

A NEW APPROACH TO PLANNING FOR RETIREMENT

By
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Overview:

As part of a portfolio management team who has designed asset allocation portfolios using both actively and passively managed mutual funds, I am asked about our “performance” as if the answer could be used to gauge the past if not the future success of one or more of these portfolios. Investment selection can’t be compared with the purchase of an automobile. Knowledgeable car buyers shop around to find the car that is right for them as mutual fund investors do. Often, car buyers will rely on ratings reported by car magazines as the basis for narrowing their choices. Cars that are consistently in the “top ten” get the attention of car buyers because they can be expected to be worth the investment. Some buyers desire style and economy while others prefer speed and muscle; they all want some level of quality and reliability to justify a substantial commitment of wealth.

Selecting a portfolio of securities is a totally different process. For mutual fund investors, the equivalent “top-ten” rating in mutual fund parlance is a “five star” Morningstar rating. Investors, searching for ideas on what mutual fund to buy often rely on the rating system of Morningstar, a Chicago based firm that rates mutual funds from a maximum 5 star to a minimum 1 star rating. These ratings are determined through a complex methodology that primarily relies on the historic performance and risk characteristics of each mutual fund. Essentially, funds that have performed better than their peers garner a higher star rating than those funds that have not performed well. When investors attempt to use the same approach in picking mutual funds as they did selecting automobiles, the outcome isn’t as likely. For car buyers, statistics support continuity in automobile performance. However, for equity mutual funds, there are a number of studies demonstrating that last year’s mutual fund winners are this year’s average performers.

Misleading Performance

If past performance is a questionable benchmark for mutual fund selection, investors have to look elsewhere to determine investments that are appropriate for them. Virtually all of the performance data reported by either Morningstar or mutual fund companies do not portray the actual performance that all investors

experience in mutual funds. For mutual fund companies, the traditional formula for reporting investment results is a measurement known as time-weighted rate of return. This performance technique includes capital appreciation or the increase in the price of the assets, and dividends and interest as if the latter two cash flows were reinvested in the portfolio at time of distribution. There are no adjustments for taxes but all fund expenses have been deducted. One important distinction of this approach in measuring performance is that all other additions and withdrawals of money are ignored. The reason for ignoring cash flows such as new investors buying into a mutual fund is that, since portfolio managers can't control the flows of money into and out of a fund, they shouldn't have their performance tainted by such cash flows.

Unfortunately for mutual fund investors, this reporting technique can be very misleading. Mutual fund companies use historic performance as the primary method to attract new investors. Newspapers and magazines are crammed full of mutual fund advertisements that emphasize the beauty queens in their lineup of fund offerings. A beauty queen is a fund that is among the best performing mutual funds within a particular investment style. After these advertisements gain recognition by the public, investors are drawn to buying these funds and the result is an increase in the total market value of the funds—and a similar increase in the revenues and profits of the mutual fund company. Given our earlier assumption that past performance cannot forecast future performance, one could see how the majority of these new fund shareholders who purchased shares after favorable performance advertisements would find themselves with completely different performance results than the statistics being reported in the media.

One solution to this problem is the mandatory reporting of investment performance on a dollar-weighted basis. This calculation will weight performance based on the amount of assets that experienced good performance as well as the amount of assets that experienced the poor performance. Given the random performance of the good funds, one would expect to see that restating these funds' performance on a dollar weighted basis would provide an accurate gauge of what the fund did, on average, for all of its shareholders. Such an approach would also reduce the tendency for investors to be drawn into funds that had the best near-term performance.

Full-page mutual fund performance advertisements provide rates of return in comparison with other funds or indices but they seldom, if ever, provide a suitable measure of risk that correlates with the fund's performance. Under most

circumstances, better than average performance requires the investor to accept a higher measure of risk—in the form of price volatility—to achieve above average returns. When those five star funds are coupled with a number first or second place finish in the asset class performance derby, there is usually a high-risk strategy behind that performance but a strategy that is not made clear to the investor.

Another distortion introduced into performance measurement standards is the backward looking skew that invariably characterizes the winners of the performance derby. Since the last quarter's performance or the last year's performance can be spectacular for one or more mediocre funds, that performance is spread over the cumulative three, five, ten year and inception to date performance of these funds. So, even if a fund has a weak performance history, a lucky last year can change the historic positioning of a fund and effectively re-write performance history. A similar performance disaster in the most recent performance period can distort years of good performance.

Another important distinction is investor characteristics. When variations in cash flow are the basis for measurement, there are two types of investors, the traditional lump-sum investor who takes a sum of money and invests it in the market all at once. Virtually marketing materials that exhorts long-term investing rely on statistics based on lump-sum investing. Mutual funds use a picture of the cumulative value of an initial investment, otherwise known as a mountain chart, to depict the value of long-term investing. Ibbotson Associates, a company that is known for measuring the long-term rate of return of different asset classes also uses an initial investment to demonstrate the performance differences among asset classes over varying time periods.

The problem with this traditional approach is that many of today's investors are people who are saving for retirement through systematic investment programs like 401(k) plans or 403(b) plans. These programs are characterized by a small initial investment and then systematic investments—usually deductions from payrolls—that are made to build wealth over long periods of time for retirement. For these investors, what is considered a bear market for traditional investors is actually a bull market because they are purchasing financial assets at a discount during a market decline. These systematic investors with a long-term horizon are better off because, if the market is weak in the short-term, they will have the opportunity to build a larger nest egg for retirement or the stock market won't have to go up as much to get them to their planned nest egg. Few if any mutual fund companies advertise the advantages of this strategy in performance exhibits

yet such characteristics should encourage retirement plan investors to choose a higher return/higher risk investment strategy for most of their working years and then gradually step down the risk of their portfolio by choosing an asset mix that is less volatile as retirement approaches.

Overcoming Investment Performance Detours

Traditional performance measurement techniques undermine the ability for individuals to save for retirement because they rely on near-term portfolio performance and encourage emotional buy and sell decisions based on this performance. We know that past performance is not a reasonable basis for judging what an investment will do in the future. Given this belief, what opportunities are available to investors to make reasonable decisions about investing for the future?

Two important distinctions that affect an individual's investment performance are timing and time. Depending on the valuations of the stock market, a commitment to stocks can be either a good or bad idea even within the framework of long-term investing. One example of this timing is the decision by many older workers to take their entire pension plan assets and invest in aggressive growth mutual funds at the top of a stock market bubble in the year 2000. For these older investors, time is no longer an ally. Neither was timing. By transferring a lump sum of their portfolio into high-risk mutual funds at the top of the market, the subsequent 50% or greater decline for some of these short-term opportunists permanently debilitated their ability to retire to a standard of living that they had been expecting. For many of these investors, working beyond retirement age may be a mandatory choice to rebuild retirement savings.

On the other hand, the young investor who began a long-term retirement plan at the top of the market in 2000 with a systematic investment strategy benefited from the stock market decline because of systematic purchases during the declining market. For the young long-term investor, time as well as timing is on his side. These examples point up other factors that can affect performance—the key is who you are and when and how you invest.

Once we get over these performance measurement hurdles that persuade us to make frivolous investment choices, we will answer the question of what can an investor rely upon to make the right choice when investing for both long-term and short-term results.

Using Investment Performance to Develop Investment Strategy

Past performance can be an effective tool in understanding the vagaries of stock market investing. Over the past few years, we have been developing a measure of investment performance that is valuable when used within the context of a long-term investment strategy coupled with the long-term return characteristics of different asset classes.

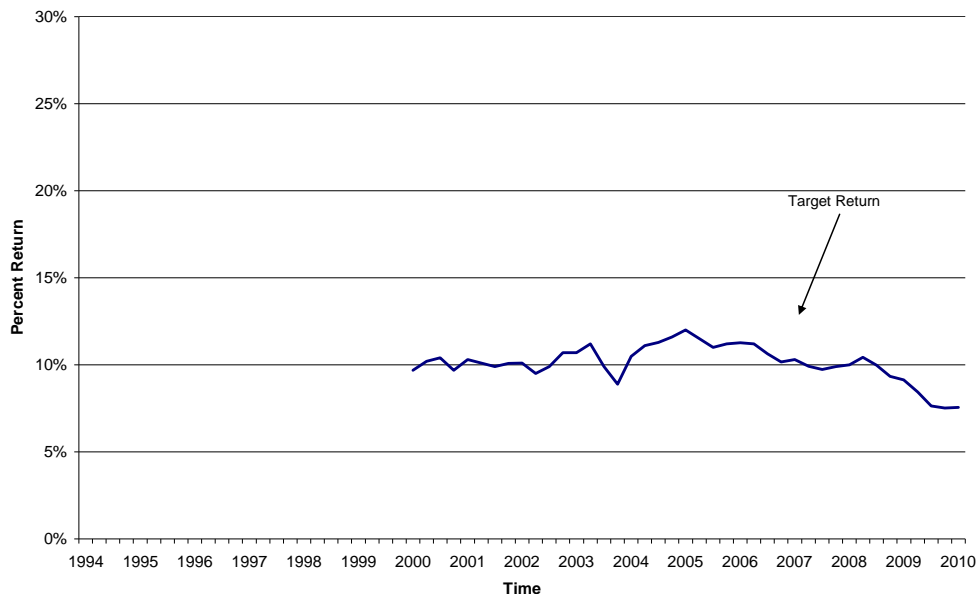
A long-term investment strategy should be based upon the historical returns of different asset classes coupled with an assessment of what those returns could be in the future. Using a traditional top-down approach, adjustments can be made to the historical long-term returns of different asset classes to reasonably determine what those returns might be over the next seven to ten years and beyond. Once these adjustments have been made to the return expectations of selected asset classes, portfolios of mutual funds can be constructed that offer varying rates of return coupled with expected volatility. As time passes and each asset class experiences varying degrees of above average or below average returns, the long-term return target return can be adjusted accordingly. To demonstrate this forecasting technique that we call portfolio return targeting, the following exhibit displays our historical forecasts for the target return of our Portfolio III, a balanced portfolio.

In 1994 we created portfolio return targeting as the basis for designing five asset allocation portfolios. This approach was not the same as forecasting rates of return. Rather the setting of target rates of return for different mutual funds took into account the long-term rate of return of the asset class, the success or failure of a given fund relative to its benchmark and the expenses of the fund that detracted from long-term performance. Once these targets were established they were used as the basis for the construction and weighting of five model portfolios, each with a different return and risk profile. We constructed each of the portfolios to meet specific return criteria so that investors would have a choice among these five portfolios to achieve their desired investment objective. These portfolios were also systematically designed to fit into a life cycle plan so that a young investor could invest in a high return portfolio and then gradually lower the risk of his portfolio as retirement drew near. In order to present this strategy in a graph, we have created a series of exhibits that allow investors to see how important long-term planning and asset allocation can be when saving for retirement. For brevity, we have tracked only one of the five portfolios created using this process.

The red line on Exhibit #1 represents the changing portfolio target for the total return of Portfolio III over the time period that we targeted portfolio returns. While traditional methodology relies on past rates of return only to project future rates of return, the new strategy is to modify these target rates of return based upon the volatility of short-term return and incorporate these changes into our new target return.

This approach provides additional flexibility in the rebalancing of portfolio weightings in order to adjust to the changing near-term returns of specific asset classes that may be experiencing a shift in long-term returns. One example of such a change is the return targets for some fixed income asset classes whose return target is dominated by the current interest rates on securities of similar maturity. As interest rates fell during recent rallies in fixed income markets, our downward adjustment in the long-term return of fixed income securities has produced a lower portfolio target for those portfolios holding larger quantities of fixed income securities. Such revisions in equity return expectations could also occur after a major stock market advance or a major stock market correction.

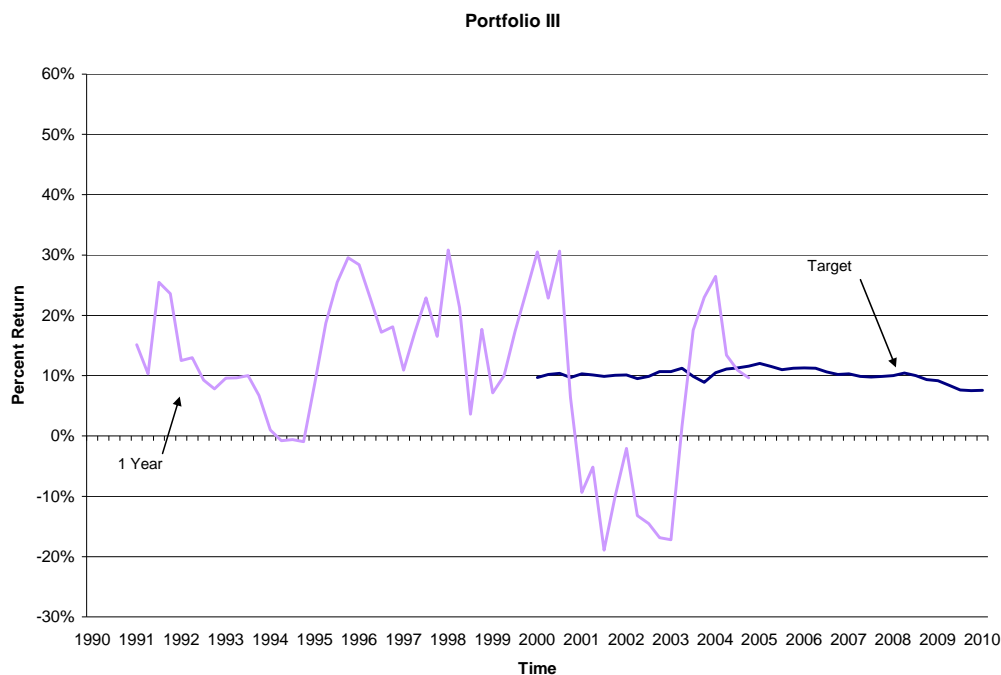
Exhibit #1
TARGET RATES OF RETURN
Portfolio III



The portfolio target return also fluctuates because we make adjustments in the targets for each asset class based on a combination of changing economic events.

Our actual portfolio experience is from early 1991 and in Exhibit #2 we contrast the target rate of return with the actual one-year performance of Portfolio III. The dotted line represents the actual one-year moving average of quarterly results as a measure of short-term portfolio returns. The exhibit demonstrates that short-term performance is very volatile. One caveat is that the volatility of this measurement period is one of the highest on record as the stock market experienced record highs and record subsequent declines over this time. Yet, swings in magnitude of a positive 30% followed by declines of 20% on a year-to-year basis could undermine the conviction of an investor who does not have the conviction needed for a long-term commitment to equity investing. The exhibit also demonstrates that, depending on when an investor chose to make an initial investment, their short-term performance relative to the benchmark can be either exciting or depressing. The spread between the highs and lows of one-year performance data also demonstrates the risk of using short-term performance to make investment decisions. In other words, short-term results have little influence on the consistency of long-term returns nor any relationship to demonstrating the reliability of the long-term target return for any of the five asset allocation portfolios.

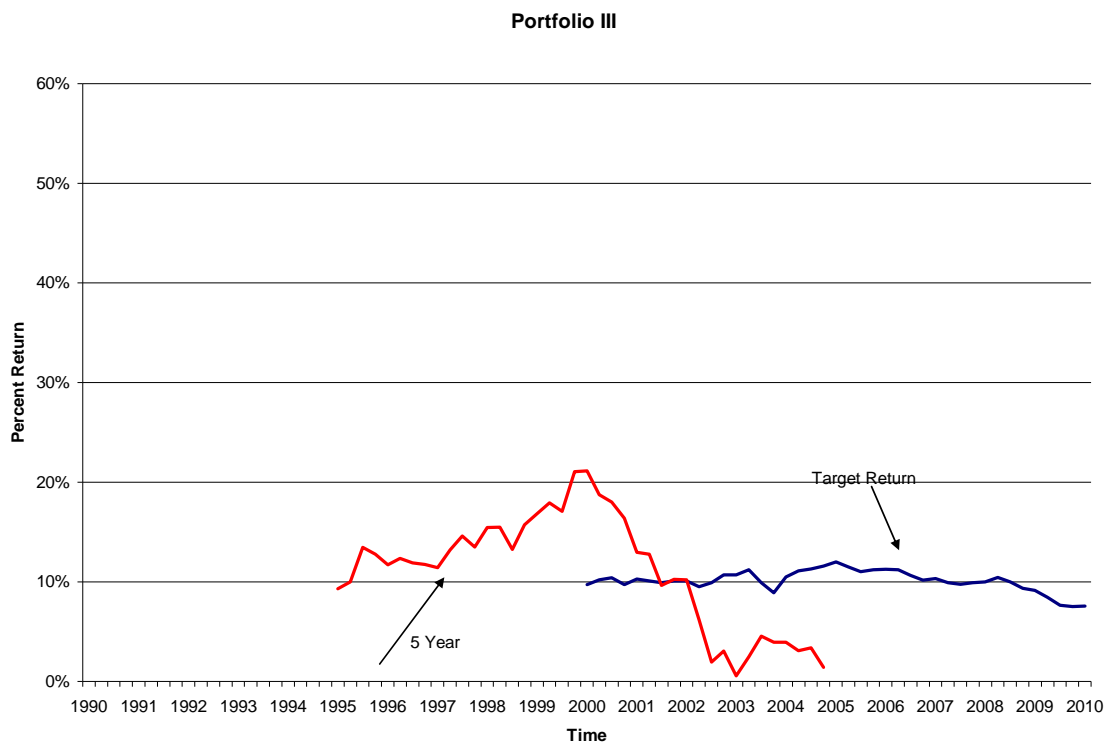
Exhibit #2
ONE-YEAR RATE OF RETURN VERSUS TARGET RETURN



Advocates of long-term investing prefer to look at a minimum of five years of performance before drawing conclusions about the success or failure of an

investment strategy. Exhibit #3 represents the performance of Portfolio III relative to the portfolio target return. This exhibit reflects the historically weak stock market performance over the five years ended in December of 2004. As Exhibit #3 demonstrates, the absence of including a full market cycle in the performance time period can also undermine confidence in a long-term perspective. However, the exhibit also can be interpreted in a positive light in the sense that over all five year periods, the portfolio returns of Portfolio III never fell below zero so that a five-year holding period through the worst bear market in our lifetime did not result in a loss for investors who held the fund for a minimum of five years.

Exhibit #3
 FIVE-YEAR RATE OF RETURN VERSUS TARGET RETURN

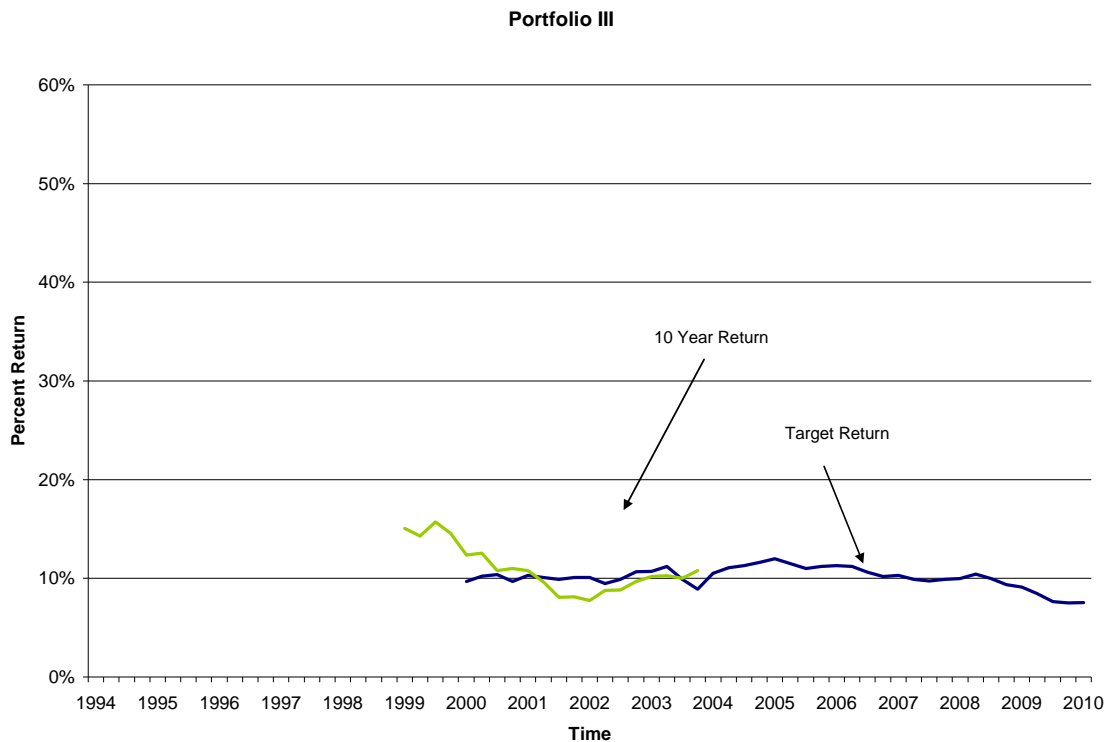


In order to assess the long-term performance of Portfolio III, we can look at the actual performance experience of this portfolio over a ten-year period, a time period that captures both the rise and fall of the stock market—a full market cycle. Exhibit #4 reflects the ten-year performance of Portfolio III relative to the long-term target return. By incorporating both the great bull market of the late Nineties and the great bear market of the early Twenty-First century, the highs and lows of these dramatic events tends to smooth the short-term volatility of the

market. The result is that Portfolio III has moved remarkably close to the target rate of return we developed for this portfolio some ten years ago.

By developing a performance measurement system that incorporates a long-term target rate of return and the analysis of both short-term and long-term rate of return experience associated with the balanced portfolio within the five asset allocation portfolios, we have been able to demonstrate that the actual long-term portfolio results tracked reasonably close to the target returns even though this measurement period incorporated the greatest bull market and greatest bear market of our lifetimes. The visual analysis of short-term results also reveals the enormous volatility in the performance of this portfolio and the risks that are obvious if short-term investment decisions are made based on these short-term results. In hindsight the savvy investor would have been selling stocks at the top of the market as measured by the short-term performance relative to the benchmark and buying near the bottom of the market based on these same measurements. Yet, we know that a systematic investor was making such decisions automatically by buying more shares of a fund during the market decline and less shares during the market advance.

Exhibit #4
TEN-YEAR RATE OF RETURN VERSUS TARGET RETURN



A review of the four other asset allocation portfolios reveal similar patterns with the lower reward portfolios showing less risk and lower returns while the higher return portfolios did in fact experience higher volatility. In virtually every case, the long-term results paralleled the long-term target returns that were developed over ten years ago.

CONCLUSIONS

By setting target returns for asset classes and then modifying these returns for the characteristics of individual mutual funds we were able to develop long-term target returns for each of the five asset allocation portfolios. An important aspect of these target returns is that they allow adjustments to the mix of mutual funds in each of the five portfolios to allow for a reasonable distinction among these portfolios based on target return expectations.

Over long periods of time we can track the actual performance of these portfolios relative to the target rates of return. The results have been gratifying. In virtually all cases, the actual long-term returns of the portfolios have approximated the target rates of return of these portfolios. These results can give a greater degree of confidence to long-term investors who are seeking out an investment program that has demonstrated results relative to a logical target return based on a combination of the historical return of asset classes and the varying distributions of different mutual funds in each of five portfolios to achieve varying return characteristics.

The use of the target return performance methodology allows investors to compare the actual returns of portfolios with the targeted returns over a long period of time and also presents the degree of volatility for each of the five portfolios. By tracking the short-term as well as the long-term results, the analysis provides for the quantification of the degree of risk short-term investors face as well as the degree to which systematic investors benefit from short-term market volatility.

This approach also can be used to invalidate traditional measures of investment performance that rely on absolute investment returns in a vacuum without any predetermined expectations for performance or without any viable timeframe to expect that performance. By eliminating the distortions caused by one recent year of outstanding performance and shifting to the viability of a long-term strategy, investors can avoid the pitfalls of getting mesmerized by the latest investment guru's performance record and a subsequent financial commitment that cannot be justified based on the historic volatility of investment performance among professional portfolio managers.

The strategy of target retirement date funds that automatically rebalance at specific points in time should also come under scrutiny as a viable investment

option because of the obvious avoidance of any dynamic asset allocation as a result of changing economic and financial circumstances.