BURNEY COMPANY
INVESTMENT MANAGEMENT

WHITE PAPER

Are You Taking Enough Risk to Enjoy a Comfortable Retirement?

A conversation on risk

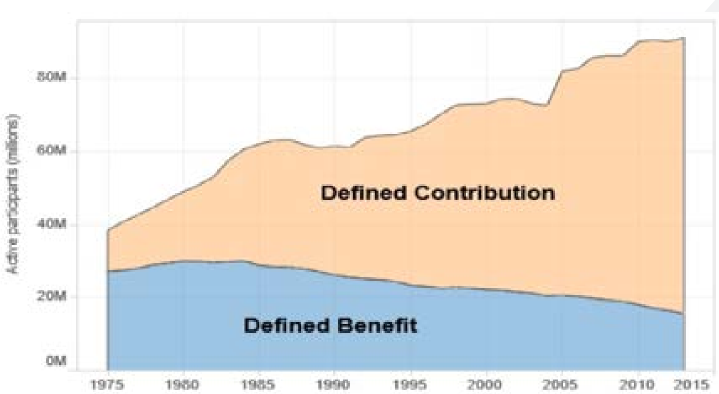
Porfolio Risk

Avoiding Retirement Shortfalls

Americans are living longer than ever before. A person in 1960 wasn't expected to live to 70 but today's life expectancy is nearly 80 years[1]. A 65 year-old today, who was only expected to live an additional 4.7 years in 1960, has a 50% chance of living to 90 years old[2].

Problematically during this same time period, the retirement burden has steadily shifted from employers to employees as defined contribution plans, like 401(k)'s, replace pensions. Americans thus far have not adjusted to the magnitude of this responsibility.

Saving For Retirement is Now on Individuals



Source: DOL, CNBC

Americans nearing retirement saved an average of $136,200, yielding just $9,150 of annual income. A huge shortfall compared to the lifestyle they are expecting.

There are several factors contributing to the insufficient retirement funds problem. First, the personal savings rate is low, only slightly above 5%. People simply are not putting away enough money for their future.

Second, widespread misunderstanding of the risks involved with investing instilled fear among retirement savers. Americans, not trusting the market and believing they are being "safe", hold 65% of their wealth in cash[3] which means the majority of their money is not generating any return. Today's historically low interest rates and low economic growth environment compound these problems.

Each person only gets one chance to save for retirement. The choices made now with retirement funds directly impact the comfort of their retirement.

[1] *Source: Legg Mason*

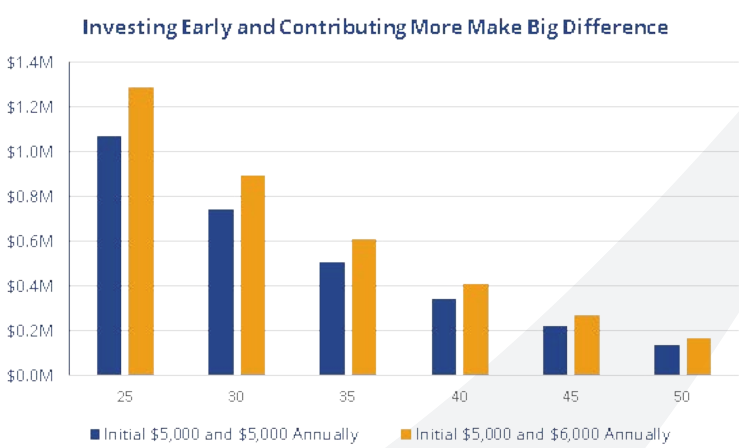
[2] *Source: Society of Actuaries*

[3] *Source: Blackrock Global Investor Pulse Survey*

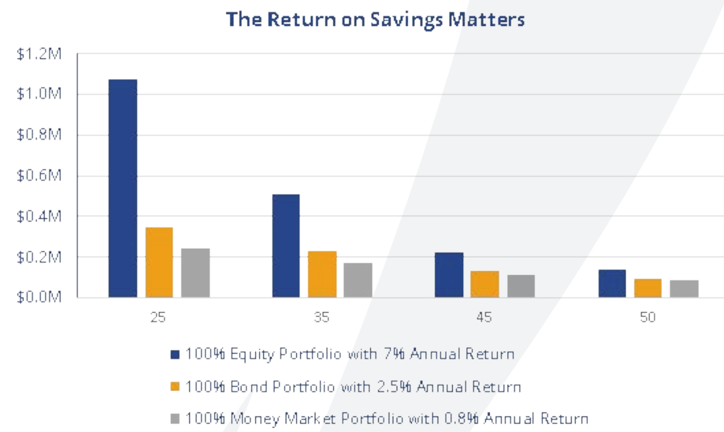
Save Early, Save More, And Invest Aggressively

It's easy to comprehend on a conceptual level the need to save early and save more but few people have an understanding of the real-life implications. See the simplified example below.

Assuming an investor deposits $5,000 initially with an additional $5,000 deposited at the end of each subsequent year, investing entirely in large-cap stocks, the retirement age ending wealth varies greatly depending on what age an investor begins investing.



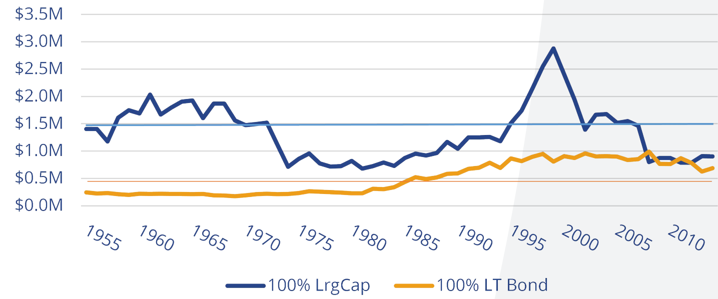
An investor who starts at age 25 would have over $1M by the age of 65 but if that same investor delays just 10 years, even with 30-years to go to retirement, he/she would have half as much retirement wealth.



Saving more and saving early is just one piece of the puzzle. Continuing our previous example, if the investor plays it 'safe' and chooses lower-returning assets, the growth potential of his/her retirement portfolio is not fully exploited, thus returns are muted.

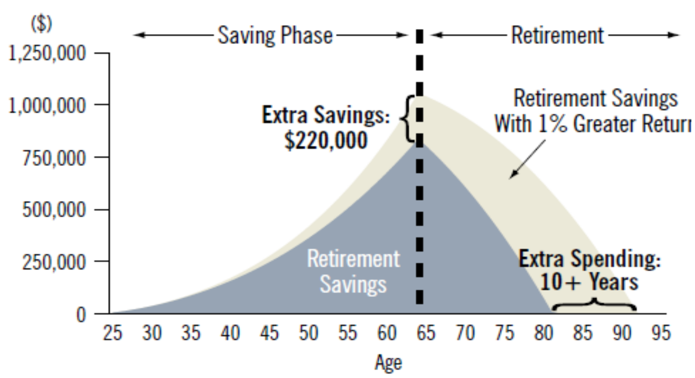
Alliance Bernstein calculates adding 1% to annual returns pre-retirement could fund more than 10 extra years of spending after retirement. 1% doesn't sound like much but 1% of added return compounded year after year translates to significant differences in spending power after retirement.

Value of 30-Year Retirement Savings in the Year Retire Stocks More Volatile But Less Likely Occur Shortfall



*Assuming $5,000 initial investment and additional $5,000 annual contribution.
For illustration purpose only. Past return is no guaranteer of future performances.

1% Additional Return Annually Funds 10 Extra Years



Source: Alliance Bernsein

Understand the Risks

It is hard-wired in our brains to value losses more than gains. This bias, known as loss aversion, causes investors to be naturally wary of potential losses. Investors need to understand risk goes beyond short-term market movements and be cognizant of other, non-obvious forms of risk as well.

The most popular but also frequently misunderstood measure of risk is standard deviation. Standard deviation is calculated relative to an average so the standard deviation and average should be evaluated together. Continuing our earlier example, the chart above depicts the rolling value of a 30-year portfolio invested in either large-cap stocks or long-term government bonds. The retirement portfolios invested in stocks jump up and down in value more than the bond portfolio, exhibiting a higher standard deviation, but ending wealth averages $1M higher in the all stock portfolio. The only years the bond portfolio outperformed the stock portfolio were in the aftermath of the financial crisis, a perfect storm of a sustained bond bull market and historic drop in equity prices.

Resilience of Stocks

1957	1958					
(10.8%)	43.4%					
1966	1967	1968				
(10.1%)	24.0%	11.1%				
1973	1974	1975	1976			
(14.7%)	(26.5%)	37.2%	23.8%			
2000	2001	2002	2003	2004	2005	2006
(9.1%)	(11.9%)	(22.1%)	28.7%	10.9%	4.9%	15.8%
2008	2009	2010	2011	2012	2013	
(37.0%)	26.5%	15.1%	2.1%	16.0%	32.4%	

*Large-caps. Only showing <-10% years since WWII.

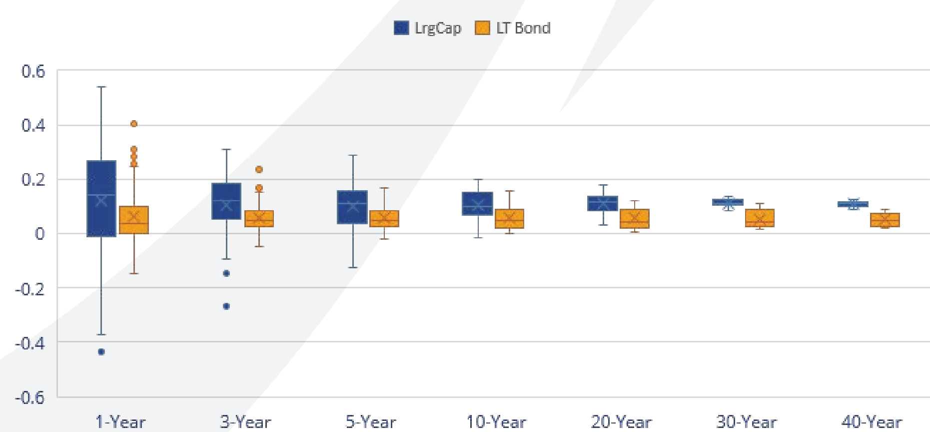
Risk is so often framed in the short-term but for a retirement portfolio, the value a year from now is much less important than the value 30-years from now. It is easy to confuse short-term risk with long-term risk. Stocks can incur significant short term losses, but given a little time, show remarkable resiliency. As the investment horizon lengthens, not only do mean stock returns outperform bonds but the standard deviation around the mean shrinks much faster.

As a retirement investment hits the twenty-year threshold, the lowest stock portfolio return approaches the average bond return, and when it hits the thirty-year threshold, the worst thirty-year period for stocks is the best case scenario for bonds.

Gross return of an asset isn't the only factor to consider. Inflation eats away at the buying power of a portfolio through time and can by just as relevant to a client's retirement planning.

Inflation has dropped to negligible levels since 2008 making it a risk easy to overlook. But saving for and spending retirement funds spans decades, a period long enough to assume at least some level of inflation.

As Investment Horizon Stretches, Return from Stocks Becomes Higher and Less Risky

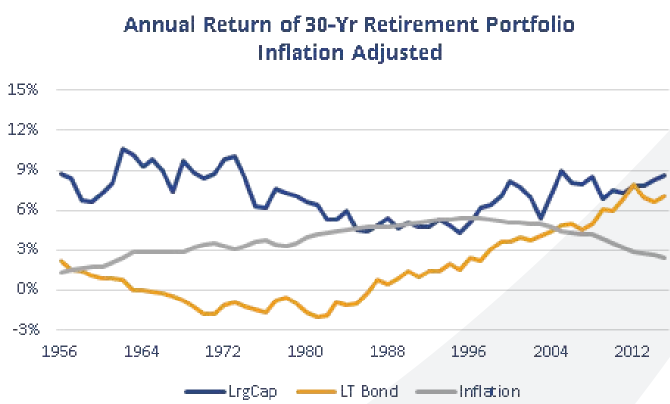


*Actual historical returns. For illustration purpose only. Past return is no guarantee of future performance.

Periods of high inflation are even more problematic, quickly decreasing the purchasing power of a portfolio and increasing the required amount for a comfortable retirement.

Inflation is essentially baked in negative return and can sometimes push bond returns below zero. It correlates much more strongly to bonds than large-cap stocks, giving stocks an important inflation-defensive role in a portfolio.

Correlation With Inflation		
	LrgCap	LT Bond
1926-2014	(0.12)	(0.31)
1972-2014	(0.01)	(0.14)



Summary

The purpose of this white paper is not to make a case of stocks over bonds but rather to start a discussion on risk. The best way to save for retirement varies from person-to-person as each person has different risk tolerance levels and risk preferences. There is no one right answer. We aim to challenge the short-term focus on risk as it can lead to overly conservative long-term outcomes.

The biggest risk investors have in retirement is not the risk of the next market panic but rather the risk their retirement savings aren't enough to last their liftetime.

Alex Shen, CFA Director of Research

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