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An Obsession for Determined Outcomes

NAVIGATING THE FINANCIAL OUTCOME PUZZLE

Protect Me from Myself

In theory, an individually directed IRA or 401(k) account is no different from a traditional employer-sponsored pension plan. Both have the same goal: to make sure the beneficiaries have a stream of payments sufficient to fund a comfortable retirement. The tools for doing so are similar, too: actuarial estimates, a disciplined schedule of employee (instead of employer) contributions, and a tailored asset allocation strategy to address projected liabilities.

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When it comes to designing and adhering to a consistent investment strategy, however, institutional and individual investors part ways.

Most individual investors don't have a strong track record in this respect, and a multitude of external pressures can throw them off well before they reach retirement. A 2011 University of California study of individual investors' behavior concluded that they "trade frequently and have perverse stock selection ability, incurring unnecessary investment costs and return losses.

They tend to sell their winners and hold their losers, generating unnecessary tax liabilities. Many hold poorly diversified portfolios, resulting in unnecessarily high levels of diversifiable risk, and many are unduly influenced by media and past experience[1]."

These failings come through dramatically in a comparison of the investment performance of collectively managed defined-benefit pension plans with individually directed IRAs and 401(k) savings plans from by the Center for Retirement Research at Boston College. ***It found that defined benefit plans outperformed 401(k)s annually by 0.7% and IRAs by 1%[2].*** That can amount to hundreds of thousands of dollars less in accumulated savings at retirement and many fewer years of income after the individual stops working.

1 Brad M. Barber and Terrance Odean, "The Behavior of Individual Investors," UC Davis Graduate School of Management, September 2011.

2 Alicia H. Munnell et al, "Investment Returns: Defined Benefit vs. Defined Contribution Plans," Center for Retirement Research at Boston College, Issue in Brief, December 2015, Number 15-21.

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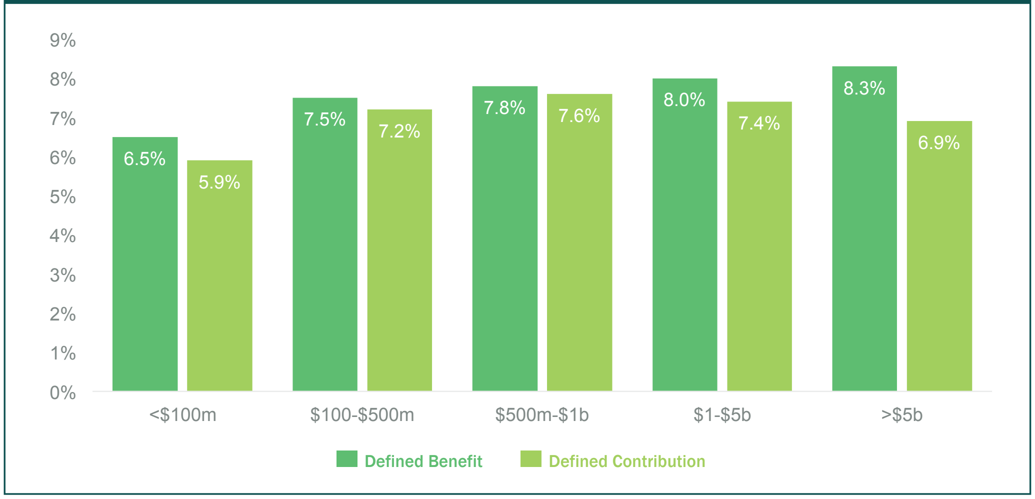
Geometric Rates of Return by Plan Size, 1990-2012

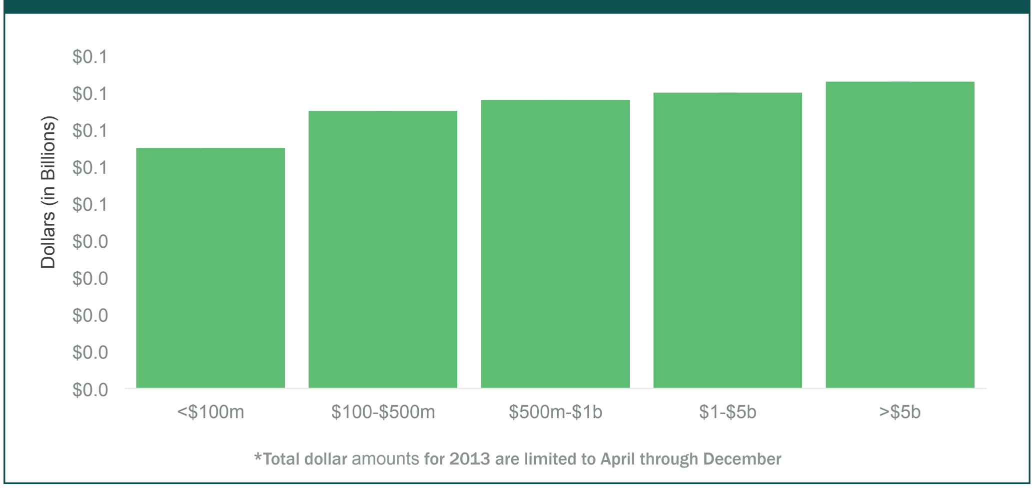


Center for Retirement Research: Investment Returns: Defind Benefit vs. Defined Contribution Plans

According to the Consumer Finance Protection Bureau, elder financial exploitation reports quadrupled between 2013 to 2017.

But individual investors are vulnerable to other pressures that institutions like pension funds are not—and this continues after they retire. These can result in ill-judged decisions to help family members, for example to start a business, cover medical expenses, or pay off other debts, or to fund continuing education – any of which could impair the individual's ability to achieve his/her retirement goals. Outright fraud is spreading as well. According to the Consumer Finance Protection Bureau, elder financial exploitation reports quadrupled between 2013 to 2017 to 63,500. More than 80% involved monetary loss to older adults, losses were greater when the victim knew the suspect—and that total likely represents only a small fraction of actual incidents[3].

Total Amount of Monetary Losses and Attempts Reported in EFE SARs by Year



Consumer Financial Protection Bureau (CFPB): Suspicious Activity Reports on Elder Financial Exploitation

[3] CFPB: "Suspicious Activity Reports on Elder Financial Exploitation: Issues and Trends, 2019"

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Institutions face fewer such hazards, in part because they are subject to strict fiduciary standards aimed at ensuring they remain fixed on meeting their obligations to beneficiaries. Unlike individual investors, who at the end of the day are solely responsible for their choices, large pension funds and other institutions are managed by professionals and usually have a board to oversee their activities and consultants to advise them. Wealthy families emulate this structure by creating a family office—but this is beyond the means the vast majority of private investors.

One thing that individuals can do, however, is create an Investment Policy Statement customized to their situation and preferences. Institutions typically operate in accordance with an Investment Policy Statement, which is designed to keep them on track to meet current and future liabilities. In the simplest terms, it focuses them on reaping the long-term benefits of compound interest rather than reacting—or overreacting—to political or business pressures or shorter-term market signals.

Individuals can keep similarly focused if they craft an Investment Policy Statement and stick to it. This reflects the reality that three things will determine their success at providing for a comfortable retirement: how they manage their assets and liabilities; the choices they make in their personal lives, including career, family, and spending habits; and the behavior of the markets. The last they cannot control; the first two they can. A personal Investment Policy Statement is intended to help the client articulate his/her goals and provide a roadmap for achieving them.

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CREATING AN INVESTMENT POLICY STATEMENT

As an advisor, once you have built a strong personal connection with your clients and gathered complete and accurate data from them, you can help them to create an Investment Policy Statement and work with them to stick to it: literally, in some cases, to protect them from themselves.

Goals come first. Creating the statement starts with an in-depth discussion of the investor's personal and financial objectives: for example, to cover a certain level of living expenses in retirement. If that's the case, how long does the investor expect to be funding that goal, and what investment objective—what real growth rate—would be appropriate to achieve it? The Investment Policy Statement should also include guardrails for your client's retirement years, to ensure they can continue to meet their objectives: for example, controlling the rate at which expenditures erode real assets.

Managing risk. Especially important is the matter of risk. The Investment Policy Statement should establish the appropriate level of risk in the client's portfolio, the metrics you'll use to align your asset allocation to match their future liabilities, and how much the client can afford to lose before selling a position. It should do so for each asset class. Risk management is inherent in all of the steps that follow as well, because the most effective element of risk management is to adhere to the philosophy set forth in the Investment Policy Statement.

What's your philosophy? Next, you need to establish your client's investment philosophy. It's important to keep this discussion top-down, not bottom-up; too often individuals fixate on an asset or a trading idea that appeals to them, without considering how it fits—or not—with their stated objectives. The key to success in the top down approach is aligning the asset allocation to address the future liabilities established in their goals.

The emphasis, therefore, should be on asset allocation, not asset picking. What do they want to be their core investments, and how do they want to achieve diversification? Some may want to concentrate exclusively on long-term return while others may want to leave room for some short-term, opportunistic bets. How important is it to them to keep trading and other costs, and tax exposure low, now and post-retirement? These considerations will help determine whether you recommend a largely passive portfolio, whether mutual funds or exchange-traded funds should make up most of the mix, and whether to leave some room for individual stock selection.

Investment selection. Only after these issues have been settled should the Investment Policy Statement address investment selection. For stocks, you'll want to design a portfolio that balances growth and value to mirror the client's objectives, decide with the client what is the maximum price and price-to-earnings ratio they are willing to accept for each, what minimum return they prefer, and what dividend return they expect. For selecting mutual funds, you'll want to set criteria including the fund's total-return ranking over various periods, its expense ratio, manager tenure, tax efficiency ratio, and how heavily it is weighted toward any one sector. Any new investment your client considers should meet these criteria.

Balance and rebalance. How often will the client evaluate their portfolio's performance and, if necessary, rebalance it? Before deciding to buy or sell any new asset, ask whether the decision is consistent with the client's investment philosophy. If it's not, ask why it makes sense. The same goes for the existing assets in the portfolio; set appropriate benchmarks for gauging the performance of each asset class and review their performance regularly. Make sure the reasons you and your clients chose each of their investments in the first place still apply.

Review and revise. The Investment Policy Statement should also take into account the fact that the world the investor inhabits is constantly in flux. The British economist John Maynard Keynes is often quoted as saying, "When the facts change, I change my mind. What do you do, sir?" An important part of executing an Investment Policy Statement is for you and your client to review it periodically, in case the facts—or the client's personal circumstances—have changed.

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THE RELATIONSHIP IS FUNDAMENTAL

Of course, individual investors are not obliged to abide by an Investment Policy Statement, as pension funds and other institutional investors often are. And here's where a close personal relationship and deep familiarity with your client's aspirations become critical.

Remember the example we discussed in our first paper, in which your client decides to buy a major consumer item, like a boat? The Investment Policy Statement gives you the formula you need to explain how that purchase would affect their ability to reach their retirement-savings aims. But your intimate knowledge of the individual gives you an understanding of what that purchase means to them, how to explain what's at stake, and perhaps how to recommend another course.

Or take another common decision that investors are prone to follow, especially in a down market: to go to cash. While the impulse is understandably rooted in a desire to preserve assets, it may not be the right choice for an investor trying to achieve long-term savings accumulation goals. In our fourth paper, we'll take a closer look at this issue, and how to keep your clients on the right track when the markets get scary.