



Rational Advice for Anxious Participants

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The last time the global financial markets experienced such volatility and turmoil, the retirement planning landscape was entirely different. In 1973, 401(k) plans didn't exist; ERISA wasn't enacted until September 2, 1974. With defined benefit plans, individual participants did not suffer major retirement setbacks during down markets and investment committees, not individuals, controlled the pooled investments of profit-sharing plans.

Today, most people are responsible for their own retirement planning. 401(k) plans require employees to decide how much to save, what investment choices to make, and even whether to participate at all. Recently, those who have them have experienced major losses in their 401(k) accounts. Even age-based QDIA investments based on target date funds have been disappointing. Some 2010 and 2015 funds have suffered significant losses.ⁱ Emotional times like these often lead investors, both individual and institutional, to make decisions that can have major negative repercussions on their long-term investment goals. This is when an advisor's guidance can be extremely valuable. While it may not be possible to recoup last year's losses immediately, just keeping participants on the right track can be invaluable for the long-term.

A recent article in *The Wall Street Journal* detailed the experiences and proposed responses of several 401(k) participants.ⁱⁱ One was a young man who had built a \$100,000 balance prior to the recent equity selloff. Believing he was diversifying, he had invested in four different styles of equity resulting in a very aggressive portfolio. Unfortunately, as a good advisor would have told him, he was not truly diversified — all four equity styles were highly correlated. After recent losses, he now worries that he will no longer be able to meet his retirement goals. Another participant was planning to retire in 7-10 years, but after her 2008 losses, she now plans to keep her remaining balance in cash equivalents. As an advisor, you know these may not be the best responses, but what can you do to help steady the course for similar participants in plans you are servicing? An illustration may be helpful.

Before the Storm

Consider a 45-year-old male participant invested in 100% large cap equity funds and saving 6% of his salary. He has a high risk tolerance and many years before retirement, so he believes his aggressive portfolio is appropriate. He doesn't have any way to analyze the risk or to develop a good strategy, and like most



participants today, he doesn't take much of an active role in his 401(k). He earns \$50,000 a year and has an account balance of \$100,000. (This example is similar to the first participant described above.) Because of his good saving habits, he has an 80% chance of being able to retire at age 66 with 90% of his pre-retirement income.ⁱⁱⁱ

Interestingly, an analysis of this situation shows he would actually have a greater chance of success with lower risk if he had only 60% in equities instead of 100%. Had he realized this, he would have enjoyed increased downside protection and would be in a much better position after the selloff in 2008.

Retirement Variables	Current Strategy	Suggested Strategy
Savings Rate	6%	6%
Investment Strategy (% Equity)	100%	60%
Retirement Age	66	66
Retirement Income	90%	90%
Chance of Success	80%	83%

After the Market Turmoil

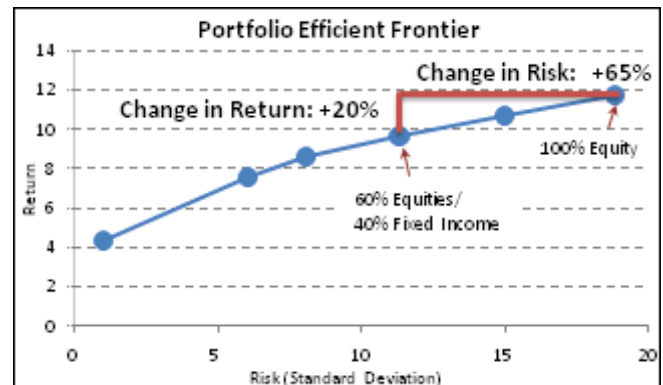
Since the participant retained 100% equities throughout 2008, his account balance likely dropped from \$100,000 to \$50,000 — a very bad year. As illustrated by *The Wall Street Journal* article mentioned above, it is during times like these that participants panic and either stop contributing altogether or invest too conservatively. The following comparison shows this participant's chance of success, given his lower account balance, using different strategies. Notice that the 60% equity strategy, which would have been a better choice before, is still his best alternative. Younger participants may feel that after losing 50% of their savings, they need to invest aggressively (100% equities in this illustration) to quickly make up lost ground, but the 60% equity portfolio has a slightly higher probability of success with considerably less risk.

Retirement Variables	Current Strategy	Suggested Strategy	Alternate Strategy
Savings Rate	6%	6%	6%
Investment Strategy (% Equity)	100%	60%	20%
Retirement Age	67	67	67
Retirement Income	87%	87%	87%
Chance of Success	75%	76%	38%



Letting fear rule and switching to a more conservative mix (like the second participant described above) actually lowers the probability of success. For the younger participant, keeping even 20% in equities has a very low chance of success unless he is willing to work longer.

It may not be intuitively obvious why some of these calculations work the way they do, but in retirement planning, it is important to remember that the goal is to have enough money to last through retirement. When planning for retirement, there is no benefit to having money left at the time of death, so the extra return does not work the same way as it would if the goal was maximizing wealth or building an estate.



A comparison of the expected risk and return for the 60% and 100% equity portfolios shows that the risk increases by 65% (11.34% vs. 18.86% standard deviation) while the expected return only increases by a little over 20% (9.63 vs. 11.69%).^{iv}

Summary

For anyone providing education or advice to participants, this example holds a few lessons:

- Even after the losses of 2008, the reality may not be as bad as the perception. In the above example, a 45 year old who lost 50% of his money can get back to where he was by working only one extra year. There is no need to panic.
- For younger participants who have not accumulated a large balance, now is the time to save as much as possible. Not only will they benefit from the leverage of a company match, they will buy into a market at the lowest prices in decades. Whether the market improves in 2009, 2010, or later doesn't really matter.
- Don't assume that a participant should be invested in a portfolio based on the risk tolerance from a questionnaire. Use typical planning tools with caution. Most calculators only analyze and recommend the most



aggressive portfolio within the risk tolerance of the investor. But, as in the example above, there are many instances where a lower risk portfolio, even with a lower return, will provide a better chance of retirement success.

- Studies show that people have a better chance of meeting goals when those goals are specific, personalized, have a rational process behind them, and are supported by a regular measure of whether or not the individual is on track to meet the goal.^v When working with participants, it is important to develop a process that can meet those criteria rather than simply rely on a general education meeting or sending the participants out on their own to execute and keep track of the results. One-time advice may be better than no advice, but without ongoing reporting to measure a participant's progress, no plan is truly complete.

Conclusions

Most retirement plan participants in the U.S. have been very hard-hit by the recent market turmoil, and now they are looking for answers. The typical participant does not have the knowledge or experience to make rational decisions about investment and savings strategies for retirement success. They can definitely benefit from your considered guidance, now more than ever.

Your challenge as an advisor is to offer personalized advice to all participants in the plans you service, and to do so in a cost-effective way. Even if you offer private consultations to each participant, many won't take advantage of the opportunity. The best, and most efficient, alternative is to deliver a personalized savings and investment strategy to each participant that doesn't require their input. A new generation of software tools now brings this ability within reach.^{vi} Advisors servicing retirement plans should seriously consider using such software. It is not sufficient to rely on traditional planning tools given retirement planning's unique objectives. One thing is certain: Participants are looking to you to set the right strategy and to keep them on course.

ⁱ See, for example, "[Bear Mauls 'Safe' Target Funds, Too](#)", *The Wall Street Journal*, January 10, 2009, by Tom Lauricella

ⁱⁱ "[Big Slide in 401\(k\)s Spurs Call for Change](#)", *The Wall Street Journal* January 8, 2009 by [Eleanor Laise](#),

ⁱⁱⁱ These calculations hold the savings rate constant at 6% and include an employer match and other assumptions typical for plan participants. The portfolios for this example are comprised of combinations of Large Cap Equities and Fixed Income. At retirement the investments are switched to a 20% equity portfolio in the simulations. All calculations in this article were performed using *K^d Plan Goals* from Klein Decisions.

^{iv} The assumptions for risk and return are arithmetic designed for use in Monte Carlo simulations. The portfolio assumptions are based on long term asset class assumptions developed by Prima Capital for use in *K^d Plan Goals*.

^v See Edwin A. Locke & Gary P. Latham, "Building a Practically Useful Theory of Goal Setting and Motivation"

^{vi} Klein Decisions' *K^d Plan Goals* is one such tool. It not only enables the advisor to offer a personalized savings and investment strategy for each participant, it also measures and reports the overall health of the plan. For details, go to www.kleindecisions.com/products_plan_goals.htm, or call 919.233.6767.

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