



Develop Business/Financial Planning

A Better Asset Allocation Strategy for Younger Investors

By Jim Otar, CMT, CFP
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The biggest risk for inexperienced investors is that short-term losses might scare them right out of the market. Right-size the risk for better long-term outcomes and you'll create clients for life.

Picture this: Your client just delivered her first baby in the hospital. The new parents are filled with joy beyond words. The baby is still crying. You whisper into the father's ear that the little one has a life expectancy of 88 years—a really long time horizon.

Overjoyed, the father grabs the baby, tosses him high to the ceiling, and then after barely catching him, tosses him up again. Those witnessing this risky madness are in shock. Finally, the father explains: "But the baby has a long time horizon!"

As absurd as this scenario may appear to you, this is exactly what we do with our clients' portfolios when their portfolios are only "babies." I call this initial phase of investing the seed money formation stage, and it's a very vulnerable time.

For example, let's say your client sends his recently graduated grandson, 25-year-old Steve, to you to open an investment account. Steve is planning to save \$10,000 each year for his retirement. He needs your advice.

What do you do? You educate him about the benefits of long-term investing. "You have a long time horizon, young man, so you can take a lot of risk!" He nods his head in excitement. After some conversation, you suggest an asset mix of 85% equity and 15% fixed income. Steve, not knowing any better, signs all papers you push in front of him. And thus, Steve enters the world of investing.

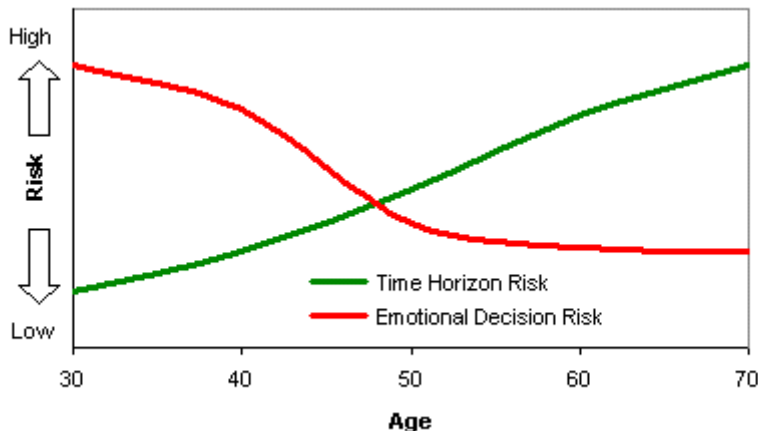
Time horizon vs. client psychology

Many researchers and academics consider the time horizon as the most important factor in the asset allocation decision. For young investors like Steve, most asset allocation guidelines will point to an aggressive portfolio with anywhere from 70% to 90% in equities, just because of the longer time horizon.

While in theory the time horizon is an important factor in how to invest, in real life, client psychology can be even more important, especially at this early stage. Put yourself in your young client's shoes. What he has to invest may be a small amount by any measure, but for him, this is his entire life's savings. He will perceive any loss to his seed money as a big loss. It does not matter how diligently you might have educated him about the long term. When a client's dream is bruised, it's hard for him to recover from it.

The biggest risk during the seed money formation stage is the short-term losses that might scare the inexperienced investor out of the market. Once he leaves, it may take years for him to gather enough confidence to return to investing, and he may not come back until the next bull market. It takes experience with investing, usually about two full market cycles, before this "emotional decision risk" decreases to a more manageable level (see Figure 1).

Figure 1: Emotional Decision Risk vs. Time Horizon Risk



Source: Jim Otar, CMT, CFP

When a baby is born, the new parents do everything in their power to protect their child from harm. Using the same analogy, one should be conservative with the seed money. According to the TIAA-CREF Institute, a surprisingly high number of young people invest in low-interest-bearing fixed accounts. They are instinctively doing the wise thing—preserving their seed money as best as they can.

Step the allocation to build the nest egg

The seed money formation stage starts when an investor puts aside his first dollar. It ends when the investor accumulates as much as his pretax annual earnings in the account. If an investor starts with no existing savings and each year saves 10% of his earnings, it will take about eight years and six months until his account value becomes as much as his annual earnings in a conservative portfolio with 6% annual growth rate.

On the other hand, a more aggressive portfolio that grows at 10% per year will get there in about seven years and seven months. The difference between the two portfolios is 11 months. In other words, 89% of the portfolio growth can be attributed to the disciplined saving process and only 11% is attributable to the difference in the growth rates.

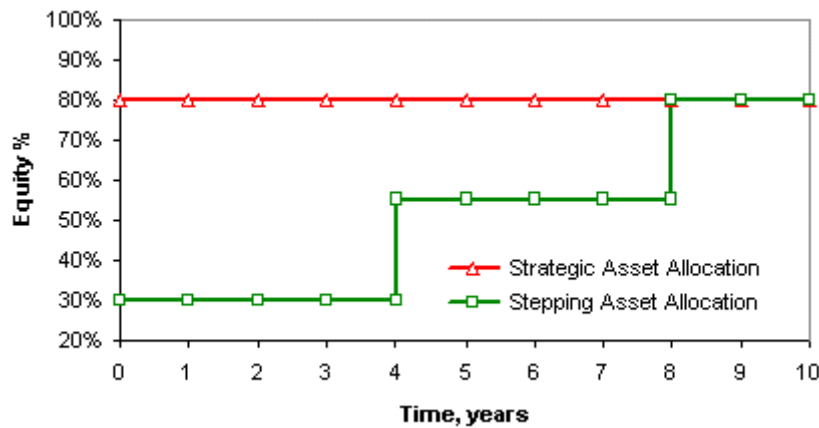
The most important thing during the seed money formation stage is to invest with discipline, month after month, year after year. The conservative portfolio with a lower volatility will give the investor the much-needed staying power. Once this critical period is over, the investor is more appreciative of how markets work and has more experience handling volatility as his portfolio becomes larger.

A strategy known as stepping asset allocation, illustrated in Figure 2, will reduce the risk of emotional decision making during the early years and enable the investor to stick to his

plan. Here's how it works:

- Figure out your client's long-term asset allocation using your standard tools. Let's say it's 80/20 (equity/fixed income).
- Start your client account with 30/70. Keep this asset mix for four years.
- After four years, increase the equity allocation to 55%, halfway between 30% and 80%. Keep this 55/45 mix for the next four years
- After eight years, set the asset allocation to 80/20, the long-term mix.

Figure 2: Stepping Asset Allocation



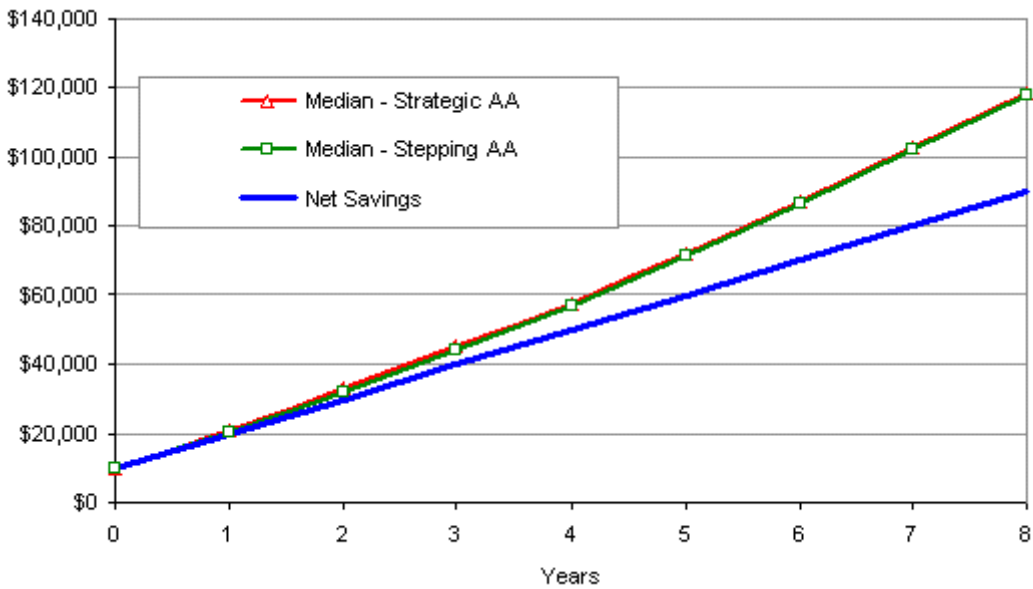
Source: Jim Otar, CMT, CFP

Stress-testing the allocation

Let's look at an example using the historic performance of the S&P 500 index. As above, Steve is just starting to save for his retirement. He is planning to save \$10,000 each year. In the first case, he allocates 80% to equities and 20% to fixed income immediately at the beginning of his plan. In the second case, he follows the stepping asset allocation strategy as described above. He rebalances his asset mix annually.

Figure 3 depicts the median portfolio, where half of the historical outcomes are higher and half are lower. The portfolio values were essentially identical for either strategy. The difference was less than 1%.

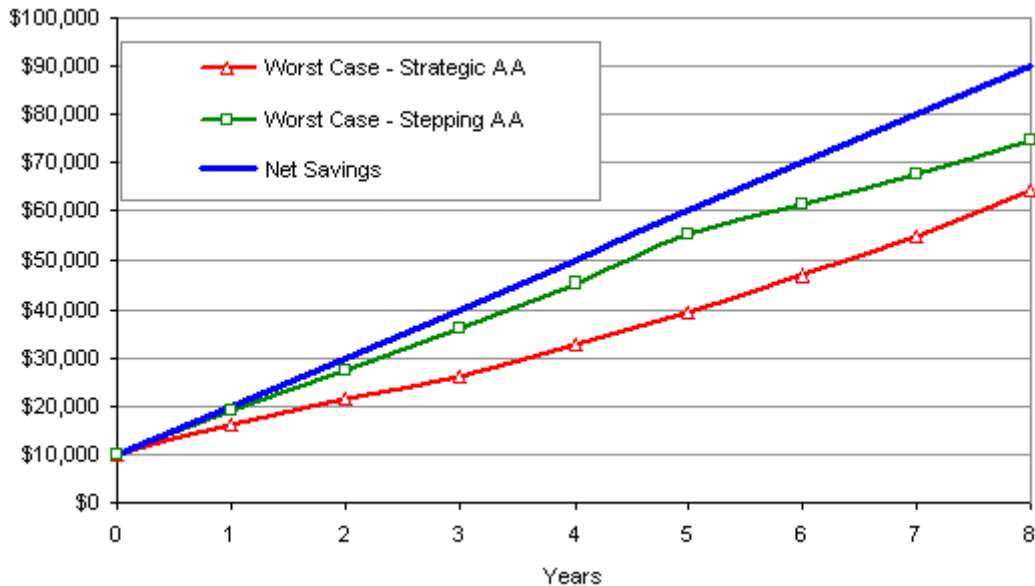
Figure 3: Steve's Median Portfolio Value



Source: Jim Otar, CMT, CFP

Figure 4 depicts the portfolio value when bad things happen. Under the worst market conditions (historically), there is significant difference between the two strategies. By the end of five years, losses with the stepping asset allocation were about one-quarter of the losses using the strategic asset allocation. This may be just enough to protect Steve from abandoning his long-term goals under duress, while it sacrifices almost nothing under normal conditions, i.e., the median outcome.

Figure 4: Steve's Worst-Case Portfolio Value

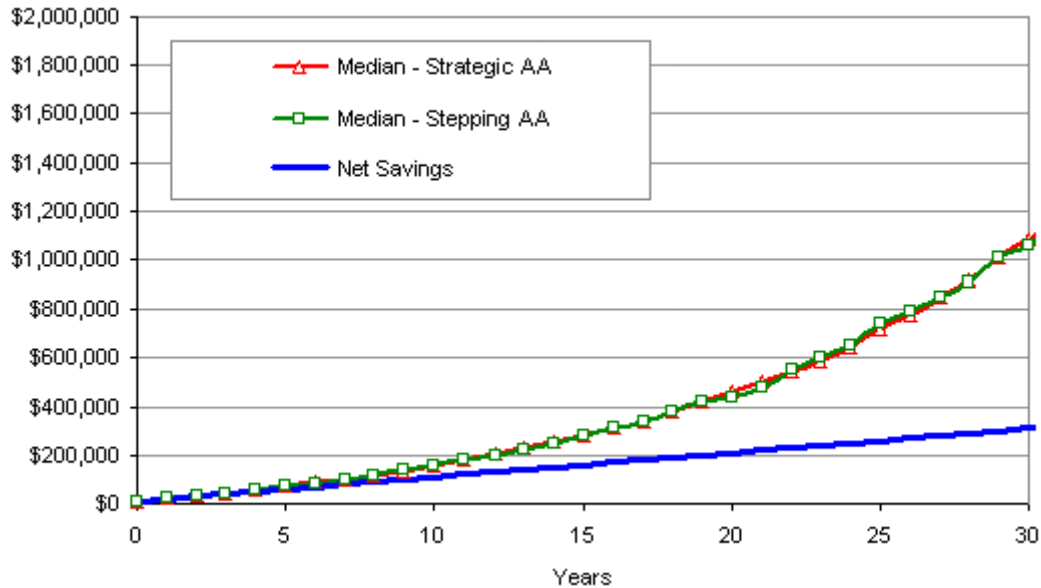


Source: Jim Otar, CMT, CFP

Figure 5 depicts the long-term median portfolio value. There is virtually no difference between outcomes in the long-term. However, you know in your heart that what may have

kept Steve on track is the stepping asset allocation you suggested during the earlier years.

Figure 5: Steve's Long-term Plan—Median Portfolio

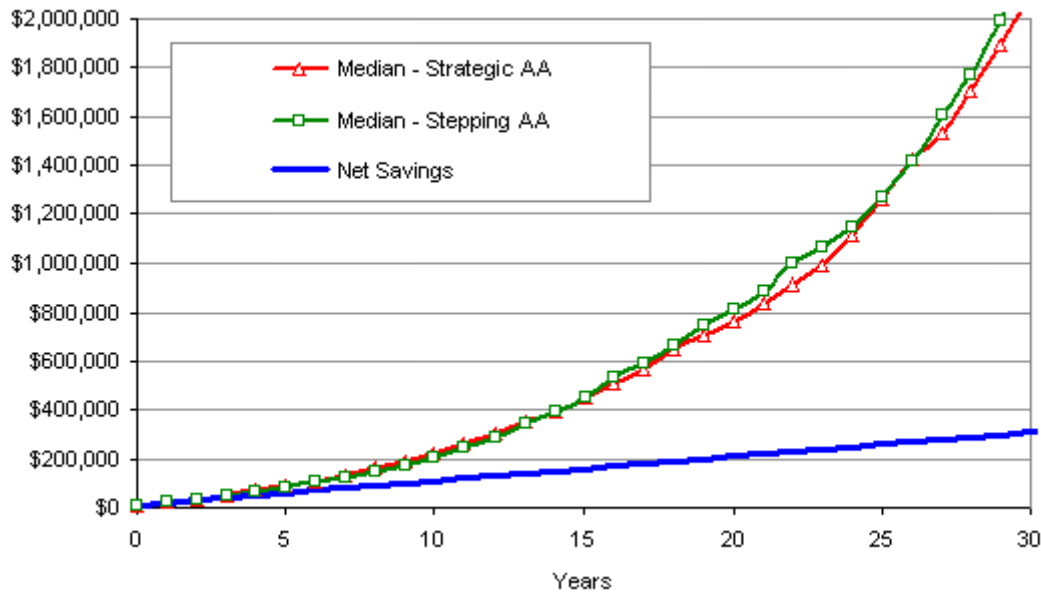


Source: Jim Otar, CMT, CFP

The final question might be "What about if Steve was lucky and markets were doing really well? How much did this strategy cost in terms of lost opportunity?"

Figure 6 depicts the long-term top-decile (top 10%) portfolio value for all historic outcomes since 1900. Because the stepping asset allocation was able to preserve the capital better initially, the portfolio had a slightly better growth in subsequent secular bullish trends.

Figure 6: Steve's Long-Term Plan—Lucky (Top Decile) Portfolio



Source: Jim Otar, CMT, CFP

You might wonder why we use an eight-year time period. In technical analysis, there is a four-year market cycle known as the presidential election cycle. The eight-year time period covers approximately two of these market cycles. This should provide enough time to accumulate the seed money required for future growth and give the investor a good introduction to volatility risk.

Having survived his most vulnerable stage, Steve is now ready to proceed to the next stage: midlife growth. Meanwhile, you have gained a loyal, long-term client. It is much easier to retain an existing client than to get a new one, so ease young clients into investing and you'll create clients for life.

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