



Toward an Understanding of Risk – Part 2

By Robert Huebscher

February 22, 2011

How should clients think about risk in their portfolios? *Advisor Perspectives* put that question to a cross-section of prominent advisors and academics. Their answers encompassed diverse opinions and underscored how crucial that question is to the investment process.

In [part one](#) of this series, which appeared last week, we heard from seven practitioners in the financial planning community. This week, we hear from seven well-known academics, including two Nobel Prize winners.

We asked each person the following questions:

1. How should a 25-year-old, who is beginning to save for retirement, think about and measure the risk in his or her portfolio?
2. How should a 65-year-old, who is beginning the withdrawal phase of their retirement, and the adequacy of whose portfolio is precarious, think about risk in his or her portfolio?

We were not asking how that person should invest, but rather how they should think about risk.

Here are their responses, in alphabetical order.

Brad Barber is the Maurice J. and Marcia G. Gallagher Professor of Finance at the University of California at Davis' Graduate School of Management. His research focuses on investor psychology.

There is risk that you can get rid of, and there is risk that you can't. First and foremost, you want to be saving for retirement in a well diversified portfolio. The risk that you don't want to take is putting all of your hard-earned money into a single stock, for example. That sounds silly to many people, yet plenty do it, because they put a lot of their money into employee-owned stock plans.

Look at Enron, for example. About half of the average Enron employee's retirement portfolio was in Enron stock. Investing a large proportion of your retirement portfolio in a single stock is among the biggest mistakes that an investor can make.

For somebody who is young, the crucial thing is to save. That is really hard to do, because we are very bad as human beings at thinking about what the future holds



for us and what saving now will afford our future selves. There are very interesting experiments where, if you give people a picture of themselves aged into the future, it can actually affect the choices they make about how much they choose to save.

Encouraging people to think about the tradeoff between current and future needs can motivate them to increase savings early on. Regular saving and making a sensible choice in their investment portfolios – for example choosing a low-cost, well diversified investment portfolio – are the two issues I would encourage young investors to address.

How should a 65-year-old, who is beginning the withdrawal phase of their retirement, and the adequacy of whose portfolio is precarious, think about risk in their portfolio?

One of the mysteries in financial economics is that we don't see a lot of annuitization of retirement savings. For someone who is approaching retirement having saved enough to buy an annuity that makes them comfortable, I see a lot of arguments in favor of doing so. There is no reason for that person to bear the mortality risk of outliving their savings (perhaps a good problem to have, given the alternative). Buying an annuity is a sensible way of avoiding that risk altogether.

Inflation-indexed annuities are preferable, and if you feel comfortable taking on market risk, you can buy a variable annuity, which is cheaper than a fixed-rate annuity.

There are lots of products, which, frankly, may lead to the kind of paralysis that often sets in when we are faced with a complicated decision and many choices. Too many choices lead folks to opt for the status quo or, in this case, not buy an annuity and instead just withdraw from an investment portfolio.

Zvi Bodie is the Norman and Adele Barron Professor of Management at Boston University. His field of research is pension finance and investment strategy. Also contributing to this response was Rachelle Taquu, an investment advisor with whom he is writing a book.

The 25-year-old and the 65-year-old stand at opposite ends of their careers. That's the striking difference, and that's what should most shape their different approaches to risk.

At the start of a career, your career path itself and your future income associated with it are your biggest risk exposure. Think about managing this risk through your career choices and education, as well as insurance to protect you against unexpected income interruption (disability, health, even life insurance). With respect to investing, be sure to take your expected lifetime income path into account by



diversifying away from your own company, industry, etc.

Toward the end of a career, exposure to career-related losses declines significantly. Not to zero, however, because most people will continue to work at least part-time for as long as they can past age 65. At this age, what you need to ensure is a minimum income flow to satisfy your essential needs. Your exposure to inflation in retirement is greater because you have little or no inflation-adjusted income to help cushion inflation's blow. And market losses are especially damaging when you are in the withdrawal phase of your life.

But age is not the only factor to consider when thinking about risk, and other factors can change the picture significantly. For example, if you are very wealthy, you will think differently about risk than if you are struggling to make ends meet.

William Goetzmann is the Edwin J. Beinecke Professor of Finance and Management Studies at Yale University. His research focuses on global investing across a range of asset classes.

The process of investing has to be considered as either a long-term process or a shorter-term process. If somebody in their 20s is planning to develop a nest egg, which then they will use to buy a house in three or four years, that is a completely different proposition than saying you are going to be putting money aside now for your retirement.

The money you would put aside for retirement 40 or 50 years from now is money you could afford to risk in the stock market – to take the ebb and flow and crashes and booms as they come – and then reap the benefits at the very end. But if you've got to save for a house, you can't afford to take the risk of putting all your money in the stock market. We have seen recent years in which the stock market has plunged, and stock portfolios shrunk dramatically.

The 65-year-old doesn't have a long horizon to make up any substantial loss, but then again somebody that age is not going to be living for another half-century. You can't afford to think, "Well, I'll just retire and cash in my chips." You've got to have a plan that is going to sustain your lifestyle throughout the course of your life.

For somebody in that age group, probably the greatest risk is inflation, because inflation steals the value of fixed assets. If you put all your money into bonds when you retire because you think they are safe, but then the governments of the world decide that inflation is the only way out of their current predicament, that will come right out of your savings. The value of those dollars that you are going to be getting in the future will be much less. It is important to find some way of hedging yourself to protect against inflation.



Some people can afford to keep a portion of their savings in liquid assets to fund their immediate needs. A great approach is to assess your liabilities and living expenses and then see if you can match cash flows against them with some sort of fixed income portfolio. If you take that approach, be mindful of the fact that your expenses could go up with inflation, and so your fixed income portfolio had better go up with inflation. Then you can take the rest of it and use it as a source of growth and try to capture the overall growth of the economy. You don't want to be left behind in terms of the quality of life.

Burton Malkiel is a professor of economics at Princeton University and a leading proponent of the efficient market hypothesis.

The most important thing a 25-year-old can do is to begin a savings program. An amount should be set aside regularly, as through a 401(k) program with the individual's employer. A 25-year-old should select a relatively risky equity portfolio in the hopes that, over time, even regular small investments can grow into a substantial nest egg. The 25-year-old should ignore the ups and downs of the market by making regular investments over time. The individual will, unfortunately, sometimes buy at market tops but at other times will get the advantage of buying at market lows. My advice is "Ignore the ups and downs of the market and never stop your program because everyone around you is convinced that the sky is falling and the risk is too great."

The 65-year-old expecting to draw out assets should have a less-risky asset allocation with fewer equities and more stable, dividend- or interest-paying investments, unless he or she is investing for children and grandchildren. In the latter case, it is the horizon of the ultimate beneficiary that should govern. The 65-year-old should also consider annuitizing some portion of whatever nest egg he or she has built up. Annuitization will guarantee that at least some income will come in as long as the individual is alive.

The problem with annuities, however, is that they often tend to be very expensive. As a rule of thumb, any annuity that is sold to you by an insurance salesman is likely to be very high-priced. Be a smart shopper. Use the internet to find the best deal and buy directly, rather than through a salesman. Also, ensure that you get the type of annuity that has at least some inflation protection.

Harry Markowitz is a professor of finance at the Rady School of Management at the University of California, San Diego. He is best known for his pioneering work in modern portfolio theory, for which he was awarded the Nobel Prize in economics in 1990.

The two questions you raise are not easy to answer. I would suggest to both the 25-year-old and the 65-year-old that if they have access to reasonably priced finan-



cial advice – such as a 401(k) advisory service available through many employers – they take advantage of it. If they do not have such access, I suggest that they get a copy of Ibbotson's SBBI (Stocks, Bonds, Bills and Inflation) and find the table (Table 2-1 in the issue on my desk) that shows a histogram of annual returns for various asset classes, plus the summary statistics of such asset classes. With this in mind, they should choose a portfolio of stocks and bonds with which they can comfortably stick over their entire investment horizon. Presumably the younger person will weight stocks more heavily than the older person.

The older person should also think of annuitizing part of his or her portfolio to protect against longevity risk and shift toward a more cautious portfolio. A large problem for the 65-year-old is determining the rate at which he or she can spend. Here an advisory service can be of especially great help. The "Four Percent Rule," which advises spending 4% of the value of the portfolio annually (adjusted for inflation) tends to be overly cautious, especially in later years. Clearly an 85-year-old retired person can safely spend at a faster rate than a 65-year-old retiree. Lacking analytic advice, perhaps it is safest to start at the 4% level and increase consumption gradually later.

Myron Scholes is the chairman of Platinum Grove Asset Management, a hedge fund. He was awarded the Nobel Prize in economics in 1997 for his work on option pricing theory.

Basically, the problem with someone who is 20 is they have most of their wealth in either their human capital or their prospective opportunity to employ themselves and grow. It is difficult to figure out what the return will be on their investment in human capital. It is necessary for them to concentrate on making money and to do that by investing. Most young people decide when they are young to invest in human capital.

When you are young, you are necessarily going to be a borrower. Either you borrow to finance your education, your wedding, a home, or against the future to start a new business. Smoothing consumption over time is the object. The question one must ask is: Should I starve myself when I am young, and then when I am old splurge and spend? Or is should I have a smoother consumption pattern?

The question is what standard of living we want to try to attain in our life and what risks we want to take. Do I want to take the educational risk? Do I want to take the risk of building a business? Do I want to take a marriage risk? Do I want to take the risk of building a home? As you get older, the investment decision changes, because your human capital has now borne fruit. Then you have other assets that you employ, and you can invest in the stock market or bonds, or a home, or other activities. That money is presumably being built up to smooth consumption through retirement.



For 65-year-olds, human capital usually decreases, as does desire to work. You want to do other things in life, perhaps in conjunction with your work, and your horizons broaden. By the necessity of time, when you are very young you are very focused on a particular activity and what you want to do. As you get older, your interests broaden and your horizons shorten. Therefore, you have many demands on your time and interests as you get older.

The ability to think about an investment program in that light depends on lots of different things. If you have just yourself, that's one thing. If you have a spouse, that's another thing. If you have children or grandchildren, or other persons who are in your "consumption basket," then you have a whole different metric to consider.

Unfortunately, when you get older you have to think about uncertainty and how to hedge against living too long. How do you hedge against dying too soon? How do you worry about medical costs? How do you worry about and hedge against the possible destruction of your home or your inability to do other activities that you want to undertake?

Meir Statman is the Glenn Klimek professor of finance at Santa Clara University. His research focuses on behavioral finance.

A 25-year-old should think of risk as a must and an opportunity. The risks facing a 25-year-old are not in his or her portfolio. Indeed, his or her portfolio likely amounts to a negative number, consisting of student loans, automobile loans, credit card loans, and perhaps a mortgage on a house with negligible equity and some paltry amount in a 401(k) plan.

Risk is a must for a 25-year-old, because he or she must choose a career that will provide the "human capital" that in turn will form the foundation of a future portfolio. There is always the risk that one who chooses a career in law, medicine, or business will later find it unsatisfying, but one must choose. A choice that turns out to be poor would initially set back their human capital as they switch careers, but that change might ultimately provide an opportunity for a more satisfying career and life down the road.

A 25-year-old also faces the risks of marriage and children. They can shun these risks, staying single and childless, but they will miss the opportunities and rewards as well.

A 65-year-old still has to think of risk as a must and an opportunity, but they should think of it as danger as well. A 65-year-old still faces choices in life, many of which are risky. Should they choose surgery or radiation for their cancer? Should they remarry? Should they retire or keep on working? Should they support children who



are struggling? These are difficult decisions, especially for one whose portfolio is precarious, but 65-year-olds have more ways to cope with risk than some imagine. They can keep working, reduce spending and increase savings. They can also ask for family support. "Filial loyalty," where adult children support elderly parents might not be in the American vocabulary, but it is practiced in America more often than it is preached. Some adult children are oblivious to the hardship of their elderly parents, but many more help.

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