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The Appropriate Asset Allocation Strategy for Retirement (Part 1) - Revisited

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We have clients who are approaching retirement. Naturally, they want to know whether they should adjust their portfolios' risk level in anticipation of and during their retirement years. There is no one-size-fits-all answer, but if adjustments are warranted we make them by shifting the overall asset allocation towards fixed-income and away from equities.

However, automatically **following the widespread, common narrative that you should reduce your exposure to equities in favor of fixed-income securities as retirement approaches and during retirement is in fact downright dangerous to your financial health.** Part I of this article below explains why conventional wisdom on asset allocation during retirement is mostly misguided, why stock price volatility is not risk, how to mitigate the real risk of stock investing, and why maintaining a healthy weighting in stocks will likely benefit you. In Part II to be published in the Summer 2017 issue of PDV *Observations*, we will describe what an appropriate asset allocation strategy for retirement looks like, and why you should increase your allocation to stocks during retirement, once the so-called return "sequencing risk" has been addressed.

What is the appropriate asset allocation strategy to avoid outliving your money during retirement? We advocate starting your retirement with a conservative allocation to stocks but increasing your stock allocation during retirement. While this strategy may seem counter-intuitive and is likely to make you very uncomfortable, we think it goes a long way to mitigating the risk that you will outlive your money.

Let us start off by noting that there is a small group of people who don't need to follow this strategy, provided they are willing to accept the opportunity cost. You are among this select group if your annual withdrawal needs are minor relative to your retirement assets, either because most of your living expenses are covered by other sources of income outside your retirement assets such as pension or social security payments, or because you have accumulated very substantial retirement assets. For the vast majority of retirees however, retirement asset growth via meaningful stock ownership is necessary to offset a

Inside This Issue:

- The Appropriate Asset Allocation Strategy for Retirement (Part 1) - Revisited p.1

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lengthy period of withdrawals.

Conventional wisdom is wrong

Conventional wisdom says that you should reduce risk by allocating increasing amounts to conservative assets (like bonds) as you approach and during retirement. This is based on the commonly held perception that stocks are risky because they fluctuate, sometimes violently and often randomly, creating uncertainty and engendering fear. But unless you have an ultra-short investment time horizon, price fluctuation (volatility) is not risk (explained below).

Provided you expect to tap your retirement assets gradually over many years, following conventional wisdom during retirement potentially hurts you. Your primary risk during an extended retirement is outliving your money because you do not own enough stocks. Yes, you read that correctly. If you retire at 65 and are healthy, actuarial tables show that you are likely to live at least another 20 years. That is a long investment time horizon by any measure. You run a substantial risk of outliving your money during a long retirement if your assets do not grow enough to fund your withdrawals. To state the obvious, withdrawals erode your capital so you need adequate capital growth to offset this depletion. Conservative assets will provide meager growth; you need more asset growth via stocks to counter asset erosion from withdrawals. Ironically, by trying to avoid or mitigate the illusory harm that comes from stocks' temporary fluctuations, you assume the much greater risk of not having your assets grow enough over a long retirement to fund all your lifetime expenses.

You need stocks for growth

The long-term opportunity cost of owning bonds rather than stocks is roughly 5% per year compounded (and even higher for short-term bonds), too much to pay for avoiding temporary stock price fluctuations and calming your psyche! Stocks have provided growth and done well for the vast majority of market history. For example, from 1980-2016 the stock market generated positive returns in 28 out of 37 calendar years (over 75%).[1] Not only has the number of bull markets far exceeded bear markets, bull markets on average lasted a lot longer as well. Since 1926, bull markets have averaged 108 months and bear markets only 16 months. A bear market is defined as the index closing at least 20% down from its previous high close. Its duration is the period from the previous high to the lowest close reached after it has fallen 20% or more. Bull market is measured from the lowest close reached after the market has fallen 20% or more to the next high.[2]

Stock price volatility is not risk

The concept of volatility as risk comes from academic finance, which favors a quantitative definition. Using statistics, academic finance measures the risk of a stock as its price volatility relative to a market benchmark (a.k.a. beta) or its return variability relative to an expected/mean return (a.k.a. standard deviation/sigma). A riskier stock has a higher beta or sigma than a more conservative stock under this definition. This quantitative concept of risk appeals to our natural behavioral tendencies to dislike high volatility or outcome variability when it comes to our money.

Since volatility measures variability in both positive and negative directions, defining stock

risk as volatility suffers serious flaws. First, nobody complains about positive variability, when the actual return is higher than the expected return. You would welcome an actual return of 15% if the expected (mean) return is 10%. In the real world, people are only concerned about negative variability or returns that are lower than expected.

Second, volatility is not constant over time; it declines as the investment time horizon or asset holding period lengthens. Stock market returns over any single calendar year can and do deviate substantially from the long-term average market return. If you are a day trader, price volatility certainly is risk because the markets are so irrational and random over the short run that anything can happen over a single day. If the stock drops for whatever reason and you have to sell by the end of the trading day, you will be forced to convert a temporary price drop into an actual, permanent monetary loss.

If you are a typical retiree who needs to withdraw money from your retirement assets gradually rather than all at once, your investment time horizon is likely to be 20+ years provided you are generally in good health. Average annualized market returns over rolling multi-year periods are much more tightly bunched around the robust long-term average market return. In academic finance and statistics parlance, the standard deviation of potential annualized returns from the mean decreases as your investment time horizon lengthens. Over a typical retirement period of 20+ years compared to shorter time periods, the range of possible annualized returns from stocks is narrower and offers more certainty that you will enjoy healthy capital growth over the long run.

WisdomTree Asset Management (as cited in Epstein, 2015) has conducted research showing that between 1871 and 2014 the stock market produced negative returns in ***only 4 out of 134 ten-year rolling periods***, while every fifteen-year rolling period produced positive returns.[3] This means between 1871 and 2014 the stock market has never lost money over any fifteen-year period and has *very rarely* lost money over any ten-year period. In fact, between these dates the median average annualized returns over ten and fifteen-year rolling periods were 8.6% and 8.4%, respectively. So, if your investment time horizon exceeds 10 to 15 years (which is true for a typical healthy retiree), your stocks are highly likely to experience good growth during your retirement years, despite unsettling and inevitable interim price fluctuations along the way.

Permanent capital loss is the real risk

What people actually fear most is permanent capital loss, not price volatility which by definition is temporary. You can ride out volatility, but not permanent loss. But when stocks are dropping in the short run as part of market vagaries and normal ebb and flow, it is difficult to distinguish between permanent capital loss (e.g. Lehman common stock getting wiped out in bankruptcy) and temporary fluctuation (e.g. Google drops along with general market weakness before rebounding).

Only three factors can turn temporary price drops into permanent capital loss: 1) you buy poor investments that suffer permanent loss because of lasting and irreparable ***fundamental business*** decline (e.g. Lehman common stock); 2) you panic and sell into the market decline (a.k.a. voluntary sale); or 3) you are forced to sell to pay expenses (a.k.a. involuntary sale). Let's address each of these factors in turn.

Diversify and do your due diligence. You can mitigate the risk of picking poor investments by diversifying and doing proper due diligence and fundamental analysis. Remember, all good and bad investments will fluctuate in price; so a price decline per se does not prove that an investment was a poor choice. Poor investments are those that do not recover over time because of permanent, value erosion from deteriorating fundamentals. Solid investments will rebound.

Remain unemotional. You need to develop a coping system and emotional fortitude to resist fearful/emotional selling. Remind yourself that fluctuations are a natural and inevitable part of stock movements. Going into stock investing expecting turbulence and bumps psychologically helps you remain calm during inevitable and recurring volatility. And having a sense of stock market history and recurring patterns will also serve you well. To benefit from the long term growth of stocks, you have to "pay the price of discomfort" that comes from periodic but temporary price declines. You cannot have one without the other, even if Wall Street spends millions of dollars a year telling you otherwise and trying to sell you market timing and hedging techniques or products to minimize downside volatility.

Avoid selling depressed stocks to pay living expenses. It is important to avoid selling stocks when they are depressed to pay living expenses. A typical retiree with at least 20 years of life expectancy can wait out weak stock markets and benefit from their recovery and long term growth. Good financial planning will mitigate the risk of being forced to sell stocks at poor prices to pay living expenses. An appropriate retirement allocation strategy should: a) set aside a cushion of more stable investments like cash and short-term bonds (note that long-term bonds can be very volatile) for you to access/sell to produce cash, when stocks are depressed, and b) allow volatile stocks time to rebound and produce long-term growth for your assets. It is, of course, acceptable to sell stocks at favorable prices to fund living expenses (remember stock market uptrends last far longer than downtrends).

In Part 1 of this article, we have presented how a diversified, carefully researched portfolio of stocks is likely to generate solid growth over time, despite bumps and price fluctuations along the way. **This inevitable volatility cannot harm you provided you avoid panicking and you do not sell stocks when they are depressed to pay living expenses**. Over time, stocks will help your retirement assets grow to counter the eroding effects of withdrawals.

We will present in Part 2 what an appropriate asset allocation strategy for retirement looks like, and why you should increase your allocation to stocks during retirement, once the so-called return "sequencing risk" has been addressed. We will explain how the asset allocation should look during the initial phase of retirement and the factors that dictate the timing and magnitude of an increasing allocation to stocks as retirement proceeds.

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1. JP Morgan Asset Management (2017), *Guide to the Markets 1Q 2017*, https://am.jpmorgan.com/blob-gim/1383280028969/83456/jp-littlebook.pdf
2. Morningstar, *Morningstar Magazine*, June/July 2014, 31.
3. Gene Epstein, "Why the Stock Market Will Keep Climbing," *Barron's*, Jan. 10, 2015, http://online.barrons.com/articles/the-bulls-long-run-is-not-over-yet-1420866621.

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