Age Discrimination

A couple of months ago I made a comment on LinkedIn about a recent paper published by the Social Science Research Network (SSRN) that suggested retirees should consider a rising "glide-path" that increases their stock investments as they proceed into retirement. The paper, titled *Reducing Retirement Risk with a Rising Equity Glide-Path,* flies in the face of consensus that retirees should reduce stock exposures as they age, also known as the declining glide-path.

Before I jump into the debate, I want to mention that one of my own personal advisors has created significant value for me over the years by reminding me to air on the side of praise and positivity in my writing. Due to his influence, I promptly deleted my comment on LinkedIn which called the rising and declining glide-path arguments the first and second worst ideas I've seen in investing. Social media is clearly not the venue for exploring complex ideas—especially those that require methodical deduction.

Instead, I hope to use the more ample space this letter provides to convince you of the following conclusions, which I believe are highly relevant to investors of all ages:

I. Your age is one of the *least* important variables in the investment process.
II. Using pre-determined "glide-paths" is risky.
III. Financial service firms are the major beneficiaries of age-based investment programs.

On the first point, simply itemizing the variables that actually impact investment outcomes will help illustrate the extremely low value that investor age has as an input variable. The matrix below lists the factors that matter most for each of the asset classes we invest in:

#	Stocks	Real Estate	Bonds
1	Purchase Price	Purchase Price	Purchase Price
2	Earnings	Mortgage Rate	Coupon Rate
3	Growth	Discount Rate	Maturity Date
4	Leverage	Lease Rate	Inflation Rate
5	Cost of Capital	Utilization Rate	Credit Worthiness
6	Competitive Advantage	Appreciation Rate	Callability/Convertibility
7	Capital Distribution Policies	Insurance Costs	Sinking Fund Protection
8	Management Quality	Maintenance Costs	Interest Rate Policy
9	Tax Liabilities	Tax Liabilities	Tax Liabilities

You will notice that investor age doesn't make the cut for a single one of them. No matter if its common stock, an apartment building, or a municipal bond—none of these assets discriminates based on investor age. Each pays dividends, rents, and interest to owners equally no matter if they are 10 years old or 100. Further, the amount of those dividends, rents, and interest are primarily controlled by the balance of factors listed above. Investor age has no bearing on the size of those payments either.

Each investment does care, however, about the tax situation of the owner. Certain investments are optimized better for certain taxpayers, but that factor exists independent of age. In the United States, tax bracket happens to be correlated to age, but it's most certainly not caused by it. The best incidental use for age as an investment variable is found in demographics. Some investments are set up to take advantage of prevailing demographic trends, but older investors can and should participate in trends driven by younger consumers—and vice versa.

Since you can't rationally use your age to make good individual investment decisions, it follows that letting it be the driver of your overall asset allocation strategy is also irrational. In fact, I can only see one coherent argument that supports the whole concept of "target date" style investing. That argument simply suggests that assets with lower historical volatility are more appropriate for older risk averse investors.

That argument has two major flaws, which are both caused by doubtful assumptions. The first assumption is that older investors are necessarily more risk averse. That assumption simply doesn't live up to my own observations about investor attitudes. In practice, risk appetite is a very personal issue, and is often unrelated to age.

The second bad assumption is that volatility is a good measure of risk on a forward looking basis. I could show you a variety of low volatility investments, like savings accounts, that would offer you a rate of return below the rate of inflation. If you invested there you would be assured of losing significant purchasing power in your savings over time. In my opinion, a high probability of losing purchasing power is clearly a serious risk, even when it's served up in a comforting low volatility package.

Further, if you look back to 2008 you will see the peak of S&P 500 volatility, as measured by the CBOE Volatility Index, occurred on 11/20/2008. The next day the S&P 500 traded for $755 per share; not the absolute bottom but very close to it. The S&P now trades for ~$1,800 per share. So peak volatility roughly corresponded with the best opportunity in stocks in a generation. Clearly, avoiding volatility is a harmful long-term investment strategy. Since volatility often represents confusion and loss aversion among investors, if you have strong fundamental analysis, it's during these times that the finest investments are often made. Volatility is too simplistic a measure of risk to rely on solely for asset allocation decisions.

On the positive side, the matrix above also reveals information about the most useful and relevant variables. The two key factors that each asset class has in common are *purchase price* and *tax liabilities.* The amount you pay for an asset is the single most important factor in the final investment outcome. If you buy a good asset cheaply you will likely do well. If you overpay, it doesn't matter what the quality of the asset is—you will have a hard time getting good long-term returns out of it. Similarly, *after-tax* returns matter much more than *pre-tax* returns. A 10% return taxed at 30% is decidedly worse than a 7.5% return taxed at zero. As the old saw goes, "it's not what you make, it's what you keep."

These two factors, *purchase price* and *tax liabilities,* make a far better foundation to build your asset allocation around. They work on individual investments just as well as they work on the broader portfolio level. Unlike your age, they have a direct causal link with investment outcomes.

The second conclusion, "*using pre-determined glide-paths is risky*," is best illustrated with an NFL analogy. Imagine yourself as a quarterback on game day. You obviously have a game plan based on knowledge of the opposing team, but you don't have every play mapped out in advance. It would be foolish to do so because so much changes during the game. When you line up your offense, you read the defense and might even call an audible and change the play at the last minute. Perhaps an unexpected injury caused the right side of the field to become the clear path of least resistance. You don't stubbornly drive the ball left just because that was the original plan.

This attitude drove a lot of our decision making over the last three years. Many target date models suggested much higher allocations to bonds over the period. We rejected that plan because stocks presented the path of least resistance. The bond market was injured by significant government intervention, so we called an audible and sharpened up our equity analysis.

A football game lasts an afternoon. The investing life often lasts 60+ years. It's unrealistic to expect a pre-determined solution to work through such a wide range of economic conditions. Accepting and embracing flexibility from the outset makes much more sense. Your investment selections can then be tailored to your ongoing needs. Truthfully, the only thing we are certain you have in common with the hypothetical "target date" investor is that you were born during the same five loops of planet Earth around the Sun. That isn't enough information to build a portfolio on.

Finally, while most target date retirement funds claim to be passively managed, they're often changed midstream to chase performance just like other mutual funds. The paragraph below comes from a press release dated 9/26/13 from Fidelity Investments—who I respect far more than most broker/dealers—related to its decision to increase stock exposure in its target date funds:

> "These glide-path enhancements reflect the evolutionary nature of Fidelity's target date retirement strategies and are based on extensive research and analysis, including refreshed review of investor demographics and behaviors derived from millions of investors in Fidelity's proprietary 401(k) recordkeeping database of 12 million participants, updated capital markets assumptions (CMAs) and an enhanced approach to evaluating loss-recovery and risk aversion."

For some reason, despite all the buzz words, I can't help but read *"Although we are 5 years late, we are now lifting your stock exposure because evidently stocks are the place to be in 2013. We concede we missed the boat somewhat over the last half-decade, but better late than never, right?"*

This leads me to my last hypothesis. *Financial service firms are the major beneficiaries of age-based investment programs.* Looking over Fidelity's series of target date funds, which are often found in 401k and 403b plans, the baseline fees charged are around 70 basis points, or 0.7%. If we look at the underlying sub-funds used in these portfolios, many of the same investments can be bought directly for between 6 basis points and 25 basis points, or 0.06% and 0.25%. Not only can nearly identical portfolios be reverse-engineered for less than half the annual cost, but custom tax optimization can also be gained to address *after-tax* returns based on the investor's specific situation. These benefits all occur even before applying a value-oriented purchasing strategy that focuses on acquiring the various pieces of the portfolio cheaply and opportunistically, rather than simply buying things whenever new money comes in.

Another worrisome feature of target date funds is their sheer size. As money piles up, Wall Street inevitably sees opportunities to manipulate them for their own benefit. This can be as straightforward as front-running scheduled portfolio reallocations, up to altering sub-fund selections and glide-path to raise fees or get unwanted inventory off institutional balance sheets. I'm sure their creativity in this regard surpasses our imagination if past history is any guide.

So please beware of any new research that suggests it's time to change your glide-path. I can't help but look skeptically at the SSRN paper suggesting people increase stock allocations five years into a historic bull market, with no meaningful discussion of current valuations. This new "insight" seems a bit late to me, and uncomfortably convenient for institutions seeking to place stocks into the accounts of middle-class Americans.

In some cases, there are sensible reasons to invest in target date funds. The first is that the investor is receiving 401k or 403b matching contributions, so the limited fund selections of the plan are wisely tolerated. Even then, most plans still present an alternate path with lower fees and higher quality final portfolios. The second is simply that the investor feels the time savings are worth the costs and inefficiencies. That's also fine, provided the total amount invested is modest. Otherwise, it soon becomes economic to pay for assistance. I'm happy with both approaches so long my clients are informed of the trade-offs.

For sophisticated investors it makes the most sense to have a clear view of the variables that actually drive investment returns. Short-cuts and fallacies should be recognized as such. Age-based investing is one of the most widely distributed of these investing fallacies. Many legends of investing continue at age 75 and beyond with the same strategies that worked for them in their 20s. That's because certain aspects of the investing discipline are timeless. Value-oriented buying strategies and keen tax awareness remain the cornerstones of success.

To borrow words from a more spiritually focused luminary, some things are just "good in the beginning, good in the middle, and good in the end."

Best,

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