The defined contribution journey to retirement (Palo Alto Weekly, Mar. 27, 2002)

by Austin Lemoine

How to manage retirement savings across your working years

Save you must, to have enough money to retire. But it's only half the story. It's necessary to grow those savings. Successful management of your defined contribution monies – the 401(k), 403(b), and 457 plans, and individual IRA's – across the journey of your working years will help you reach your retirement goal.

How should you manage your defined contribution portfolios. You must play the hand you're dealt by concentrating on those factors affecting your investments that you can influence, and ignoring those you can't.

You can't impact the economy or interest rates. But you can influence how your savings are invested. Distributing your savings among stocks and bonds and various subgroups (or "asset classes") thereof is called "asset allocation." Studies suggest that in the long-term, asset allocation is the single most important factor in accounting for the variability of investment returns.

Accordingly, there are two prudent steps you should take: (1) diversify your investments across several asset classes; and (2) periodically "rebalance" your portfolios to a target asset allocation.

Portfolio diversification and rebalancing are all about managing risk while pursuing reward. Risk is reflected in the uncertainty or variability of investment returns. Risk and return are joined at the hip. Safer investments (such as Treasury bonds) produce lower returns. Investments with historically higher returns (such as small-cap stocks) can inflict punishing losses.

Risk is real. From time to time financial markets impose severe losses. Damaging declines are unavoidable in a free-market system. A $10,000 market investment in January 1973 was worth $5,600 by December 1974, a decline of 44 percent. The investment eventually broke even ten years later, in 1983. Fast forwarding to the present, when the recent stock bubble burst some $4 trillion of market value evaporated. It's too soon to tell how long the aftershocks of that market quake will be felt.

Diversification

Putting bonds in your portfolio is a prudent first step toward diluting your risk. In general, bonds are less risky than stocks. "Stocks" include domestic and foreign stocks, and stock mutual funds. "Bonds" include domestic and foreign bonds, bond mutual funds, and cash (money market funds).

Decide on a portfolio split between stocks and bonds. It should take into account your tolerance for risk and the number of years you have to invest before you need the money. First, consider how much loss in portfolio value you could tolerate before starting to sell off assets?

Call that loss your "selling threshold" and calculate it as a percentage of your portfolio.

Then a recommended stock percentage is 10 percent plus two times your selling threshold. (The formula is not law and applies for thresholds up to 45 percent.) For a zero percent threshold, the indicated stock percentage is ten.

Factoring in your time horizon, it may be prudent to revise downward the stock percentage recommended by the above formula. The longer one's time horizon the lower the risk of long-term

loss. But as retirement approaches, one rule of thumb is that your maximum stock percentage should be 10 times the number of years until you have to spend the money.

Suppose you decide on a portfolio split of 60 percent stocks and 40 percent bonds. You can then diversify another level down by populating the stock and bond categories with mutual funds representing various asset classes. Your 60-percent stock portion could include U.S. large-cap (growth and/or value), small-cap (growth and/or value); real estate investment trusts (REITS); foreign; emerging markets; or precious metals. Your 40-percent bond portion could include U.S. government and corporate bonds, foreign bonds, and cash.

Company stock, of course, might be part of a 401(k), preferably limited to 15 percent or so of the portfolio value.

The asset classes you choose will depend on investment choices available, your tolerance for risk, and appetite for detail. A sample breakdown by asset class might be 35 percent large-cap stocks, 15 percent small-cap, 10 percent foreign, 35 percent domestic bonds and 5 percent cash.

Information and software tools can be helpful in making your "asset allocation" decisions. Check out www.financialengines.com and www.morningstar.com, particularly the retirement and portfolio sections of the latter. Both sites charge fees for use of their tools.

You've now got a target asset allocation you're comfortable with. You compose the portfolio, selling and buying securities to mirror the target allocation. (Buying and selling have no tax consequences in a defined contribution account.) Stick with that allocation until prudence dictates otherwise. You'll want to increase the bond percentage as you get older, for example.

Rebalancing

While diversification can increase your potential return, rebalancing realizes or "books" the return. After a time, say that stocks have outperformed bonds, altering your portfolio composition to 70 percent stocks and 30 percent bonds – and resetting your return-risk profile to a higher level in the process.

Then rebalancing requires selling some of the better performing asset (stocks) and buying more of the poorer performing asset (bonds), to get back to the target 60-40 stock-bond split. In other words, rebalancing forces you to sell higher and buy lower.

This will be emotionally difficult to do, since it usually involves going against market conditions. Don't underestimate the resolve required for this process – because it dictates doing exactly the opposite of what most of the investment world is doing.

Rebalancing is necessary to keep your risk at the level you targeted and to capitalize on the returns of your better performing assets. In point of fact, rebalancing can be viewed as the only consistently effective method of market timing.

How often should a portfolio be rebalanced? A longer interval between rebalancing, say one year, is generally preferable because it gives more time for market trends to play out.

Finally, we consider a retrospective lesson on the virtues of disciplined investing. Dalbar is a Boston-based company that's been researching mutual funds for 25 years. A recent Dalbar study focused on how stock mutual fund investors fared during the biggest and longest bull market in history.

Dalbar found that for the years 1984 through 2000, when the annualized return of the S&P 500 Index was 16.3 percent, the typical stock fund investor had an annualized return of 5.3 percent. That's terrible! For the same period, annualized return on Treasury bills – the safest investment around – was 5.8 percent, adding insult to injury.

Remarkably, however, those investor returns of 5.3 percent also trailed by a wide margin returns of the typical stock mutual fund, which earned a percent or so less on average than the S&P 500 in the years covered by the Dalbar study. So what went wrong?

It appears investors had an inevitable tendency to pile into funds at market tops, together with an equally consistent tendency to unload at market bottoms. The impact of buying high and selling low over the period in question was greatly magnified by the phenomenal rise and fall of technology stocks; and the effects on mutual funds that bought them. It seems that our investor's meager returns also stemmed from a habit of chasing the latest "hot" fund, shifting money into it just before it started to cool down.

Implications of the Dalbar study are clear: discipline, diversification, and annual portfolio rebalance constitute a sensible strategy for defined contribution portfolio management.

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