirement*** Robert Arnott *et al* question the wisdom of target date fund glidepaths that reduce equity exposure through time, arguing that a reverse approach with increasing equities delivers greater ending wealth, even at the lower tail of the wealth distribution (see [Arnott, 2013]). Arnott shocks us with an apparent recommendation for a glidepath with increasing risk through time.

After all, who would advise their 70-year-old client to hold 80% in stocks and 20% in bonds?

<u>The fact of the matter is that glidepaths really don't matter much</u>, regardless of their pattern up or down. Saving enough is what matters most; it's the most important step on the path to a comfortable retirement. No glidepath can compensate for inadequate savings. And the second most important step on the path to a comfortable retirement is protection – don't lose your savings. Protection is most critical as retirement nears because savings are at their highest and lifestyles are at stake.

Here's the economic, behavioral and emotional reality of glidepaths. We each have only one life path, not the thousands that a computer can simulate. And we each prepare differently for retirement. As noted above, the most important aspect of our preparedness is savings. Some of us will save "enough" and some of us won't. Those who haven't saved enough will redefine "enough" – they'll reduce their standard of living. Regardless of our savings history, we all develop a plan as retirement approaches. Some of us see yachts in retirement while others see trailer parks. Either way, a plan is a plan. Disruptions to our planned lifestyle take a huge toll, and can lead to deep depression and physical calamities, like drug and alcohol abuse.

That's the human side of glidepaths – safety at retirement makes a big difference. Despite the subsequent recovery, 2008 was devastating to those in and near retirement at that time; the typical 2010 fund lost 30% in 2008. Reports show that most TDF participants withdraw their savings at retirement so they did not enjoy the recovery unless they rolled over their savings into stocks, an unlikely choice in light of the 2008 debacle. Bear in mind that there was only a couple hundred $Billion in TDFs in 2008, whereas today the number is $1.5 Trillion. The next 2008 will be substantially more devastating for TDF participants.

Retirees cannot recover from investment losses the way they could while working. Their only course of action is to lower their standard of living, which takes an emotional and physical toll, as well as burdens our society which thankfully cares for its elderly.

Buying insurance

So how safe is safe? The common practice is to increase bond exposure as the target date nears, but long term bonds are not safe in this economic environment. The right "Safe" is short term Treasure bills and Treasury Inflation-Protected Securities (TIPS). Note that this safety need not apply to retirement years. Rather it's critical to the transition from working life to retirement. Choices in retirement can and should be unique and individualized. For example Pfau and Kitces argue for a U-shaped lifetime glidepath, decreasing in risk through our working life and then increasing in retirement.

I'm writing this from the perspective of a semi-retired pension consulting veteran. I am personally one of the many human faces of glidepaths who suffered the consequences of 2008, so I take this topic very seriously.