GETTING GOING

Why Your Paycheck Is Really a Bond

Many folks think the world revolves around them. And financial experts agree.

Among leading investment advisers, one of this year's most discussed topics is so-called lifecycle finance. The notion: Often, our most valuable asset is our ability to earn income, so we ought to figure our "human capital" into our investment mix.

By Jonathan Clements

Indeed, lifecycle finance provides a great framework for thinking about money—and it could help you build a more prudent portfolio.

■ **Managing capital.** If you are in your 20s, you likely have precious little savings, but ahead may lie four decades of paychecks. By contrast, if you are in your 60s, your income-earning days are probably drawing to a close. With any luck, however, you have amassed a fair amount of financial capital to replace your human capital.

How can you best manage your financial capital to complement this gradual decline in your human capital? Think of your paycheck as similar to a bond, with its steady stream of income.

Early in your career, you will want to diversify this bond by investing heavily in stocks. But as you grow older, you should prepare for the eventual disappearance of your paycheck by buying more bonds in your portfolio.

■ **Seeking stability.** Seem reasonable? Problem is, not everybody's paycheck is bondlike. Suppose you're a salesperson on commission. Your month-to-month income may be highly unpredictable, so you might want to lean toward bonds in your portfolio.

Favoring bonds can be especially smart if you're a Wall Street employee whose income rises and falls with the stock market. Terry Burnham, director of economics at Boston's Acadian Asset Management, tells the story of a friend in the money-management business.

"He has 100% of his money in short-term, high-quality bonds," Mr. Burnham recounts. "His broker says, 'You could earn higher returns in stocks.' His response is, 'I am the S&P 500.'"

■ **Avoiding yourself.** Once you decide how much risk to take with your portfolio, think carefully about which particular investments you buy.

Workers will often invest heavily in their own company's shares. Real-estate brokers will buy rental properties. Silicon Valley employees will load up on technology stocks. This "invest in what you know" strategy may be comforting. But it isn't as safe as it seems.

"What are the characteristics of your human capital?" asks Moshe Milevsky, a finance professor at Toronto's York University. "If you're a real-estate developer, maybe you're a real-estate investment trust. If you're a miner, maybe you're an ounce of gold. If you work for Weyerhaeuser, maybe you're a forest product."

The implication: Your income is already riding on one sector of the economy. Don't crank up your risk even further by sinking your savings into the same sector.

What You're Worth

How to figure your paycheck into your finances:

- When you join the work force, think of your **earning ability** as a bond and diversify it with stocks.
- As you age, you have **fewer paychecks** ahead of you, so you will want to shift toward bonds.
- When you retire, consider replacing your salary with an **income annuity**.

■ **Insuring income.** Lifecycle finance can also help you figure out what type of insurance to buy.

Given that your human capital is so valuable, you will want to protect your family against the loss of this income by buying life insurance and, if your employer doesn't provide it, maybe disability insurance as well. The amount of life insurance you need, however, should decline as you grow older. After all, not only will you accumulate more savings, but you will have fewer paychecks ahead of you.

Meanwhile, once you quit the work force, you will want to replace your paycheck. "Up until now, we've been telling people that what matters is how big your portfolio is on the day you retire," notes Milwaukee financial planner Paula Hogan. "But what really matters is how much you can spend each year over your whole life."

If you try to pay for retirement by slowly drawing down your nest egg, there's a risk you will outlive your savings or your finances will get derailed by rotten markets. To protect yourself, you'll want insurance—in the form of guaranteed lifetime income.

Your Social Security benefit will provide some of this insurance, and you may have a pension as well. If you want further protection, consider buying immediate annuities that pay lifetime income.

INSIDE THE NEWS

ECONOMIC VIEW

DANIEL ALTMAN

Why Do Stocks Pay So Much More Than Bonds?

YOU might think that the nation's high priests of finance would have agreed by now on why stocks have paid much higher returns than bonds over the years.

You'd be wrong. But depending on whose explanation you believe, there are some important implications for the economy's future. The outlook may not be so good, at least not for everyone.

As every first-year finance student knows, there is a not-easily-measurable number called the equity risk premium. Simply put, this premium is the extra return that stocks have to pay, because they're riskier than safe government bonds, in order to attract investors. It's the same reason that individual numbers on a roulette wheel pay more than odds or evens: higher risk, higher return.

For decades, the returns on stocks have usually been much higher, relative to bonds, than risk alone would seem to justify — perhaps as much as six or seven percentage points higher. If risk were the only explanation, the difference would suggest that investors were extremely risk-averse, to the point that they would never leave the house for fear of having to cross the street.

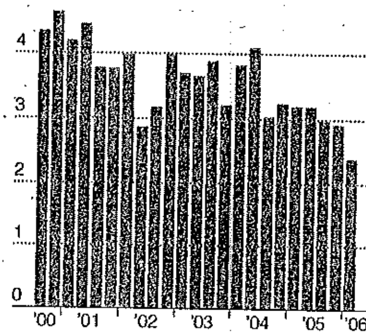
Some economists have suggested that the equity risk premium is reasonable, if you account for very rare but very costly events, like depressions and wars. But there is still much debate, and there are other explanations for the gap in returns.

Worth the Risk?

The premium for investing in stocks — their expected return, minus the return of Treasury bonds — has been declining, according to a long-running survey of financial executives.

Expected annual return of the S.&P. 500 over the next 10 years, minus the return of the 10-year Treasury note.

5 percentage points



Source: Campbell R. Harvey, Duke University

The New York Times

Think about the two types of securities in terms of supply and demand. The market for safe government bonds includes investors who can't buy stocks at all: foreign central banks, other government agencies, some institutional money managers and certain kinds of trusts. Moreover, financial planners may be too eager for their clients to buy safe government bonds. If their paychecks depended solely on whether their clients made or lost money, they might try to avoid losses at all costs.

In other words, it may just be ridiculously easy to raise money for bonds. Or investors' expectations of stock returns may be irrationally low, focused more on crashes than booms. Either way, the equity risk premium wouldn't explain the entire gap in returns.

We do know, though, that the risk premium must be some part of that gap. According to research by William N. Goetzmann and Robert G. Ibbotson, two finance professors at Yale, that premium has stayed fairly constant over long periods through virtually all of American history. For lack of a better reason, there may just be something special about American capital markets, so that a high equity premium would tend to revert to some sort of long-run average. In other words, the equity premium may be a partial predictor of future stock returns and even the future growth of the economy.

Yet many financial economists believe that the equity risk premium has been dropping in recent times. "Over the last 20 or 30 years there have been dramatic changes in the financial markets," said John C. Heaton, a professor of finance at the University of Chicago. "Investors have become just more comfortable with the stock market. Part of that is education. The other thing is sort of a classic finance effect, which is that the level of diversification that investors have available to them has increased."

Professor Heaton said that with the coming of age of American financial markets, many types of investors have found it easier to diversify their assets. For example, it's easier now for entrepreneurs to bring their businesses to the market, and after selling off shares or partnerships, they can invest in other securities. The same goes for homeowners, who can take equity out of their houses and then diversify their holdings.

The ability to diversify makes the buying of risky assets, like stocks, more palatable. "It makes wealthier people more comfortable holding positions in the stock market," Professor Heaton said. He suggested that the equity risk premium might now be around three or four percentage points. A result is more money available to the corporate sector. "The cost of capital is going down, and therefore we're going to see more investment," he added. "The riskier projects that investors would have shied away from are now going to be taken on."

But does this mean more economic growth? It may in the long term, if those risky investments pay off at a higher rate than less-risky alternatives. In the shorter term the effects may be quite different.

In addition to the long-term decline in the equity risk premium, there may be changes over the course of the business cycle, said Campbell R. Harvey, a professor of international business at Duke University. "If you're in the depths of a recession, to get people to use some of their income and invest in the stock market, you have to offer a larger premium to do that," he said. When times improve, the necessity of paying a premium fades a bit; people are more willing to take on risk when they're feeling more comfortable in general.

THE last couple of business cycles have been pretty mild, Professor Harvey noted. But he said that the reduction in the equity risk premium could actually mean lower growth in the near future. "It's true that we've got lower volatility, but with the lower volatility, there's a lower expected return," he said. "The lower expected return translates into a lower growth rate in the economy." Professor Harvey predicted that the economy would expand at a rate of about 3.25 percent annually in the next several years, well below its long-term average in boom times.

Yet even if the economy's growth slows down, people could feel better off than they did before. "In my opinion, the lower volatility of economic growth helps the people that are less advantaged," Professor Harvey said. "Those are the people that are most likely to be laid off in a recession. There's less disruption in the part of our population that's less well off." □

New York Times

March 8, 2014

When You Evaluate a Fund Manager, Look Beyond Results

Paul Sullivan

THIS Sunday will be five years to the day since the low point for the Standard & Poor's 500 stock-index during the Great Recession. Since bottoming out on March 9, 2009, at 676.53, the index has risen some 170 percent.

Passing the five-year mark may be cause for celebration, but it also allows mutual fund managers to report better performance. Starting next quarter, the losses from the financial collapse will no longer be included in the five-year picture.

"The numbers are going to change dramatically," said Joe Jennings, investment director for PNC Wealth Management in Baltimore. "You lose one quarter, but it's going to make a significant difference."

He said the impact of the new numbers could be the greatest among younger people who had a bad first experience as investors and have consequently stayed away from equities. "Now, they're going to start to realize markets don't always perform that poorly," he said.

Yet there will be another significant effect of these impending spruced-up returns. Investors are going to be skeptical of funds that promote their five-year returns, knowing that those numbers paint an incomplete picture.

"Generally speaking, investors are smarter now than they were five years ago," said Daniel Jacoby, chief investment officer of Stratos Wealth Partners. "They're more untrusting. If fund companies try to hide from the drawdowns, they're going to ask questions, and that makes investors more defensive."

While every fund prospectus carries the disclaimer that past performance does not guarantee future returns, the past, in some form, is all investors have to go on to judge a manager's skill — even though what matters is what the manager can do in the future. Here are some suggestions for delving deeper into a manager's track record so that you don't pick one whose performance will get an undeserved boost with the new quarter.

FULL CYCLE Any period in which a manager's returns are judged is going to be arbitrary. When the period started can make a huge difference.

Steven M. Krawick, president of West Chester Capital Advisors, pointed to the current five-year trailing returns for the fund Legg Mason Opportunity I. The fund, which was the best performer last year, averaged a 36.33 percent annual return in the five years ending Feb. 28, 2014, according to Bloomberg. But that period excluded the fund's 65 percent drop in value in 2008. If a six-year return were taken, also ending last month, the return would be 5.97 percent a year — below what the S.&P. 500 did for the same period.

Mr. Krawick said he preferred to evaluate managers through a market cycle. "I think five-year trailing returns are only appropriate if you had a full bear and bull market," he said. "If you're not looking at a complete market cycle, you're only looking at one side of a manager's ability." And in the last five years, stocks have gone mostly up.

REPRESENTATIVE YEAR According to Morningstar, more than 60 percent of the 7,496 mutual funds in the United States today have been created in the last 10 years — and a third in the last five years — so looking at long-term performance may not even be an option. Several advisers prefer to look at just one year. While it might seem too short a period to judge a manager's skill, advisers say it depends on the year.

Trying to glean anything from 2008 and 2013 would not be helpful, since stock markets largely went down in 2008 and up in 2013. But a year like 2011 is one that advisers focus on to assess a manager.

Also, "2011 was a great year to study because we experienced outsized intrayear volatility and performance was essentially flat on the S.&P. 500," Mr. Jacoby said. "Understanding how fund managers were positioned in this type of market will shed a lot of light on how they view and manage risk."

Choosing a year in which there were large macroeconomic events, like the financial meltdown in 2008, is not a good reflection of an individual manager's ability to pick one stock over another, because good and bad stocks were moving together.

"If you don't know if the world is going to end or not, no one really cares about one company versus another," said Chris Blum, global head of equities at J. P. Morgan Private Bank. "It doesn't matter what multiple a company trades against another or their earnings growth."

BETTER METRICS The next layer down is to look at metrics that can tell you the quality of the returns.

A fund's standard deviation will tell you how volatile a manager's strategy is. The higher or more volatile it is, the more likely an investor could get scared and sell before the strategy plays out. "People want consistency and stability," Mr. Krawick said. In his example of the Legg Mason Opportunity fund, the standard deviation was a wild 23.81, according to Morningstar.

Investors want low volatility, says Steven Krawick, president of West Chester Capital Advisors. Credit Jeff Swensen for The New York Times

The Sharpe ratio, a method for measuring risk-adjusted return, can help assess one manager's skill in achieving a return versus another manager's willingness to take a lot of risk. Someone who took very little risk to get to an 8 percent return is better off than someone who made 8 percent but should have made 12 percent given the amount of risk in the investments. The higher the Sharpe ratio, the better.

Since funds do not always rise, there is the Sortino ratio, which measures a fund's volatility on the downside. As with the Sharpe ratio, the higher it is, the better, because it means the manager has a strategy in place so the fund doesn't absorb all the losses in a down market.

Then there is the information ratio. It measures a manager's skill in delivering returns relative to a benchmark with less volatility along the way. The managers whose returns look like a straight line are better than those that look like a sine curve.

STYLE POINTS In conjunction with the quantitative is the qualitative. How does a manager do what he says he is going to do? This is a lot like showing the calculations that got you to the correct answer.

Mr. Blum says he looks for managers who have a well-reasoned process for making investments and who can stick to that process. He said he was more forgiving of a manager who goes through a rough patch if he has a process that he understands. He is less trusting of managers who suddenly change what they're doing to achieve returns.

"If someone calls themselves a large-cap growth manager but they're sitting in small-cap value stocks, I'd question that," Mr. Blum said.

More difficult to assess are newer funds that can invest in various securities. BlackRock has several bond funds that can also invest a significant percentage of their assets in different types of bonds or stocks.

"These unconstrained bond funds look terrific, but they could be 20 percent in equities," said John W. Rafal, founder and vice chairman of Essex Financial Services. "We have to be careful with what they own and how they did it. What is the correlation to a benchmark?"

ASKING FOR EXPLANATIONS The easiest advice may be to talk to the fund managers and understand how they think about what they're doing — something average investors cannot do, but their advisers presumably can.

Gene Goldman, vice president for research at the Cetera Financial Group, said his firm tracked rolling 12-month returns on the funds it monitors to compare them to their peers. He had liked the Edgewood Growth Fund, which remained near the top of its peer group since he had tracked it, but he was worried when it suddenly dropped in 2010. So he called the fund managers.

"We basically said, 'We've known you since 2005, what happened?' " Mr. Goldman said. "They said, 'We made two stock mistakes. We misinterpreted market signals.'"

Since managers make mistakes like anyone else, Mr. Goldman asked them what they had done to improve their stock picking. "They said now if a stock drops more than 20 percent, they move it into a penalty box and another manager who didn't recommend it evaluates it," he said.

Mr. Goldman said he found this reasonable. More broadly, he said he always looked to gather as many data points as he could to make a decision on a manager's performance. "They all come in with their canned stories," he said. "We want to pelt them with questions so that when things are going crazy in the markets, you have confidence in who is navigating the ship."