A TACTICAL APPROACH TO MANAGING INVESTMENTS SHOULD BE THE CORNERSTONE OF THE RETIREMENT CONVERSATION

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At RPg Asset Management, we see problems emerging as the greatest generation is in retirement and the baby boomers continue to move into retirement. The issues are a convergence of a number of factors:

1. Countries raising the age to start benefits, slashing the amount of the benefit, and life expectancy growing.
2. Companies having eliminated traditional pension plans and pushing the burden onto the workforce via self-directed plans like 401(k)s.
3. Investor's savings rate remained low entering the Great Recession, and subsequently saw much of their wealth disappear upon its onset.

The Organization for Economic Co-operation and Development (OECD) says the average man in 30 countries the OECD surveyed will live 19 years after retirement. That's up from 13 years in 1958, when many countries were devising their generous pension plans[1]. Compounding that issue is that birth rates globally are falling just as a bulge of people born in developed countries after World War II are either in retirement or entering retirement, and the world's stock markets are at record highs, as are the debt levels in many developed countries. Or in other words, we are entering a period with far more retirees and far fewer workers to support them.

In addition, the outlook became worse after the Financial Crisis of 2008 when the world's central banks cut interest rates to record lows to stop the economic free-fall. While that worked for investors in risk assets (equities, Emerging Markets, REITs, etc.), it punished fixed income investors with much of their money in investments that pay interest (CD's bonds, money markets).

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In response, governments are raising retirement ages and slashing benefits. In 30 OECD countries, the average age at which men can collect full retirement benefits will rise to 64.6 in 2050 from 62.9 in 2010; for women, it will rise from 61.8 to 64.4[1]. In wealthy countries it studied, the OECD found that the pension reforms of the 2000s will cut retirement benefits by an average of 20 percent.

In addition to governments slashing benefits, corporations have shifted the responsibility and risk for retirement savings to employees. They've moved from the defined-benefit pension they used to provide as they don't want to bear the risk and costs of guaranteeing employees' pensions. Instead, they have moved to "defined-contribution" plans which shift the responsibility for retirement savings almost entirely to the employee.

Now that we have multiple decades to analyze the effectiveness of the defined-contribution plans, they have proved to not be so effective as people haven't taken advantage of them, nor have they managed them well. Employees don't always enroll, they don't contribute enough, and they dip into the accounts when they need money. In the U.S., 26% of workers with a 401(k) plan take loans or hardship withdrawals before they reach retirement[2].

They also make poor investment decisions. According to the consulting firm Towers Watson, defined-contribution investment plans return 0.76% below that of the defined-benefit plans. That may not sound like much, but on a portfolio annualizing 5% for 30 years, $100,000 would grow to $432,000. At 5.76% annualized return for 30 years on the same initial investment would grow to $537,000 or 24% more[3].

This lack of performance can be linked to the cognitive decision making process that occurs during large equity drawdowns. Many participants purchase stocks when times are good and share prices are high, and they sell when prices are low. Large drawdowns are not usually the problem, rather the emotional decisions made during drawdowns that can permanently impair a portfolio.

As the global equity markets continue to rise and US markets hit all-time high levels, many retirees have been frightened away from utilizing equities as the cornerstone of their asset allocation. Equities can be riskier than other investments, but they generally provide greater return characteristics than many other asset classes. This is an important feature as we are living longer and hoping to spend more years in retirement than ever before.

Because of equity risk, many investors have been under allocated to the asset class coming out of the Great Recession while the world's stock markets have soared. In addition, many Americans spent a number of years before the Great Recession borrowing and spending rather than saving for retirement. According to the Federal Reserve Bank of New York, U.S. households took on an additional $5.4 trillion of debt from 2003 through mid-2008[4]. The savings rate fell from almost 13% of after-tax income in the early 1980s to 2% in 2005[5].

Meanwhile many of the Investment Committees that publish their asset allocation models think of asset class time horizons in terms of centuries, when the average investor is seeking to simply have their nest-egg outlive them in retirement - which could be 20 – 30 years. This disconnect leads to differing definitions around risk. Institutions generally use measures like standard deviation and/or tracking error to a benchmark, while individuals typically think of risk as loss of capital.

With a significant difference in the way institutions define risk from the way many investors define risk, tactical asset allocation models may make for a logical solution. Tactical investing can involve quantitative models that are used in an effort to reduce volatility, limit losses and remove the cognitive biases that enter the investment decision making process. Many strategies look and sound logical and have mass appeal especially at times when investors have fresh memories of significant market declines and multi-year bear markets that decimated portfolio values.

At RPg we provide Global Tactical Asset Allocation solutions that are rules-based and primarily seek to avoid bear markets while materially participating in upwardly trending markets. Our models have the ability to take any asset class to 100% cash if our model expects a negative return from the asset class. We utilize Exchange Traded Funds (ETFs) that provide exposure to global markets in the major asset classes and understand that when an investor is taking withdrawals to endow their retirement (cover liabilities through retirement), the path taken to earn returns matters.

[1]OECD Pension Indicators

[2]HelloWallet online services

[3]Towers Watson, "Defined Benefit Plans Outperform Defined Contribution Plans Again – Should We Care?" July 2013

[4]Federal Reserve Bank of New York

[5]Bureau of Economic Analysis

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