SHOULD YOU REDUCE RISK EXPOSURE AS YOU GET OLDER?

A study suggests the "conventional wisdom" may be flawed.

Presented by Lavon H Welch, CFP®

If you move away from equities with age, are you making a mistake? For some time, financial professionals have encouraged investors to lessen their exposure to the stock market as they get older. After all, a 60-year-old has less time to recover from a market downturn than someone decades away from collecting Social Security checks.

Is that conventional thinking flawed? It might be. It isn't simply a matter of looking at the future; you may also want to look at the past.

What's the price of playing not to lose? It could be significant – at least in terms of opportunity cost. At this moment, how many people really want to shift money into fixed-rate investments?

Obviously, bonds, CDs and money market accounts will always hold some appeal as they tout protection of principal. Aside from that sense of safety, how does a 1% or 2% return sound? As we enter Q4 2012, the highest-paying 5-year CDs yield less than 2%.[1]

Who would want to be locked into these yields for five whole years when the Federal Reserve is going in for open-ended easing? With QE3, the Fed just opened a door to inflation – and it may have to leave it open for some time.

On October 1, Chicago Fed President Charles Evans told CNBC that the central bank will keep buying mortgages until unemployment falls below 7%. That might take a while: while the jobless rate fell to 7.8% in September, it was 8% or higher for the previous 42 months.[2,3]

With the Fed and the European Central Bank flooding the global economy with cheap money, the tame inflation of the past few years may give way to something greater. Fixed-rate investments are great tools for diversifying a portfolio, but retirees and pre-retirees with significant assets in investments yielding 1-2% will start wincing if inflation gets back to 4-5%.

As interest rates are so low now, some conservative investors are thinking about adding riskier bonds to their portfolios. The central problem with that is that corporate bonds don't act like Treasuries. Lower-quality bonds can have stock-like risks, and those risks become more evident when the stock market is slumping. Stocks are also more tax-efficient – bond interest is typically taxed as ordinary income whereas stock returns are taxed as capital gains.[4]

Is the "glide path" strategy overrated? You may or may not have heard of this term; it refers to a gradual adjustment in asset allocation across an investor's time horizon. With time, the asset allocation mix within the portfolio includes more fixed-income assets and fewer equities, becoming more conservative. (This is the whole idea behind target date funds.)

A recent article in *Investment News* questions the glide path approach. Research Affiliates chairman (and former global equity strategist) Rob Arnott looked at a whopping 140 years of bond and stock market returns (1871-2011) and ran model scenarios using three different asset allocation approaches across 41 years of hypothetical retirement saving and investing. The findings?

**"Prudent Polly" saves $1,000 annually and practices "classic glide path investing", gradually devoting more and more of her portfolio assets to bonds after age 40. This way, she winds up with an average portfolio of $124,460 at age 63 (with a $37,670 standard deviation across assorted 40-year windows).
** "Balanced Burt" also saves $1,000 annually, but he invests it in an unchanging 50/50 mix of equities and bonds across 41 years. He ends up with an average portfolio of $137,870 at age 63. In terms of deviation, his worst-case scenario, 10th percentile outcome and median outcome are all better than Polly's.
**"Contrary Connie" saves $1,000 annually while practicing the inverse of the classic glide path strategy – her portfolio tilts more and more toward stocks after age 40. She ends up with an average portfolio of $152,060 at age 63 and her worst-case, median and best-case scenarios all give her more retirement funds than Polly's.[5]

A recent CBS MoneyWatch article noted the risk-adjusted returns (i.e., annualized Sharpe ratios) of the equity premium (0.43), investment grade credit premium (0.07) and high-yield credit premium (0.21) from August 1998-June 2012. Stocks look good next to all that. (For that matter, who have predicted that the 10-year Treasury would someday have a negative real yield?)[4]

As many people haven't saved enough for retirement to begin with, they more or less have to stay in stocks or other forms of equity investment. Instead of shifting their focus from wealth accumulation to wealth preservation, they need to focus on both. Accepting more risk may be necessary as they seek suitable returns.

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Citations.

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