Mad Men

By Editor Test *Tue, Mar 27, 2012*

The leitmotif of the Retirement/Pension track of the Society of Actuaries Investment Symposium in New York on Monday was that risky assets and pensions mix like, say, metallic sodium and water. Explosively, that is.

Stocks were battered on Monday, but the bloodletting didn't happen on any stock exchange and Bloomberg didn't report it. The damage occurred at the Roosevelt Hotel on Madison Ave., during presentations at an otherwise composed Society of Actuaries meeting.

The SoA hosts periodic Investment Symposiums, and this one was staged in New York. One of the event's four subject tracks—Retirement/Pensions—was of relevance to *RIJ* readers, as was a session on demographics and investments, where financial pundit Robert Arnott was video-conferenced in from Budapest.

For me, the leitmotif of the Retirement/Pension track was that risky assets and pensions mix like, for instance, metallic sodium and H_2O. Explosively, that is. The critique of equities, or more specifically, of equities as the most appropriate feedstock for retirement income flooring, came from several angles:

1) Longer time horizons don't make stocks safer,

2) Asset-liability matching is the only way to ensure positive pension outcomes,

3) TIPS, not equities, should be the primary raw material for generating essential retirement income,

4) As Boomers age, demand for stocks will fall.

If there were any bulls at this meeting, they were repeatedly gored—at least by the speakers on the retirement/pensions track. (Since these were pension folks, rather than, say, active fund managers, that's not surprising.)

Zvi Bodie, the Boston University economist, advisor to pension fund managers and co-author of a recent book (*Risk Less and Prosper* (Wiley, 2011)) that urges individuals to finance their retirements primarily with ladders of Treasury Inflation-Protected Securities, set the tone early.

Taking a position that he articulated in his book, Bodie argued that time-diversification—the conventional wisdom that stocks always pay off in the long run—doesn't work. Instead, it's an illusion based on a small and biased set of historical returns.

As evidence, Bodie cited the fact that no sane options dealer would sell you a long-dated put on the S&P 500. Average returns admittedly become less volatile over time (because ups and downs cancel each other out), but cumulative returns can diverge widely over time, as Monte Carlo simulations attest.

When it comes to achieving a no-risk personal pension, Bodie recommends no-risk investments. “If a neighbor comes and asks me for financial advice,” Bodie said, “I tell him, ‘I can’t give you any recommendation on the stock market.’ But I do say, ‘Buy the maximum number of [U.S.] I-Bonds that you can get. They’re paying a zero real rate of return, you can cash them in at their accrued value at any time after the first year, and there’s no downside price risk.’”

Henry Hu of the University of Texas, who gained a mix of fame and notoriety in 2011 with a plan for investors to buy government annuities, followed in a similar vein. “Many investors have a mystical belief in ‘stocks-for-the-long-run.’ Even at the height of the NASDAQ bubble, a Paine Webber survey showed that the average investor expected an average annual return from stocks of 15.3% over the next 10 years.

“The fundamental problem, the 800 lb. gorilla in the room, is that we don’t save enough,” Hu added. He suggested that Americans buy U.S. bonds to fund inflation-adjusted annuities issued by the federal government. “If you price it right, it won’t cost the government anything,” he said. “It will also diversify the base of U.S. debt. We’re too dependent on Asian countries for their willingness to buy Treasuries.”

Ron Ryan of Ryan ALM, Inc., came up next to say that public pensions are running huge deficits in part because they don’t have the right benchmarks. Instead of using market benchmarks, he said, they should be using “customized liability benchmarks.”

If each fund’s investment policy were dictated by its own goal, more precise asset-liability matching would be possible, and the achievability of the goals wouldn’t swing up and down with the value of the investments. But that never happens today, he said.

No customized liability benchmarks have existed, however—until now, said Ryan, who helped created the original Lehman bond indices and whose company is now in the business of creating customized liability benchmarks for corporate and public pensions.

“How can you use a generic market index when pension liabilities are all different?” he asked. “Until a customized liability index is in place, nothing on the asset side can work. A handful of market indices dictate how pension assets are managed, but they have nothing to do with the liabilities.”

The long decline in interest rates since 1982 hurt defined benefit pensions badly, Ryan said, by making them more expensive to fund. Pension fund managers also failed to take advantage of surpluses during the mid- to late 90s by rebalancing from stocks to bonds. From an accounting standpoint, public pensions looked particularly underfunded after the 2008 market crash, he added, because their assets were marked to market while the value of their liabilities were still based on an assumed growth rate of 8%.

Appearing via a broadband video connection from Budapest, Robert Arnott of Research Affiliates spoke about the findings in his paper in the latest issue of the *Financial Analysts Journal*, which forecasts slowing GDP growth and declining share prices in developed countries that are aging.

It was no coincidence, for instance, that the bull market in the U.S. started when leading-edge Boomers hit their mid-30s and ended when they hit 62. As he puts it in the paper, “Young adults are the driving force in

GDP growth; they are the sources of innovation and entrepreneurial spirit. But they are not yet investing; they are overspending against their future human capital. Middle-aged adults are the engine for capital market returns; they are in their prime for income, savings, and investments."

He goes on to write, "Large populations of retirees (65+) seem to erode the performance of financial markets as well as economic growth. This finding makes perfect sense; retirees are disinvesting in order to buy goods and services that they no longer produce, and they are no longer contributing goods and services into the macroeconomy. This effect is less pronounced for bonds, presumably because they are sold later in retirement than stocks, in conformity with widespread financial advice."