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Risking a standard of living

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If you can't stand the heat, get out of the kitchen.

President Harry Truman's famous line applies to more than politics. Applied to retirement investing, it suggests that poor households should avoid investing in stock. The poor, after all, have fewer assets and would seem less able to absorb losses.

But when it comes to personal finance, conventional wisdom is often at odds with basic economics. From an economics perspective, the poor are in a better position to invest in stocks than the rich.

Here's the logic: The real concern with risky investing is not losing your assets. The real concern is suffering a decline in your standard of living.

Our living standards in retirement, however, are financed by more than just our financial assets. Social Security benefits are a biggie, and they carry a lot more weight if we're poor because they represent a much bigger share of our economic resources.

Compare two single retirees, Thelma and Louise. Both are 62. Both collect \$20,000 a year in Social Security. Thelma is loaded, thanks to a nice inheritance. She's sitting on \$3 million. Louise is sitting on \$75,000, thanks to lots of penny pinching.

Suppose both women invest their assets exclusively in the U.S. stock market, with its very high 9 percent average real return.

If Thelma could count on this return, she could spend, in today's dollars, \$211,380 a year through age 95, which is about the high end of her life expectancy. The

corresponding number for Louise is \$26,728. Both figures include their Social Security benefits.

But stock returns are volatile. Consequently, we can expect both women to adjust their spending through time in light of market performance.

Thelma's higher risk

Let's suppose that each year Thelma and Louise set their spending based on their remaining assets as well as Social Security benefits.

Specifically, suppose they set their spending each year at the level they could keep spending if their future stock returns were to equal the market's historical average.

In this case, Monte Carlo simulations of the variation in stock market returns (run on Mr. Kotlikoff's ESPlanner software) indicate that Thelma will experience much more living standard risk than Louise.

At 80, for example, her living standard will be below \$113,845 one-quarter of the time. There's an equal chance it will be north of \$251,944. That's a lot of risk when measured against the \$211,380 Thelma will spend this year.

Louise faces much less living standard risk. Her 25th percentile low and high spending amounts of \$23,089 and \$28,325 are much closer to her current spending of \$26,728.

Indeed, Louise faces no chance of seeing her living standard drop by half or more at age 80. For Thelma, this chance exceeds 20 percent.

The lessons

There are two lessons here:

- First, you should think about portfolio risk in terms of the variability of your future living standard. Taking on lots of living standard variability means disrupting, not smoothing, your consumption.
- Second, being rich is not the same as being safe.

So how should Thelma invest? If she has little tolerance for risk, her best option is probably investing in TIPS – Treasury Inflation-Protected Securities. Today you can buy 20-year TIPS that yield 2.5 percent above inflation.

If Thelma invested exclusively in these bonds and rolled them over through time as needed at the same real rate, she'd be able to spend \$125,464, year after year, without worry.

That's a far cry from hoping to spend \$211,380 or more each year, but so it goes. Thelma needs to sleep at night.

If Thelma were less nervous, she might invest 70 percent of her assets in TIPS and 30 percent in stocks.

This will guarantee her ability to spend \$94,638 no matter what happens to the market. Everything else will be upside. Each year Thelma could buy additional TIPS by selling off any increase in the value of her stock relative to what she initially invests.

Focus on the downside

In our view, Thelma needs to worry about the downside by adopting an upside portfolio.

Specifically, she needs to use TIPS to limit the downside – to lock in a sure minimum living standard – and invest her remaining funds in stocks and other securities that guarantee that her lifestyle can only go up.

And what about Louise? Again, it depends on her risk tolerance. But, as we've shown, her living standard risk is small. She could reduce risk (and sleep better) simply by investing in a traditional balanced fund, a mix of stocks and bonds.

Consumption-smoothing doesn't dictate zero risk. But it will focus your attention very sharply on the downside. Indeed, sacrificing the upside to avoid the downside is precisely what leads to a smooth ride.

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