

## Avoid the gimmick: Age-based asset allocation

By Art Ernst

Over time, about 90 percent of the rate of return on one's investments will be determined by the allocation among equities, bonds and cash. Regardless of one's luck or lack thereof in picking stocks, locking in yields or choosing mutual funds, the vast majority of portfolio performance will be due to the proportion of assets devoted to each of the major asset categories.

In addition to determining probable results, asset allocation will also determine expected volatility. In general, the more return one seeks, the more risk one must be willing to accept. Historically, stocks have provided the best combination of growth and income though they have also experienced frequent and sometimes dramatic episodes of decline. Bonds have produced far lower returns but with more assured payments and price levels. Cash has been the safest and yet least rewarding of the asset groups.

If appropriately managed, a portfolio should seek the maximal amount of return at an acceptable level of risk — plain and simple. Yet every day, people across the country are advised to either take on an excessive level of risk or seek inadequate rates of return. Such occurs any time a portfolio is shaped with age-based allocation.

### What is age-based asset allocation?

Briefly, it's a sales gimmick providing a simple formula to determine the percentage of assets one invests in stocks, bonds and cash. As there is no scientific — or even prudent

— basis for this strategy, the schemes can vary from salesperson to salesperson. One such scheme is to invest one's age in bonds and cash and the rest in stocks. Thus a 30-year old would invest 30 percent in cash and bonds and 70 percent in stocks while a 60-year old would invest 60 percent in bonds and cash with only 40 percent in stocks.

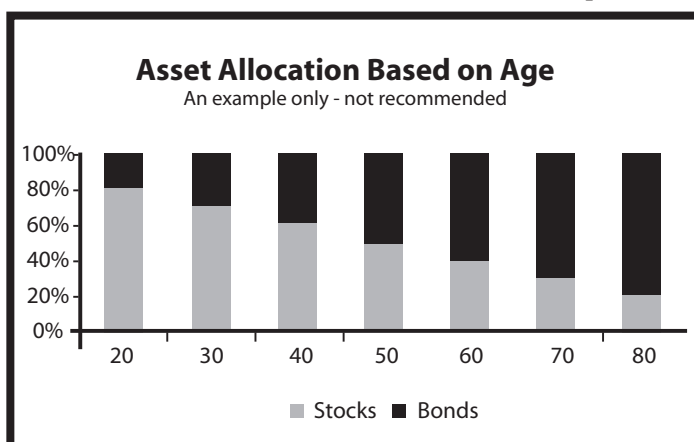
Still other formulas involve subtracting one's age from 80 or 90 to derive the stock percentage. But these mechanisms are all the same in this respect — one's age determines one's market exposure. Not risk tolerance. Not goals. Not even needs. Just age.

### Problem 1:

#### Not all elderly are nervous Nellies, and not all young are thrill seekers

The most obvious problem with age-based allocation is that it is not risk-based. There are wary young people who would not be comfortable with a portfolio that could decline. Building a stock-rich portfolio because of youth would be irresponsible and cause undue worry, especially during bear markets. There are also a growing number of retirees who are comfortable with market fluctuations given the superior returns of stocks. Placing the vast majority of assets into bonds because of one's elderly status would needlessly damage long-term growth, perhaps limiting life's choices later on and certainly reducing the estate that would be passed to heirs.

Interestingly, most investment firms have detailed questionnaires with which they try to assess a given prospect's tolerance for market volatility. In fact, there are laws that require advisors to "know the client" before providing any direction. If a firm's questionnaire consisted of the single question "what is your age?", or if the "know your client" clauses only required knowledge of a client's age, then the age-based schemes, while still ridiculous on investment merits, might meet some minimal level of the scrutiny. But more is asked, and more is required. Age-based asset allocation is not merely imprudent; it may be illegal.



## Problem 2:

### Pushing current income over total return is just wrong

One of the reasons age-based asset allocation might sound logical is that senior citizens with limited means need extra income, not asset growth. Of course, any intelligent investor knows that performance takes into account both income and growth. As most securities are very liquid, it easy to get money out of accounts, whether assets are stocks, bonds, or funds. Increasing cash income while reducing total return is a bad idea at any age.

## Problem 3:

### People nearing retirement are not nearing death

Annualized Returns: 1928-2007*				
Investment Horizon	1 Year	5 Years	10 Years	20 Years
Stocks – Best	53.99%	28.56%	20.06%	17.88%
Stocks – Worst	-43.34%	-12.47%	-0.89%	3.11%
Stocks – Average	10.05%	10.05%	10.05%	10.05%
Bonds – Best	30.71%	19.80%	13.80%	11.07%
Bonds – Worst	-2.66%	-0.37%	0.78%	1.64%
Bonds – Average	5.04%	5.04%	5.04%	5.04%
Cash – Best	14.04%	10.93%	9.04%	7.64%
Cash – Worst	0.02%	0.06%	0.17%	0.49%
Cash – Average	3.77%	3.77%	3.77%	3.77%

\* Stocks – S&P 500; Bonds – 10-year Treasury notes; Cash – 3-month T-Bills

Equities have in the long run provided the best returns and in turn the best mode to grow real net worth vis-à-vis inflation. Moreover, though annual performance can show extreme moves up or down, there has been no 20-year span over which stock returns have been negative.

Life Expectancy as of Attained Ages					
Age Now	Remaining Years	Age Now	Remaining Years	Age Now	Remaining Years
0	77.8	35	44.6	70	15.2
5	73.5	40	39.9	75	12.0
10	68.5	45	35.3	80	9.2
15	63.6	50	30.9	85	6.8
20	58.8	55	26.7	90	5.0
25	54.1	60	22.6	95	3.6
30	49.3	65	18.7	100	2.6

Source: National Center for Health Statistics, U.S. Dept of Health & Human Services

Now, a defender of the age-based formulas might argue the time horizon of older people is short, so they cannot wait for long-term results. However, as one attains a higher age, one's life expectancy rises. A newborn may be expected to live to 78, but one who is already 60 is likely to live to 83 – hopefully longer.

Inflation can be just as debilitating to wealth in life's later stages as in its early ones. One should invest from the vantage point of reason, not fear.

## Problem 4:

### At some point, the time horizon of one's heirs becomes paramount

What is the appropriate time horizon if one has heirs? Unless one intends to spend every last dime before death, the appropriate time horizon for investing is not one's own life but rather the time horizon of those heirs. What a shame it would be for one to work hard, save, and build up an estate only to have the real value of that estate obliterated because a slick salesperson pushed an insipid investment regimen.

Given its obvious shortcomings, why is age-based allocation so commonly used by retail advisors? For one, it is simple. Most client-facing professionals are salespeople who can barely distinguish between yield and appreciation, much less advanced portfolio techniques. With less than ten minutes of training, "advisors" can master a thumbnail view of investing over a lifetime. Further, by recommending and later carrying out major adjustments to the portfolio, age-based allocation creates a natural flow of trades and thus commissions.

## How to best use age-based asset allocation

You and your clients can still use age-based asset allocation as a handy tool. If an advisor makes recommendations using it, find a new advisor. If his or her firm earns fees through the personal coverage of such professionals, close your accounts.

Whether the firm trained that salesperson or simply allowed him or her to impart such amateurish and imprudent advice, you and your clients deserve better.

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