



## Letters to the Editor

February 14, 2012

*The following is in response to Larry Siegel's article, [Jeremy Siegel, Rob Arnott and Other Experts Forecast Equity Returns](#), which was published last week:*

Mr. Siegel:

Good article. There were a couple of areas for which I need clarification. What role do savings and asset allocation, in aggregate, play in determining the realized ERP? For example, if adults saved on average 10% of their earnings from 1900 to 1980, but now save on average 5% of their earnings, how does this affect the ERP? If interest rates normalize, because of government spending and realized inflation, how does this affect the ERP? What is the breakeven time period for achieving a given ERP? For many investors, time is relevant, and the sequence of returns is important. How does this fit into your discussions?

One last point. Academics are generally extremely overconfident in their perceived knowledge of the economy and financial markets. This impacts their discussions of concepts such as ERP, and often misleads financial advisors. It's not what you know that hurts you in investing, it's what you think you know that just ain't so.

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*Larry Siegel responds:*

The realized ERP is the outcome of a large number of forces, the supply and demand for capital being only one. Among the others are the growth rate of the economy, the profitability of corporations, the amount of risk in the market, and investor sentiment.

Remember that the ERP is not a total return, but the difference in two rates of return. All other things equal, if households save more, there is probably no net effect on the ERP since they buy both more stocks (raising the past ERP and lowering the future one) and more bonds (doing exactly the opposite). However, there is some reason to think that as households become wealthier, i.e. save more, they are less risk averse (more risk tolerant) so they buy more stocks. Thus a higher savings rate might be associated with a higher past ERP and a lower future one. The recent dearth of savings, therefore, may have led to lower equity prices (two crashes in 6 years) and a higher forecast ERP.



In regard to your next question, when interest rates go up to historically average levels, our experience tells us that this would be temporarily bad for equities, lowering the historical or past ERP and raising the future ERP. There is, however, no “good” theory that forecasts this. The ERP should be the same in a high interest rate environment as in a low one. (By a “good” theory I mean one that is not an obvious retrofit.)

The ERP is a statistical concept called “expected value,” and not a time period-specific forecast, so a breakeven period cannot be calculated for it. If the ERP is 4%, then in any given year the realization could be +20% or -20% and we would not say that the forecast was wrong, only that the actual return deviated materially from the expected return. Over long enough periods, however, forecasts should be in some sense right, or they’re not worth making. My paper with Grinold and Kroner assumed that the forecast of the ERP we were making was for 10 years. However, we would be very surprised if the actual 10-year realized ERP fit the forecast tightly. It is very difficult to say what is a long enough period to evaluate a forecast like this, but if after 30 years the realized ERP was nowhere near 4%, on either side, I hope I’d have the modesty to admit that my forecast had been wrong.

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*The following is in response to Joe Tomlinson’s article, [An Innovative Solution to Retirement Income](#), which appeared last week:*

Dear Editor,

One important disadvantage to the deferral option for Social Security (SS) benefits is that taking early benefits preserves wealth since the recipient can keep and invest the money. If he lives a long life, these savings can accrue to his beneficiaries.

SS is a poor protector of savings as there is only a \$200 insurance policy for SS recipients. Imagine you accumulated a stream of SS payments for 10 years—from age 67 to 77 (\$2,000 per month or \$24,000 per year less taxes for 10 years). Assuming a reasonable return you could have between \$200,000 and \$300,000 saved, money that could be passed on to beneficiaries. (My assumption is that the money wouldn’t be spent since the author is suggesting a deferral strategy that means the money isn’t need for living expenses.) If the recipient begins taking SS in the 11<sup>th</sup> year, his monthly payment might be in the neighborhood of \$5,000 per month or more depending on inflation. If he lives, he might catch up to the up front-payment strategy but the returns on that money would make for an interesting comparison. But the downside is that, if he dies in that 11<sup>th</sup> year all of those ten year savings are gone!



I would also find it interesting if the amount saved in the distribution strategy was used to buy an immediate annuity at age 77. The monthly payment is likely to exceed the deferred-distribution strategy by a bundle.

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*Joe Tomlinson replies:*

Mr. Nugent's raises an important question about the Social Security (SS) delay – whether if it might work better to take SS earlier and invest the extra funds in the stock market – in other words, grab the money as early as possible and get it invested.

I ran some numbers based on the example used in the article. I assumed inflation of 2%, a TIPS rate of 0%, and real returns for stocks of 5.5% with 20% volatility. (The 5.5% was based on a 2011 survey of 6,000 economists and other financial professionals.)

I estimated life expectancies for healthy, non-smoking, white-collar individuals intended to be typical clients of financial advisors – 20 years for a 66-year old male, 22 years for a 66-year old female, and 30 years (for the last to die) for a couple where the husband is 66 and the wife 64.

I then ran the same example used in the article. The SS benefit at age 66 was assumed to be \$20,000. Delay credits would boost the benefit to \$26,400. The particular goal in this case was to produce \$26,400 of income beginning immediately to cover basic living expenses. One way to do this would be to delay SS to age 70, and set aside \$109,000 to cover expenses during the four-year interim period. Under this approach, the \$26,400 of annual expenses would be covered regardless of length of life, but nothing would be left of the \$109,000 for a bequest after the four-year interim period.

I tested the alternative strategy suggested by Mr. Nugent of beginning SS immediately at the \$20,000 level, investing the \$109,000 in the stock market, and taking withdrawals to make up the difference between the \$20,000 and the needed \$26,400. I then calculated expected bequest values at life expectancy and probabilities of running out of money while still living.



Here are the results:

<b>Social Security Delay Test</b>				
Scenario	Life Expectancy	Expected Bequest	Present Value of Bequest	Probability of Failure
Male Age 66	20	\$61,542	\$14,488	33%
Female Age 66	22	\$48,950	\$9,972	39%
Couple F64/M66	30	\$0	\$0	55%

For either a single male or female, the "grab the money early" approach does produce a non-zero expected bequest. However, the probabilities of running out of money while alive and not being able to pay for basic living expenses are alarmingly high. For a couple, the table shows the enhanced value of the joint-life annuity built into SS via the survivorship benefit – the "grab the money" strategy produces zero expected bequest value (same as the SS delay strategy) and produces a greater than 50% chance of running out of money while at least one member of the couple is still alive.

These results provide another way of demonstrating the value of delaying SS, particularly for married couples.

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