A Lawyer's Guide To Prudent Asset Allocation

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**This text is based on a talk I gave to an industry group recently and so it is written from the point of view of someone advising an investor. It has relevance to attorneys working on securities law cases. For a fuller discussion of prudent investing choices and expectations investors can reasonably place on financial planners and advisors, please contact me through www.MorningInvestmentsCT.com*

Many people think of retirement planning and investing in stocks as synonymous, but the two are actually quite different. In fact, picking stocks is notoriously difficult for the average investor, while effective retirement planning can be easy and satisfying.

The problem with picking stocks is that most investors simply do not have enough information or skill to be able to choose stocks successfully. Instead, numerous studies have shown that larger investors are often able to take advantage of the lack of information by smaller investors to earn a larger profit.

This issue has always been a problem throughout the history of financial markets, as one story about legendary financier Nathan Rothschild illustrates. In the early 1800's, Rothschild was the founding scion of what is today the European Investment Bank N. M. Rothschild, which is headquartered in London.

The story goes that in 1815, on the eve of the battle of Waterloo between the British and Napoleon, Rothschild had a scout posted at the edge of the battle. His mission was to ascertain the victor of the battle and relay this information back to Rothschild before the general public could become aware.

The result of this battle would have had significant consequences on the value of British bonds since a victorious Napoleon would present a credible threat to the British government. As it so happened, Napoleon was defeated and Mr. Rothschild's scout dutifully relayed this information days before official informants could do the same.

According to the legend, Rothschild who was well know at the London financial exchanges, then went to the exchange and loudly announced "I would like to sell!". The Rothschild's intelligence network was legendary and Tthe crowd took this as a sign that Rothschild knew that Napoleon had been victorious leading other investors to follow in Rothschild's wake selling bonds. Rothschild agents then spread the rumour that Napoleon was, in fact, victorious, and investors believed what they were hearing was genuine. This caused a panicked sell-off of British bonds at

the London Stock Exchange. Rothschild used this opportunity to purchase huge amounts of these securities and when news of the genuine victor reached London, he profited immensely from the trade as bonds rebounded in value.

Like the investors outsmarted by Rothschild, most individual investors today are ill-prepared to deal with the torrent of information that comes out every hour of the day and impacts stock prices. As a result, most people are much better off simply focusing on asset allocation instead of picking individual stocks.

For instance, just $1 effectively invested in a broad basket of US stocks and bonds in 1802 would be worth more than $8 million today. No one lives to be 200 years old of course, so you probably don't have a time horizon that long, but the broader point is that with proper asset allocation and financial planning, a relatively small amount of money invested now can result in a significant sum in a decade or two.

Are your investments allocated in a way to put you on a path to a financially prosperous future?

To help you figure out the right asset allocation, we are going to discuss several topics over the course of this lecture. First, we'll talk about a simple rule of thumb that you can use to come up with a basic breakdown of stocks and bonds that you should hold as you age. Next we'll talk about determining how much you need to actually be able to successfully retire. After that we will look at your specific choices when investing in stocks. And finally, we'll wrap up by talking about different types of bonds and figuring out which one is right for you.

Let's get started!

Retirement Planning Overview

For many people as they enter their 30's, 40's, and 50's, a series of questions related to the issue of investing start to become more and more important.

Will I be able to retire?

How much money do I need to retire?

At what age can I accumulate enough money to retire?

Are my savings invested efficiently to allow me to meet my goals and retire without having to sacrifice my lifestyle?

These questions are the basis for much of the financial planning industry today. Financial planning can be a very scary thing for many people simply because there is so much uncertainty surrounding the issues of investing effectively. Making matters worse, many people have a

fundamental aversion to talking about money with their friends and family which makes it difficult to determine if you are taking the right steps and investing the way you should.

In today's lecture, we're going to discuss the basics behind how you should choose investments, and how those investment choices should evolve as you age. This process of choosing different types of investments is called asset allocation and it's a very important tool in ensuring a successful and prosperous retirement. The investment needs of someone who is 20 years old are very different than those of someone who is 70 years old.

Asset Allocation vs. Stock Picking

Let me ask you an important question? What do you think about when you think of a great investment?

For most people, a great investment means picking a great stock that increases significantly in value. Yet studies have shown that the most successful individual investors don't maximize their wealth by making great stock picks. Instead, they maximize their wealth by effectively picking different types of assets to invest in over time. Essentially this means that smart investors are choosing what percentage of their savings to invest in stocks and bonds rather than which specific stocks or bonds to buy.

One good rule of thumb when trying to decide how much to invest in stocks and bonds, is based on your age. The rule says that whatever your age is, that percentage of your assets should be invested in bonds. If you are 30 years old, 30% of your assets should be in bonds. If you are 75 years old, 75% of your assets should be in bonds. The remainder of your assets should be in stocks.

That rule of thumb is a good starting point for most investors.

Most investors have heard that bonds are safer than stocks. We say that bonds are safer than stocks because their values do not fluctuate as much over time. The average stock rises or falls about 25% during the course of a typical year. Think about that for a minute.

That means that if you have invested $100,000 in a typical stock, then at some point during the average year, your investment will only be worth $75,000. That kind of uncertainty is scary for many people. Investors can balance out this risk by holding a variety of stocks, but that still does not completely sold the problem.

It is true that stocks are a much more profitable investment than bonds over the long run. Since 1966, the S&P 500, a group of 500 large stocks, has returned an average of 11% each year. In contrast, Treasury Bonds have only returned 3.89% on average each year. Yet Treasury bonds rarely fall in value the way stocks do. During the 2008 Recession, the entire group of 500 stocks

in the S&P 500 lost more than half of their value. Holding a large number of stocks did very little to help investors avoid serious losses during that time. Yet treasury bonds actually increased in value by 20% - their largest annual return in more than twenty years.

Mixing bonds into a portfolio ensures that whether stocks go up or down, you will always have some income coming in. This point gets to a very important issue for all investors; how should we choose between maximizing income and ensuring consistent income from our investments?

The Age rule of Thumb I talked about earlier helps investors to deal with this issue. A friend of mine who was 60 in 2007, and who might have been nearing retirement, lost more than half his investment portfolio by holding all of his investments in a broad set of stocks similar to the S&P 500. That friend is still working today an trying to recoup his losses. If he had held 60% of his portfolio in bonds, in particular Treasury bonds, and 40% in stocks as the Age Rule of Thumb suggests, his investments would have fallen by less than 10% in value.

Perhaps you understand now why successful long term investing relies more on proper asset allocation rather than picking one great stock? We call this portfolio diversification.

There is a lot more to portfolio diversification than just making a basic choice between stocks and bonds though. In particular, we need to figure out what kind of stocks and bonds are right for you given your particular situation.

More on that issue in a few minutes, but for now, let's turn out attention to figuring out how much money we need to save given a properly diversified portfolio in order to ensure a healthy retirement.

How Much Money Do You Need In Retirement?

To figure out how much money we need for retirement, we need to start with a few assumptions based on historical figures. We can assume that over the long run, in the future, the average return of stocks will be about 11%, and the average return for all types of bonds – Treasury bonds, corporate bonds, and municipal bonds, will be around 6%. If we assume inflation of 3% - which is about the average over the last 40 years – then stocks will have an after-inflation return of 8%. That is 11% total return minus 3% for inflation. Similarly, bonds will have a 3% after-inflation return.

Using those numbers and the Age Rule of Thumb above, an investor who wants to retire at the age of 65, can withdraw 4% of their total portfolio every year to live on starting at age 65. If the investor withdraws 4% of their portfolio, then the value of that portfolio will stay roughly constant over time no matter how long the person lives. An investor who is 65 years old with a one million dollar portfolio will still have about one million dollars in savings when they are 95

years old, even after withdrawing 4% every year from the time they turn 65 to the time they turn 95.

That level of safety and security should give most investors a good feeling – no matter what happens in the market, they will not be left impoverished if they stick to these guidelines.

So how much do you need to save if want to follow the 4% rule and the Age Rule of Thumb and have a happy retirement? The answer is that you need to have saved 25 times whatever amount you want to be able to spend each year. If you need $50,000 for housing, food, travel, and all the other expenses that go with a comfortable retirement, then you need to save $1.25 million for retirement. If you want to be able to spend $100,000 a year, then you need $2.5 million for retirement.

These numbers are before taxes of course, but if you have set up an effective investing system where you buy and hold stocks and bonds for the long-term in a tax-advantaged account like a 401K or a Roth IRA, then your taxes should be quite low. Most investments held for the long run qualify for the long-term capital gains tax which is currently 15% for most people. And even this 15% can be offset by intelligent use of tax credits and deductions. That is a topic for another day though.

If you don't have enough saved for retirement or aren't on track to have enough, don't panic. We'll talk in a minute about a few tips and tricks you can use with both stocks and bonds to help boost your returns by taking on minimal levels of additional risk.

One point to note here before we move forward – this portfolio allocation that I have described did not depend on picking specific stocks or bonds. Even if you know nothing about the stock market or bond market, just following the basic rules I have laid out can help you have a prosperous future.

Stock Allocation

Moving along, let's talk a little bit about the different types of stocks and how you can decide which ones are right for you. First though, let me ask you another question. Are men or women better investors? What do you think?

Studies have shown that on average men are more aggressive and assertive than women, while women are more patient and risk averse than men. That is probably not true of every single person on the planet, but researchers have found it to be true on average.

Because of this, studies have shown that men make better professional stock traders, but women make better investors. Most Wall Street stock traders are men and this is consistent with the idea that being a trader requires aggressive confident decision making. But most of us don't work on

Wall Street and we certainly don't trade stocks all day every day for a living. And in these circumstances, women have the advantage. In particular, men tend to buy and sell stocks too frequently which leads to higher trading commission costs and negative tax consequences.

For most average investors, the key to successful stock investing is not finding a single great stock or buying and selling individual stock picks. Instead, most investors are better off picking a stock allocation they are comfortable with and only making changes to that allocation as their life circumstances change.

That is not quite the same thing as the simple "Buy and Hold" rule that you may have heard though.

Instead, intelligent stock allocation means picking the type of stock portfolio that fits your personal lifestyle and then changing it when your life circumstances change. If you have kids going to college, or you are thinking of starting a business, or changing careers, it's probably time to take a look at your portfolio and make sure the type of stock you are investing in is still appropriate.

There are two basic types of stocks that every investor can choose from when building the stock section of their portfolio; value companies and growth companies.

Value companies are companies whose stocks trade at a modest price relative to their level of profits. These types of companies are usually firms that are older and more stable in industries that are mature and not growing quickly. Railroad stocks, utility stocks, industrial equipment makers, and some energy stocks are often value stocks. There are several metrics that can be used to gauge when a stock is a value stock; price to earnings ratios, price-to-book ratios, and the Tobin's Q ratio are three examples. But not again, most investors should be looking for broad investment allocations rather than trying to pick individual value or growth stocks. For that reason, many investors turn to an Exchange Traded Fund like the Russell 1000 Value ETF.

An exchange traded fund is a basket of many stocks that trades just like a single stock does. There are many ETFs out there. Here's how they work.

Let's pretend you want to allocate 50% of the stock portion of your portfolio to value stocks. If you want a broad basket of value stocks without having to go through and find individual companies to invest in, you might buy the Russell 1000 value ETF or one of the many other competing value ETFs. You buy the ETF online or with a call to your broker just like any other stock. But instead of having to pay for 1,000 shares in different companies, you instead buy a single share of the ETF which gives you a fraction of a share of all 1,000 firms. This creates instant diversification without the hassle or cost of picking individual companies. Given the cost

and effort efficiencies, it's probably not going to come as a surprise when I tell you that ETFs have become extremely popular in the last decade as investors have become aware of them.

On the other side of the coin, we also need to consider what are called Growth companies. These are companies that are typically fast growing, but they may have lower levels of profits, and they are relatively expensive compared to their earnings. Stocks in this category often include new technology industries like information technology, internet companies, and even popular fast growing consumer goods brands.

I might surprise you to learn that despite their name, growth stocks actually have lower average returns than value stocks do. Over the last 60 years, growth stocks have had average returns before inflation of about 9%, while value stocks have had average returns of around 13%. In other words, on a pure returns basis, value trumps growth.

Yet that does not mean that investors should hold all value stocks. Value stocks tend to be even more volatile than the overall market. They go through slumps and may have negative returns for a period of several years punctuated by very fast price appreciation over a short period of time. So while on average, value may beat growth, that will only hold true for investors who can stomach a rough ride in their returns. In contrast, growth stocks tend to have more frequent positive returns than value stocks, but their returns are lower and they pay smaller dividends than value stocks do.

Can you handle stock returns that may be down 20% in any given year, then up 30% the next year? If so, then you should probably tilt your portfolio towards value stocks. If you prefer a more stable set of returns then growth stocks should probably be given more weight. Either way, it is usually worth holding both value and growth stocks in most portfolio allocations. If you do not like the idea of risk, then holding 70% of your stock portfolio in growth stocks and 30% in value stocks might be the right mix for you. If you have a long time horizon or really need to maximize your returns to catch up on your savings goals, then perhaps a 70% value/30% growth allocation is a good choice.

Whatever you choose, remember that for most people, stocks should only be a part of your portfolio. Bonds are an important component as we discussed earlier.

Bond Allocation

Now that we have outlined some basic stock allocation options, let's turn our attention to bonds. There are three basic types of bonds that you can allocate between in your portfolio; these are treasury bonds, municipal bonds, and corporate bonds.

Your income level and tax circumstances play a major role in determining how you should allocate the bond portion of your portfolio.

Treasury bonds are debt securities issued by the US government. They are the safest securities available to most investors and income earned on them is exempt from state and local income taxes. That makes them especially useful in states like California, Oregon, Iowa, and New Jersey where state income taxes are high. In addition, in some major cities like New York and Washington DC, local income taxes also make treasury bonds an exceptionally good investment choice. Treasury bond returns have averaged roughly 4% over the last half century.

For investors in the highest income tax brackets, the best choice of bonds is often municipal bonds. Municipal or muni bonds are bonds issued by state and local governments entities as well as by other types of non-profit entities like universities. Municipal bonds are almost as safe as US treasury bonds – the odds of a municipal bond defaulting and not paying investors back the full amount owed is less than 1%. There are muni bond defaults, but they are quite rare. Best of all though, ever since a landmark 1898 Supreme Court decision, municipal bond coupon payments have been completely free of federal income taxes. I personally know several successful retirees who swear by muni bonds because of this safety and the tax free benefits. No matter how high income tax rates go in the future, muni bonds will continue to pay tax free income. It would likely take an act of the Supreme Court to overturn this tax benefit, and my guess is that no matter who is on the court, Democrat or Republican, the Justices would be very reluctant to overturn a bedrock decision that has been an important component of US law for more than 100 years. US Municipal bond returns are often between 5 and 6%

Finally, for investors who are not concerned about tax considerations and those who are investing through tax-advantaged accounts, corporate bonds may be the best choice. Corporate bonds are issued by corporations and they generally pay a higher rate of return than either municipal bonds or treasury bonds. The level of safety of corporate bonds varies a little more than with munis and treasury bonds. Some corporate bonds, called junk bonds, carry very high rates of return – comparable to the returns on stocks - but they can default on average 10% or more of the time. In contrast, safer corporate bonds, carry a lower rate of return – perhaps 7% - but they default less often than junk bonds, usually around 2-3% depending on the year.

Choosing the right allocation of bonds for your portfolio is generally a function of what your tax circumstances and risk tolerances are. Individuals close to retirement should skew a little more towards safer choices like investment grade corporate bonds and municipal bonds. If you are less than 45, you are willing to take on a little more risk, and you don't have a high tax rate, then junk corporate bonds and perhaps a few of the riskier municipal bonds are reasonable choices.

Conclusion

This concludes our discussion of asset allocations as you age. Let's talk about what we've learned.

First, most people cannot pick individual stocks or bonds effectively. Trying to do so is often ineffective and can even lead to lower returns as you trade more frequently racking up higher trading commissions. You are better off picking a portfolio allocation that meets your financial return expectations without taking on too much risk.

Second, it's usually a bad idea to have all of your savings in either stocks or bonds. Instead, it's a better idea to choose a combination of stocks and bonds based on the Age Rule of Thumb we discussed earlier – whatever your age is, that's how much you should have invested in bonds.

Third, if you pick a healthy asset allocation, when you reach retirement you should be able to withdraw 4% of your retirement savings every year and never run out of money no matter how long you live. To figure out how much you need to retire, simply multiply what you expect to spend every year by 25.

Fourth, allocating to a stock portfolio, remember that while stocks overall have returned about 11% per year on average over the last half century, not all stocks are created equal. Value stocks tend to have returns closer to 13% but they are a little riskier. Growth stocks have returns average 9%, but they aren't quite as volatile as value stocks.

Fifth and finally, your bond allocation needs to take into account your personal tax circumstances. There are three major types of bonds. Treasury bonds are the safest, have the lowest returns, and income from treasuries is exempt from state and local income taxes. Municipal bonds are slightly riskier, but they have a little bit higher returns, and the income from them is exempt from Federal income taxes. Corporate bonds are the riskiest of all, but they also have the highest returns. They are not exempt from any form of income taxes though, so you want to carefully consider whether to hold these type of bonds in a tax advantaged account like a Roth IRA.