Are Most Glide Paths Upside Down?

By Editorial Staff *Wed, Jun 3, 2015*

Investing in equities early in the lifecycle, when balances are low, offers little advantage and may even discourage young investors who suffer losses. So says one of the studies in this roundup of recent retirement research.

It's an axiom of retirement advice: Allocate the lion's share of an investment portfolio to equities early in one's working life and gradually reduce that share on the approach to retirement. This strategy is baked into target date funds—the default investment for auto-enrolled 401(k) participants.

But axiom dissolves into myth in a new study, "**Two Determinants of Lifecycle Investment Success**," published in the spring issue of *The Journal of Retirement*. Asset allocation doesn't matter much early in life, the authors argue, because account balances are low. What matters is the amount you contribute.

The conventional wisdom of having a high equity allocation in your 20s and 30s "doesn't make sense," said the study's co-author, Jason Hsu, a co-founder of Research Affiliates LLC in Newport Beach, Calif. "Under-contributing early on is so meaningful that you can't really fix that later with [riskier] allocation."

Monte Carlo results

To measure the importance of making larger contributions early, the researchers compared two hypothetical contribution patterns on a portfolio with 50-50 stock-bond allocations and average annual real returns of 4.6% on the stocks and 1.7% on the bonds. [Results for each scenario were based on one million Monte Carlo portfolio simulations.]

A participant who contributed $10,000 annually for the first 20 years and reduced it to $7,500 for the final 20 years would have, on average, a 22% larger nest egg—$734,000—than if he or she had contributed $7,500 for all 40 years, producing a $603,000 portfolio.

Flipping that strategy around didn't work as well. A participant who started with a $7,500 contribution and raised it to $10,000 in the last 20 years would achieve only a 12% larger portfolio than one who made constant $7,500 contributions for 40 years.

To quantify the potential impact of asset allocation later in life, the authors analyzed two sets of hypothetical portfolios. In one set, they compared results from portfolios with either a high or a low equity allocation early in the life cycle. In a second set, they compared results from portfolios with either a high or a low equity allocation in the years just before retirement.

A high-risk strategy (70% stocks/30% bonds) used in the early years of investing generated only $16,000 more, on average, in the account's final average balance at retirement than did a low-risk strategy (30%-70%) used early on. By contrast, the high-risk allocation at the end of the lifecycle generated a $66,000 larger ending balance than did the low-risk strategy in the final years.

Too risky, too soon

If losses occurred, a high equity allocation might even harm savers in their 20s, the authors (Hsu and Research Affiliates colleagues Lillian Wu, Vivek Viswanathan and Jonathan Treussard) concluded. They advised plan sponsors to recommend high contributions for young participants, and educate older participants about the potentially high impact of asset allocation on big balances.

"The importance of incentives and education motivating young workers to contribute to their DC plan completely swamps any benefit that might arise from selecting a higher-returning early-stage allocation scheme," the authors wrote. "In fact, considering the documented psychology and behavior of younger plan participants, we think the volatility associated with a higher-returning scheme might prove harmful to the eventual welfare of the participant."

Don't reduce equity allocation after retirement

Not everyone agrees with Research Affiliates' advice for young investors. In another article in the same issue of *The Journal of Retirement*, two BlackRock analysts recommend that target date funds should start with a high equity allocation and reduce equity allocation over time—but only until the retirement date. They see no logical reason for anything for a constant equity allocation during retirement.

In "**Reexamining 'To vs. Through': What New Research Tells Us about an Old Debate**," BlackRock's Matthew O'Hara and Ted Daverman assert that the glide path should flatten at retirement, based on the human capital theory that is used to justify TDFs in the first place.

Young workers by definition have lots of potential human capital, which provides them a regular paycheck for decades; this human capital is similar to a bond. To neutralize their implicit overweighting in fixed income, it's assumed that young people should invest heavily in equities. But when they fully retire and their human capital flattens out at zero, "the rationale for evolving the glide path [also] ceases," the authors contend.

The retiree should settle on whatever level of equity exposure he or she feels comfortable with, they write, citing the 1969 work of Nobel laureates as evidence: "Robert Merton and Paul Samuelson each independently demonstrated that… in the absence of labor income… the optimal strategic asset allocation is constant, with the amount of risk reflecting individual risk aversion."

'Boomerang effect' of peer information

A new **paper** in *The Journal of Finance* refutes prevailing academic beliefs about the way people behave in response to information about other people's behavior.

Older studies have shown that people who obtain information about the financial behavior of their peers tend to adapt similar behaviors. That isn't always so when it comes to 401(k) enrollment, according to "The Effect of Providing Peer Information on Retirement Savings Decisions," by Ivy League researchers John Beshears, James Choi, David Laibson, Brigitte Madrian, and Katherine Milkman.

In their case study at a manufacturing company, they found that only about 6% of the firm's union workers who didn't participate in their employer's retirement plan (and weren't eligible for automatic enrollment) enrolled after receiving information about their coworkers' savings habits. By comparison, there was a nearly 10% enrollment rate among union workers who *didn't* see the peer information.

But this "boomerang effect" wasn't universal. It was limited to the lower-paid employees, the researchers found. While workers with relatively high incomes were more likely to enroll after receiving the peer information, low-income workers were less likely to do so. They may have been "discouraged by the reminder of their low economic status," the researchers wrote.

Why the Swiss like their annuities

Americans don't seem to understand annuities, and they certainly don't buy them to the extent that academics believe they should. The Swiss, on the other hand, seem to love annuities.

Nearly two-thirds of Swiss workers convert the savings in their employer-sponsored retirement accounts into annuities at retirement, writes Benjamin Avanzi, a senior lecturer in the business school at the University of New South Wales, in a **paper** published in the *Australian Actuarial Journal*.

The reason can be found in the structure of the country's retirement system, he explains. The Swiss typically buy their annuities within their retirement plans, where they benefit from institutional pricing and the implied endorsement by employers they generally trust.

Also, because the Swiss can use retirement plan funds to buy a house or start a business as well as save for retirement, they tend to consolidate much of their savings in the plans and therefore accumulate large balances. This leads them to ask, "Why not annuitize at least some of this big sum?"

Switzerland's tax law also encourages its citizens to hold mortgages for life, and annuities can help pay that mortgage throughout retirement. Finally, the Swiss government provides survivor and disability benefits to children, which minimizes the bequest motive that can make Americans avoid annuities.

Bequests: IRA vs Roths

In ***The Journal of Personal Finance***, Baylor University professors Tom Potts and William Reichenstein challenge the assertion, made last year in *The Wall Street Journal,* that "Roth IRAs are good accounts to leave to loved ones." The paper demonstrates that it may depend on who has the lower tax rate, parent or beneficiary.

The authors consider a hypothetical elderly widow with $100 in a Roth IRA and $100 in a traditional IRA. Her average income tax rate is 40% and her son's is 15%. If the widow requires $60 for consumption, she can take it a) from her Roth IRA (leaving $40 in the Roth for her son when she dies) or b) she can empty out her traditional IRA to net her $60 in spending money, after taxes). But which would be best for her son?

Counter-intuitively, her son would be better off if she had spent down the Roth IRA, say Potts and Reichenstein. In the first scenario, the son would inherit the $40 left in the Roth IRA plus $85 (after paying his 15% taxes) from the traditional IRA, netting $125. In the second scenario, he would inherit only the $100 in the Roth IRA. (Reichenstein is co-author, with William Meyer, of *Social Security Strategies*, self-published in 2011.)

The cost of poverty? Six years of life expectancy

A well-paid 25-year-old American can expect to live six years longer on average than a 25-year-old living in poverty, according to a new study from the Urban Institute and the Center on Society and Health entitled "**How are Income and Wealth Linked to Health and Longevity?**"

The study attributes the shorter life spans to higher rates of heart disease, diabetes, stroke, emphysema, depression and hunger. Health may be harmed by such factors as a lack of access to nutritious food and well-stocked grocery stores, high crime rates in their neighborhoods, fewer screenings for cancer and other diseases, overcrowded schools, polluting industries close to home and longer commutes to work.