Zvi Bodie on Stocks and Annuities in Retirement

By Dan Richards
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Zvi Bodie is Professor of Finance and Economics at Boston University School of Management and has served on the finance faculty at the Harvard Business School and MIT's Sloan School of Management. Professor Bodie has published widely on pension finance and investment strategy. His textbook, Investments, is used in the certification programs of the Financial Planning Association and the Society of Actuaries. His latest book is Worry Free Investing: A Safe Approach to Achieving Your Lifetime Financial Goals.

Dan Richards interviewed Bodie at the CFA Institute annual conference in May.

A video of this interview appears here.

I want to talk today about your argument that stocks in the long run are riskier than many people believe. Where does that opinion come from?

What's interesting to me is, how did people ever get the idea that stocks were less risky? You figure the longer you are out there the higher the chance you're going to deviate from the right path. Think about it in terms of hurricanes. You are trying to predict where a hurricane is going to hit the coast. How big is the area of uncertainty when it is far away?

If you go further out in time, you are getting further away from you're starting point. Things that would seem only remotely possible in the short term -- and of course I'm talking about bad things as well as good things -- become probable. People talk about this in terms of the lower tail of a distribution. Books have been written about this, especially lately, because these highly improbable events in the stock market have happened with greater frequency than they should.

So your thesis is quite plausible. The further you go out the greater the uncertainty you experience.

This is really important -- even though the probability of a loss, of an extreme loss is low, it's actually higher in the long run. Extreme losses have a greater chance of happening the further out you go.

The major proponent on the contrary side, most people would agree, is Jeremy Siegel of Wharton, whose very well-known book, *Stocks for the Long Run*, is sometimes cited as one of the top 10 most influential books on investing ever. His research going back to the early 1800s would draw a different conclusion, that stocks are risky in the short term, but the longer you hold them, based on nearly 200 years of data, the lower the level of volatility and risk. How do you respond to that?

The difference between our positions on this is a lot smaller than you might think. Jeremy has never said that stocks become safe in the long run. At least when I am debating him he is very careful and how he states it. He says, stocks are not as risky as you might think they are. He believes there is a kind of mean reversion which doesn't make them safe. It just makes them safer than they otherwise would be.

In my view, stocks are still very risky. Jeremy wouldn't disagree with that. When it comes down to actual policy decisions, like what should your mother be investing in when she retires, Jeremy supports the idea of inflation-protected annuities based on TIPS. But he is constantly reminding people, and I agree, that means you're probably settling for a low rate-of-return in return for reducing your risk exposure. But that's what investing is all about. It's trading off risk and return.

Say you were talking to a 60- or 65-year old investor and they were to ask what scenario they should be most concerned about – inflation, a double-dip recession, or the market crashing further. What would your answer be?

My answer would be that you always want to look at several scenarios, and then try to assign probabilities to them. One of the mistakes that a lot of analysts make is to consider only one scenario. You hear this all the time on television in an interview with someone who is bullish, and then someone else who is bearish. How do they possibly know? Why aren't they considering probabilities?

Let's take inflation as an example. We've had this tremendous run-up in government debt in the United States and everywhere in the world. Some people are saying that's going to have to be monetized. That means we're going to have runaway inflation or at least very high rates of inflation in the next few years. Prominent analysts are saying that. Then the next guy or woman makes the case for why, because we've had such a severe recession, we're going to have prolonged unemployment. It's going to be like Japan, with a long period of deflation.

I don't know about you, but I think both of those things are possible. I wouldn't go with either one of them as the most likely scenario. In fact, I probably would average them out and say we are going to have inflation that's somewhere in the middle, but there is a high degree of uncertainty about it.

That is the spirit that a risk manager brings. That's the essence of risk. It constantly amazes me that people in the finance field who study markets and have seen in the past how wrong their forecasts can be, as recently as the last decade, still make point forecasts of the future with absolute certainty and great confidence. It seems nuts to me.

There is an upcoming revised edition of the book which you co-authored, Bodie, Kane and Marcus on *Investments*, the number one text for investments in universities around the world. What led to you and your co-authors to write the first version of that text back in 1987?

It's been a long time. We were teaching a course in investments in the MBA program at Boston University. The textbook that we used at that time was by Bill Sharpe (a Nobel Prize winner) which we thought was a wonderful book, and had been a big change from the textbooks that came before him. He was really the first author to take an economic approach to the subject. Although we loved the book, students didn't like it.

Was it too complex or difficult?

Yes. We found ourselves writing up all sorts of supplementary materials, and then re-ordering and reorganizing our teaching plan. The Sharpe book and other books that were out at that time talked about managing a portfolio of risky assets, where all the assets were risky. Once they talked about that – that's called a Markowitz model – then they would add a safe asset and derive what's called the efficient line, capital market line, or capital allocation line.

We said that's not the most understandable way to do this. It's actually much simpler, for a host of reasons, to introduce students first to the idea of combining a safe asset with a risky asset. Indeed, that is the way it's done in a lot of the economics literature, one safe asset, one risky asset, and then later talking about how you get the composition of that single risky asset. We had a hard time in the writing stage of the book convincing other professors that our way was better, but we basically won most people over, and that's the way it's done now.

The last edition, the eighth edition, was released two years ago, which is not a long period of time. What's changed in the last two years that caused you to update the book?

The big change that we are going to see throughout the investment industry and the advisory industry – and it's already occurred in many ways – is a shift of emphasis from performance to risk. Think of the two elements of investing as being reward and risk, and trading them off. Over the last 30 years, under the influence of the long bull market in equities, the emphasis really was on performance. You talked about risk a little, but it wasn't really the main thing.

There was a conventional wisdom that developed which is totally false, that as long as you have a long time horizon, the risk goes away. You don't have to worry about it that much if you are a long-run investor. That was never right. Now I think there's a heightened awareness that it isn't right, and an openness on the part of investment advisers and lots of people that I speak to, who in the past wouldn't give me the time of day because I was constantly emphasizing the fact that you have got to worry about risk. Now they are interested in hearing what I have to say.

You are well known for your recommendation that investors, if they can possibly do so, should hold exclusively inflation-protected bonds when they retire. They should sell their stocks and shift to bonds.

I'm glad you're giving me an opportunity to correct that statement. I may have said it, but I certainly didn't mean it. Or if I did mean it at that time, I'm changing my mind.

What I really meant to say is the logical place to start thinking about what you want to hold when you retire is a portfolio that is as free as possible of risk. It is one that gives you the most complete protection against inflation risk, market risk, and other forms of risk, and then you can see how much income that produces. That's you're starting point. It's not the ending point. You may decide, given that level of income, that you're willing to go for more risk. But you must recognize that if you shift some of your money into equities, then you want to take risk, and you could wind up with less.

Let's say you are willing to put 10% of your money at risk. You could lose it. That means you're only going to have 90% of what you would've had. There's no way of getting around that.

So you're starting point is the income you could get with an absolutely safe portfolio.

Correct, although no portfolio is absolutely safe, so a portfolio that is as safe as possible.

So you begin with inflation-protected government bonds, and then you start making trade-offs along the way.

Right. It's not just and inflation risk, it's also the risk of outliving your money. So you'd want to start with a life annuity as well, and see how much it costs to lock in an income that is going to last forever. As it turns out, you can actually wind up getting more income out of a given amount of retirement savings by annuitizing it (by buying a life annuity) than if you tried to manage it yourself.

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