
Value Investing for Retirement

By Kerry Pechter *Thu, Mar 12, 2015*

“Purgatory is what I’m calling our set of forecasts,” said Ben Inker, GMO’s co-head of asset allocation, at the Morningstar Institutional Conference in Phoenix last week. “We won’t make much for seven years. But then we’ll see a steady rise to heaven.”

The saguaro cacti near Phoenix lifted their stubby, prickly arms in motionless gratitude last week, thankful for the recent spring rain. And at a well-watered golf oasis on the north edge of Scottsdale, Morningstar hosted its annual Institutional Conference.

A talk by Ben Inker, co-head of asset allocation at GMO, the money management firm known for “value” investing, was one of the conference highlights. This unfashionable-by-definition style of investing, he claimed, should suit retirement savers just fine.

Inker’s message in a dice-cup: Retirement savers will have to save more in the future to accumulate the same nest egg as in the past. In other words, funding a retirement will be more expensive.

And conventional wisdom won’t help, Inker said. While the efficient market hypothesis and Modern Portfolio Theory may have their place, their use of risk-return optimization, faith in average long-term returns, and use of buy-and-hold strategies don’t necessarily work for investors who get only one series of returns per lifetime, he said.

That’s where Inker believes that GMO’s style of value investing can be useful. It assumes that today’s stock valuations and bond yields are predictive of future equity and fixed income returns, and that buying what’s cheap while avoiding what’s expensive is, over the long run, the best way to ensure a safe retirement.

“Retirement is not a returns problem; it’s a wealth problem,” Inker (below left) told a Marriott ballroom of 325 or so investment managers. “A wealth problem is different from a return problem. It has a different distribution. Hypothetically, if you invest \$1, the expected value after 40 years is \$12. But that’s irrelevant to a retirement investor, because the returns come from the few times when you were really lucky.”



Sequence of returns risk isn't just a problem for people in the so-called retirement red zone, when nest eggs are considered most fragile, he said. According to his slides, a saver who worked from 1955 to 1995 could contribute the same amounts and experience the same average returns and volatility as someone who worked from 1965 to 2005 and end up with 40% less money.

The difference in accumulation arose from the simple fact that they had different balances at different times. This observation has profound implications for the design of, say, target date funds. A glide path that worked for one period won't necessarily work for another.

Though their average return will be the same, person who experiences a bull market when her balance is new and small will retire with a very different amount compared with the person who experiences a bull market later in his career, when his account is large.

"If you have good returns when you have more money in the account, it matters much more," he said. So we think that even if things average out over 40 years, that's not a good-enough reason to assume that you'll be OK. Traditional glidepaths ignore sequence of returns risk, and this is a crucial risk from long-term investors."

Inker also took issue with the practice, based on the belief that equities have an inherent risk premium and unpredictable forward returns, of allocating investors' assets to stocks and bonds according to their risk tolerance, without adjusting for current valuations.

"In 1981, stock prices were eight times earnings. In 2000, they were forty times earnings. Starting at those two points, it would be absurd to assume that you would have the same returns," he said. "Today stocks are in the most expensive quintile in history. So you can't assume 5% real return from stocks. It's even more absurd that you'll get 'normal' returns from bonds. Starting yields tell you a lot about expected returns of bonds."

That doesn't mean things will stay the same, Inker said. "Embedded in bond yields is an assumption of continued stagnation and low volatility. That's silly. Stagnation will cause a political response. Voters are getting tired of stagnation, and if things don't get better, they'll change. It's hard to see how you get to 5% real saving for retirement. Timber isn't feasible in retirement plans. High quality large stable blue chips should make you

something above nothing. We like emerging markets value. You should own as much as you can stomach.”

Value investing would be more popular, he said, if advisors and investors weren't so focused on short-term goals. “The problem of career risk has made professionals think shorter and shorter term,” he noted. “So you try never to look like an idiot. You know that if you buy assets that everybody hates, you'll run the risk of looking stupid. But if you are looking for a group of people that stays put, it is retirement investors. They've got 40 years to save money and 30 years to spend it down. That means you can really harness the long term.”

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