



Treating Asset Allocation Like a Roadmap

MANAGING RETIREMENT DECISIONS SERIES

A WELL THOUGHT OUT ASSET ALLOCATION PROGRAM is a key ingredient of successful retirement for many Americans. But just what is asset allocation, and what decisions do people need to make regarding asset allocation as they approach and enter retirement? That's what this Decision Brief is all about.

Asset allocation is like a road map for long-term financial stability. It involves deciding how to allocate savings and investments among risky assets like equities and lower risk assets like bonds. It also takes into account other resources such as Social Security, pensions, annuities, housing, etc.

The goal of asset allocation is to increase the retiree's chances of achieving his or her financial needs and goals for as long as the retiree lives.

The process can start at any time in life. For retirement purposes, however, most experts agree that asset allocation will have maximum benefit if it starts at the beginning of retirement if not before. In addition, it should continue throughout all of the retirement years.

Important: Asset allocation involves careful decision-making. Uninformed decisions made early on may lead to undesirable long-term financial consequences from which retirees may have difficulty recovering.

Disclaimer

This Decision Brief does not provide advice for specific individual situations and should not be construed as doing so. It is an information tool for general guidance. Individuals needing advice should seek the services of a qualified professional. Keep in mind that tax codes change, taxation of products and strategies vary, and personal tax needs and issues are unique. Consideration of tax issues is beyond the scope of this work.

Following are some key asset allocation strategies and concepts for retirement. Each requires thoughtful analysis, but should result in better decision-making.

First, Assess Risk Tolerance

When starting to do asset allocation, individuals first need to assess their tolerance for taking investment risk.

One way to do this is to fill out a Risk Tolerance Assessment questionnaire offered by mutual fund and other financial companies. The answers help gauge where a person falls on a scale of conservative to aggressive. Some tools even recommend asset allocation mixes based on the responses.

Caution: Risk tolerance is but one of several important factors to consider in setting up an asset allocation. For that reason, it may not be prudent to go directly from completing a risk tolerance assessment questionnaire to investing in a specific allocation.

Another approach to assessing individual risk tolerance is to answer just one question: What percentage of loss in the investment portfolio would cause the investor to sell risky assets and flee to safety?

Unfortunately, not everyone answers this question accurately, at least not without some serious deliberation.

Case in point: Some investors in the mid-2000s thought they could tolerate a substantial loss. But the 2008–09 crash triggered irrational responses. Many investors bailed out of the stock market, only to sit on the sidelines when the market rallied. Perhaps the best approach is to answer the question honestly and rationally, and then shave a bit off the result to allow for irrational behavior. Those who can recall how they felt and acted during 2008–09 may gain useful decision-making information as well.

It helps to keep the maximum tolerable loss number in mind as a sort of guardrail for evaluating the other factors that feed into the asset allocation decision.

Rules of Thumb Help, But...

People often use rules of thumb in decision-making. These can be handy guideposts but should not replace mathematical analysis or careful consideration of individual circumstances.

A common rule of thumb is to set stock allocation to 100 percent minus the age of the investor. The thinking is that the allocation to stocks should go down with advancing age, even though stocks typically outperform bonds over the long term, because older investors have fewer years to recover from market downturns.

However, it pays to examine individual circumstances carefully before applying any rules of thumb. Some key income considerations for individuals and couples are:

Heads Up:

The biggest reason that investment plans fail is the tendency to dump stocks in down markets—exactly at the time when investors should be adding to their stock allocations.

- What are annual wages if still working?
- Are there defined-benefit pension benefits?
- Has Social Security been taken yet?
- How much debt exists from mortgages and other liabilities?

Generally speaking, income that is stable and secure is equivalent to owning a bond investment. But for purposes of asset allocation, remember that debt is like a negative bond.

John's Account

Savings in stocks	\$400,000
Savings in bonds at 5% interest	\$400,000
Total savings	\$800,000
Outstanding mortgage	\$400,000 (at 5% interest)

Consider the case of John, whose account is shown in the chart. He thought he had a 50/50 investment allocation, but he really didn't. He effectively had a \$400,000 investment portfolio 100 percent allocated to stocks. His bonds and mortgage simply offset each other, because they both had the same interest rate. The "100 percent minus age" rule of thumb would not have picked up this problem.

Deciding on an asset allocation involves balancing the impact of potential losses versus potential gains. That does sound reasonable. But asset allocation involves more than that. Individual circumstances are important considerations, too.

For instance, for people who are struggling financially, losses far outweigh any potential upside from gains. But those who are more comfortable may be able to absorb losses without disrupting their living situations. The more comfortable group may therefore benefit from a more aggressive asset allocation. Monte Carlo analysis can help in determining the probability of running out of money.

Decide on the Asset Classes

A key asset allocation decision involves which asset classes to include. An asset class is a group of similar securities that respond to marketplace developments in a similar fashion. Common asset classes are stocks, bonds and cash alternatives.

The most straightforward allocation might involve a simple mix of stocks and bonds—perhaps a U.S. stock market index mutual fund and bond mutual fund.

Other possible asset classes include:

- **Foreign stocks:** The return prospects are similar to those of domestic stocks, but the correlation is less than 100 percent, meaning there is likely some diversification benefit from including foreign

What's Monte Carlo?

Monte Carlo analysis involves the use of random number generation and computer simulation. This helps demonstrate ranges of financial outcomes.

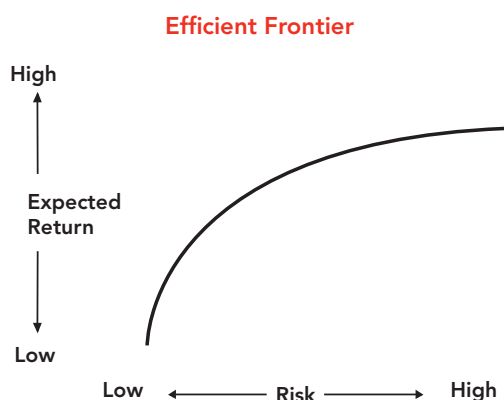
stocks. Advisors typically recommend holding 20-40 percent of total stocks in the foreign category.

- **Real estate:** This class has shown itself to add diversification value. This may not be appropriate if the retiree already has a heavy investment in personal real estate.
- **Commodities:** Commodity funds have been good diversifiers.
- **Bond funds:** Some experts favor including only funds in Treasuries and Treasury Inflation-Protected Securities (TIPS) and leaving any risk-taking for stocks. Others favor holding several different types of bond funds—Treasuries, TIPS, corporate bonds, high-yield bonds, foreign bonds as well as municipal bonds for taxable accounts.

The ideal types of assets to include in asset allocation are those that have attractive return prospects and low correlation with the existing asset classes. Unfortunately, these are not easy to find.

Spot the Efficient Frontier

Asset allocation uses a concept known as the efficient frontier. Its purpose is to find the mix of asset classes that maximizes expected return for any given level of risk.



As the chart illustrates, this analysis entails plotting points with risk on the horizontal axis and expected return on the vertical axis. The positively sloped line that results is known as the efficient frontier. Points below the line are considered inefficient and points above are considered impossible to achieve.

This is a useful concept. However, it should not be not applied to a plan too precisely, as considerable subjective judgment goes into developing the input assumptions.

Several financial planning software packages will do the number crunching necessary to generate efficient frontiers. This can provide useful information for decision-making. But again, since the quality of the output is dependent on that of the input and since there are numerous uncertainties about the input, such software is not a substitute for careful analysis and good judgment.

Consider Location, Location, Location

Asset allocation also involves the consideration of asset location—that is, whether assets are located in taxable or tax deferred accounts.

For example, assume an individual has \$500,000 in regular investments and \$500,000 in a 401(k). Also assume the risk analysis indicates that a 60/40 stock/bond mix is appropriate. One could simply allocate 401(k) and regular investments on a 60/40 split. However, that would likely be inefficient in a tax sense.

A more appropriate approach might be to invest in mostly bonds in the 401(k), and mostly stocks in the regular investments, particularly if the stocks are not traded frequently. The idea is that stocks are already somewhat tax efficient, with low tax rates on dividends and capital gains taxed at favorable rates and not taxed until realized. Changes in the tax code could impact this strategy, of course.

After Retirement Starts: Rebalancing

Asset allocation is not a “set it and forget it” exercise. It requires frequent monitoring and possible adjustments. Here are some common triggers for considering changes:

- **Advancing age.** Each year, the retiree has fewer years in which to recover from market losses, so moving to a more conservative allocation may make sense. Allocations should reflect individual circumstances.
- **Major financial events.** The retiree could experience a significant change that makes review and readjustment necessary. Examples include receiving a windfall gain or paying off a big mortgage balance.

Allocations typically need periodic updating. This is a rebalancing process that involves adjusting investments back to the target allocation percentages. This activity goes against intuition, but it does help investors to buy low and sell high. To gain the most benefit from this activity, consider rebalancing at least quarterly.

Monitor Company Stock Ownership

Many 401(k) plans permit employees to invest in their company’s stock. Some

plans even direct investments to company stock automatically. Investing in any single stock is much riskier than a diversified portfolio of stocks. However, having significant investments in company stock introduces additional risk, since a worker's job also depends on how well the company does.

Most planners recommend minimizing any investments in company stock.

Weigh the Mutual Fund Advantage

One can generally achieve greater diversification by investing in index mutual funds or exchange traded funds (ETFs) than by investing in individual stocks and bonds. Here are some considerations:

- **Index funds:** These funds offer very broad diversification, low cost and tax efficiency through low turnover (important for taxable accounts). They adjust exposure to various stocks as the values change. That helps to keep the funds diversified.

Some people prefer investing in index funds rather than individual investments for the simplicity the funds afford. These individuals have little interest in doing labor-intensive securities selection.

- **Target-date funds:** These mutual funds gradually decrease allocations to risky assets over time until the investor reaches a set future date. For example, an employee considering retirement in 2025 could invest in a target-date 2025 fund. The design has made these funds increasingly popular, particularly as default choices in 401(k) retirement plans.

But fund managers differ over the allocations they recommend in target date funds. This means retirement decision-makers need to ask a lot of questions about the asset allocation policy of the fund.

A Very Personal Choice

Even experts disagree about the most basic asset allocation choices. Some favor primarily investing retirement assets in super-safe Treasury Inflation Protected Securities (TIPS), while others prefer placing a high percentage of long-term investments in stocks.

Index Fund Pointer

Some large index funds are indexed to the S&P 500, so they have a large-company bias. Others are based on the total U.S. stock market but also include a representative share of smaller companies; these may be more appropriate for providing diversified exposure to the total U.S. market.

Rebalancing Tip

For portfolios where withdrawals are being taken, rebalancing can be accomplished by being selective about choosing the asset classes from which to take withdrawals.

Do the Homework

Target date funds can help investors reduce the effort it takes to manage investments before and during retirement. But it pays to do some homework before investing.

Consider a target-date retirement fund for a 65-year-old. What portion of these assets should be in risky investments?

Based on the “100 minus age” rule, the answer would be 35 percent. But, since retirement plans are sensitive to investment returns near the time of retirement, other experts say the answer should be zero. Investors need to find out which is best for their own situation.

Another issue is the design approach. Due to the steep U.S. recession in 2007–09, investors holding funds with target dates of 2009 and 2010 suffered losses of 20 percent or 30 percent. These losses were in funds that the investors had incorrectly assumed were right on track for their retirements!

Lesson learned: Before investing in a target-date fund, check out the fund’s asset allocation approach. Be sure it matches asset allocation and retirement goals.

Divergent opinions like that can be vexing to investors. But if they have saved and built up a portfolio of investments, they have already been making asset allocation decisions. That is so, even if they have put all of their money in a mattress! So why not become an informed asset allocator?

In the end, asset allocation for retirement comes down to people doing the best they can to understand the important issues and then making educated decisions. Books and papers, such as those below, can help. So can consultation with a competent and unbiased advisor who has asset allocation expertise.

Those who take their time, ask questions and make informed decisions will be well on their way to achieving their financial retirement objectives.

Learn More about Asset Allocation

- Bernstein, William. *The Intelligent Asset Allocator*. New York: McGraw-Hill, Inc.
- Brinson, Gary P., L. Randolph Hood, and Gilbert L Beebower. “Determinants of Portfolio Performance.” *Financial Analysts Journal*.
- Evensky, Harold; John Clark; and Brian Boscaljon. “Asset Allocation—New and Improved?” *Journal of Financial Planning*.
- Gibson, Roger C. *Asset Allocation 4th Edition*. New York: McGraw-Hill, Inc.
- Ibbotson SBBi *Classic Yearbook: Market Results for Stocks, Bonds, Bills and Inflation 1926-Latest Year*. Chicago: Morningstar, Inc.
- Milevsky, Moshe. *Are You a Stock or a Bond? Create Your Own Pension Plan for a Secure Financial Future*. Upper Saddle River: FT Press.

The Society of Actuaries would like to acknowledge the work of its *Committee on Post-Retirement Needs and Risks* in producing this series.

The committee's mission is to initiate and coordinate the development of educational materials, continuing education programs and research related to risks and needs during the post retirement period. Individuals interested in learning more about the committee's activities are encouraged to contact the Society of Actuaries at 847-706-3500 for more information. Additional information and research reports may be found at <http://www.soa.org>.



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