

A Practitioner's Perspective: Comments on "Asset Allocation, Life Expectancy and Shortfall"

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As I reviewed one of the articles in this issue, I thought of a client I met for the first time on November 1, 1987, a month before his planned retirement date. Until the past month, which included the market crash of October 17, this dentist had been delighted with the performance of his all-equity portfolio. However, now it was valued at about half of what he had expected, and in his view, was insufficient to produce the retirement income he needed. Over the next few weeks, he and his wife met with me several times to discuss some tough choices about income and expenses. They concluded that while the children's educations would not be disrupted, for the next two years he would continue drilling and filling and their plans to buy a retirement home would be deferred. This back up plan worked well, the investments recovered and the couple is now very happily retired.

In this issue's "Asset Allocation, Life Expectancy and Shortfall," Kwok Ho, Moshe Arye Milevsky, and Chris Robinson (HMR) construct a model which supports this client's 100% equity position, based on his wealth to consumption ratio and age. And ultimately, things did work out just fine; however, this particular client was lucky because he did have the option to continue working and he knew intuitively that with time his investments would recuperate. But the lives of this investor and his family had been severely disrupted by his investment position, a position to which few responsible planners will knowingly expose a client.

But the model makes some very important points that should not be so quickly dismissed.

HMR's analytical model allocates a retiree's assets between risky and risk free investments with the goal of minimizing the probability of not meeting consumption requirements. The model uses age, life expectancy, and consumption level to arrive at an ideal investment mix for the initial wealth. To see how a practitioner could benefit from HMR's work, it may be instructive to view it in the context of constructing a financial plan for an individual at retirement age.

First, let's consider the approach of a typical planner. The planner and client discuss the individual's investment attitudes and experience, and together they define goals and construct a list of priorities. Now let's look at the approach of a model. Some models use

the utility curve to describe the set of risk-return trade-offs that an individual is willing to make, and seek to determine the mix of risk and return that provides the most satisfaction, or utility, to the individual. Instead of incorporating a utility function into their analysis, HMR make the assumption that minimizing the probability of outliving their funds is the solution to maximizing the individual's utility function. Like the client I described earlier, while individual's needs are usually more complicated than this, if a client were confined to expressing only one goal, this could very well be the one.

Retirement non-investment income can be projected and the additional investment income necessary to fund consumption is easily obtained. Generally, the planner will construct the portfolio so that income producing securities generate sufficient supplemental income to cover expenses and the remainder, or some portion of it, is allocated to growth oriented securities. Instead, HMR would apply their model to obtain the appropriate allocation and use income, capital gains, and principal, as necessary, to finance consumption.

Most clients are reluctant to use principal, and especially for young retirees (younger than 75, for instance) a typical practitioner likewise will be reluctant. Some planners rely on matching income to expenses, and will make adjustments in investment risk to produce increased income. Of course, this is the way that so many widows looking for increased income migrated up in risk-taking from CD's to junk bonds as interest rates dropped in the mid 1980's.

However, under some circumstances, it is inevitable, even desirable, for a client to tap principal to pay expenses. Many planners fail to recommend this responsibly by including in their plans back-up strategies such as reverse mortgages, supplemental income programs, and expense subsidies. A comprehensive plan will include projections of the social programs that would be available should funds be depleted; this planning increases the likelihood that should the situation arise, the client will be eligible for benefits when needed.

As we observe the results of HMR's model, the most striking implication is the importance that equity plays in the portfolio, even in the later years. The authors anticipated that this would be surprising to those of us who generally expect large equity holdings to pose excessive risk to most aging retirees.

However, the result is not as surprising when the construction of the model is examined. It is the authors' use of the volatility of the real return after inflation for both the treasury bills and the equity in the portfolio that drives their results. They remind us that the risk-free asset is only *default risk* free, not entirely risk free.

But the emphasis on equity can be supported intuitively when we consider a few societal changes over the years. Retirement is occurring earlier today, partly due to corporate tightening that encourages early retirement and reduces job availability. When they do retire, most individuals are healthy and look forward to an extended retirement period; in fact, the fastest growing segment of our population is the 85 + age group. So it is no surprise that retirees, especially women, need to pay more attention to growth oriented investing than they ever have before .

Their reminder to consider equity in older individual's portfolios may be HMR's most significant contribution to the practitioner.