Are stocks the only alternative for baby boomer investors?

By Matthew P. Havens, CFP®

A recent study from Citi Private Bank revealed that investors with $25 million or more of investable assets have roughly 40 percent of their assets in cash and 25 percent in equities. Harvard's endowment's latest disclosure shows that they have less than 33 percent invested in publicly traded equities. At the same time, recent data shows that over 2013 retail investors have been increasing their investment in equities. This behavior by retail investors is similar to what played out in 2000 and 2007 prior to what turned out to be significant declines in broad market averages.

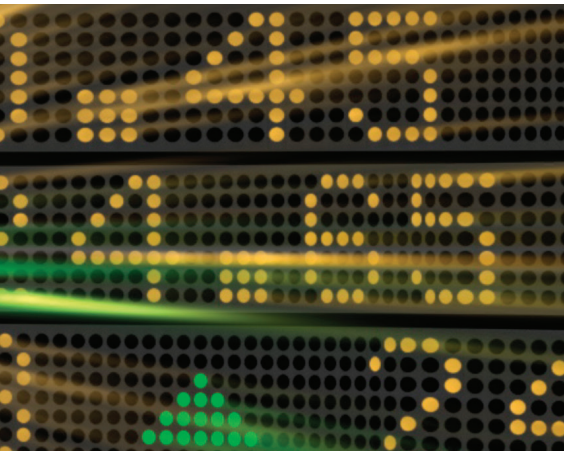
The question we want to consider today is: What do people approaching retirement or in retirement need to consider when planning their investment and income strategies? The first question should be: How much income do I need to live? The second: How can I safely generate the return I need to deliver that income over time? The third question should be: What would interfere with my ability to achieve that return over time? For instance, how would a large drop in the value of my portfolio affect my ability to maintain my lifestyle? Fourth, investors should ask: What type of investments or investment strategies can give me the highest probability of success?

There are many forces driving baby boomers toward investing in equities. The Federal Reserve, through its policies, is making it very difficult to earn a return in any other asset class. In 2013, bonds and commodities lost money. The fascinating psychology of investing has investors wanting to buy more of something after it has gone up. Another factor is that long-term-return numbers for equities used in financial planning software make asset allocation models lean toward equities to drive returns. These historical numbers always look better near market peaks. Should investors respond to the forces driving them toward equities or resist? Consider that if you retired in 2000, your investments in stocks have generally underperformed inflation for the last 14 years with two 50 percent declines along the way.

This increase in volatility is a really important consideration because volatility is easier to withstand during the accumulation phase of an investment strategy. Volatility can have a significant negative impact on portfolio sustainability during the distribution phase. This has been a lesson learned all too painfully in recent history and is borne out in many academic and industry research papers. Investors have been lulled into a sense of comfort that even if markets go down again, they will come right back. Unfortunately, even if this is the case, withdrawals during declines can have a long-term impact on income strategies. There are fundamental reasons to be cautious of equities as well.

Boston Firm GMO headed by Jeremy Grantham is well known for their diligent value investing and asset allocation strategies. In November they released research titled "Breaking News, U.S. Market Over Valued" that suggested that U.S. stocks were 75 percent overvalued. Their forecast was that U.S. stocks would deliver negative returns for seven years. They made similar forecasts based on their valuation work in 2000 and 2007 and while not popular at the time, it turned out to be quite precient. This analysis suggests that stocks would either have to fall 45 percent to reach fair value or stay flat for long enough for earnings to catch up. The idea of a stock market falling 50 percent should not sound like such a stretch given that we have experienced this twice in the past 14 years.

Fortunately for baby boomers and other investors, the choice of investment products has grown tremendously in the past 10 years. Investments that had previously been available only to very large institutional investors allow smaller investors to consider diversi-



fying their investments – not just by asset class but by strategy as well. This is what the really "smart" money managed by the large endowments and foundations is doing. At the same time, the study from Citi Private Bank cited above tells us that even those with the resources to tap into the more complex investment strategies are choosing to keep a good portion of their money in the safest alternative possible. Even it means foregoing some potential gains in the short term.

Too often a cautious view of equities can be characterized as "Bearish" in a way that implies an emotional position. One does not have to be Chicken Little to see that markets and economies have cycles that go up and down. Planning for a comfortable retirement means having strategies for many potential outcomes. No one can predict what will happen next, but with the right planning you can prepare and increase your odds of success. When we think about what retiring baby boomers need to hear from their financial planners today, we think the right message is to proceed with caution.

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