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Planners benefit when we take risks

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***Third in a series* by SCOTT BURNS and LAURENCE J. KOTLIKOFF**

Prostitution is the world's oldest profession, but selling risky investments is surely the most lucrative.

Just ask today's college seniors, many of whom are dying to land a job on Wall Street. These jobs start in the six figures and head north from there. With the right stuff, you can pull down millions within a couple of years.

Take New Jersey Gov. Jon Corzine. His last private-sector job was running Goldman Sachs. In his 25 years with the company, he amassed close to a half-billion in personal assets.

This for a guy who can't even dunk a basketball! How'd he get so rich?

The answer: Courtesy of us.

Year after year, we get conned into paying financial wizards to "beat the market," although only a handful do. Worse, we get sucked into deals where the financial institutions and advisers conveniently match our needs to the securities they're peddling.

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Official site: [Professor Laurence J. Kotlikoff](#)

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It starts by getting us to define those needs – our retirement spending targets – at levels far above what we can safely afford. Then they assume that we will spend this amount regardless of what we actually earn on our investments.

Finally, they add a professional gloss by using Monte Carlo simulations, a mathematical approach that uses random numbers to solve problems of chance. When used for financial planning, a Monte Carlo simulation can calculate the probability an investment or portfolio will provide a given return.

The last step allows them to show us that we can increase our probability of success by investing in higher-return (and higher-risk) assets that just happen to involve higher fees and expenses.

End result: We assume more downside risk, and they collect higher fees.

Two paths

Take, as an example, a single 60-year-old named Joe. He has \$500,000 in assets. Assume Joe will live to age 95. Assume also that he faces no taxes of any kind.

If he chose a smooth and risk-free consumption path by investing only in TIPS – Treasury Inflation-Protected Securities yielding 2 percent after inflation – he could spend \$20,413 a year for life. He would have a 100 percent probability of success.

Now suppose he visits a financial service firm and asks for retirement investing advice. They'll ask him what his retirement spending goal is. He'll pick one he likes. Let's say he picks a spending target of \$30,000 per year.

What's Joe's probability of meeting his target if he invests in TIPS?

It's zero.

Spending \$30,000 a year will drive Joe broke for sure. The only way to make the plan succeed is to die early, a route few people want to consider.

But what if Joe invested in large-cap stocks instead? Since 1926, the real return on large caps has averaged 9.16 percent on an annual basis. If Joe were able to earn this return, he'd be able to spend \$48,264 per year.

But large-cap stocks are volatile. Prices go down as well as up. Even so, there's a 67 percent chance that Joe will be able to spend \$30,000 per year.

Knowing the downside

So when the financial service firm uses a standard Monte Carlo portfolio analyzer, the TIPS route fails completely. But investing in stocks will meet his goal two-thirds of the time. Joe may view this as a pretty good bet, given the way the investment outcome information is being presented.

But suppose Joe had the misfortune of investing all his assets in large caps at the end of 1998. He would have had losses in 1999, 2000 and 2001 – minus 12.1 percent, minus 13.2 percent and minus 23.9 percent.

At that point, would Joe continue to spend \$30,000 per year and remain in the stock market, given that his wealth after three years has dropped from \$500,000 to \$217,583?

Probably not.

In fact, Joe may switch to holding just TIPS. He would be forced to live from that point on only \$9,469 per year, and he'd kick himself for those stock losses for the rest of his life.

Wrong focus

The real culprit is the advice he received, which never addressed sustainable consumption. It focused his attention on the odds his plan would succeed in delivering the \$30,000 of income he wanted. It also glossed over the precise nature of the downside.

Which well-known financial institutions engage in this type of risk solicitation?

Wrong question.

The question is, which don't?

Many planners approach financial planning through the targeted-spending approach. That differs fundamentally with the economic approach, namely consumption-smoothing. Consumption-smoothing entails adjusting your spending, saving, insurance and asset holdings on an ongoing basis to secure a relatively stable living standard. It's a spending standard that's as high as your wages, current assets and other economic resources permit.

To smooth their consumption, people need to look at the range of actual living standards they might experience in sticking with a particular portfolio.

If Joe had been shown that in holding stocks he could quickly end up living on less than \$10,000 a year, he'd have thought twice about holding stocks.

Financial institutions aren't our friends. Rather than address the question of sustainable lifetime consumption, they put a pretty face on risk and sell it. They do this for their benefit, not ours, because their fees rise with risk.

Coming Sunday: Part 4 – Maximizing Your Living Standard

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Scott Burns answers questions of general interest in his Thursday columns. Write Scott

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