Investing for Retirement Requires a Disciplined Approach

By Jerome Clark, CFA

Article Highlights

- Investors should consider the potential negative implications of reallocating based on recent events.
- Maintaining a substantial exposure to equities improved results in more than 80% of rolling periods since 1950.
- Investors should maintain a meaningful equity exposure prior to and throughout retirement.

Over the past decade, equity investors have been blindsided by two severe bear markets, a global financial crisis, and the worst recession since the 1930s. As a result, they have seen generally meager investment returns.

So it is not surprising that many had been fleeing stocks and equity mutual funds. Since the stock market peaked in October 2007, industry-wide net outflows from equity mutual funds totaled several hundred billion dollars through 2010.

Historically, investors often have abandoned the stock market during steep downturns, missing out on subsequent recoveries. This time, the bulk of the outflows occurred in 2008, before the S&P 500 index skyrocketed 93% (from March 9, 2009, through the end of 2010).

Moreover, an annual survey by the Investment Company Institute shows that the percentage of investors willing to take above-average or substantial risk has declined steadily over the past decade through 2009, especially among young investors.

Those saving for long-term goals such as retirement, however, should consider the implications of reacting to recent events by reducing their equity allocations—and therefore reducing the growth potential of their portfolios.

Diversification, of course, cannot assure profits or protect against losses in a declining market. A new T. Rowe Price study, however, shows the benefits of maintaining a well-diversified portfolio with significant equity exposure through thick and thin.

Three Investors

The study focused on three hypothetical retirement investors, ages 35, 45, and 55, who expect to retire at 65. For illustrative purposes, each pursues an asset allocation strategy that takes into account their respective time horizons until retirement. In each case, the portfolio’s emphasis on equities is gradually reduced as investors near retirement.

The 35-year-old investor, with a 30-year time horizon to retirement, starts out with an asset allocation of 90% stocks and 10% bonds. For the 45-year-old, the allocation is 78% stocks and 22% bonds, and the 55-year-old starts with 67% stocks and 33% bonds.

The equity portion for the three investors is systematically reduced so that by age 65 they have the same allocation—55% stocks and 45% bonds.

Taking each investor’s time horizon into account, the study examined the historical investment results based on all rolling 30-year, 20-year, and 10-year periods on an annual basis from 1950 through 2009.

Rather than measuring just the most recent period for each investor, this approach reflects performance over a wide range of market environments, including the hyperinflation of the 1970s and the stock market bust of the past decade.

The results are reflected in Table 1 and Figure 1.
heart that the median annualized return for the 30-year periods was 10% and even the worst 30-year period (ended in 1984) had an annualized return of 8.9%. It also is noteworthy that every period handily beat inflation, with a median annualized real (inflation-adjusted) return of over 5% (not shown).

For the 45-year-old investor with a 20-year time horizon, the asset allocation strategy produced a median return of 9.8% over the 20-year periods, and the return for even the worst period (ended in 1981) was 6.4%. All of the periods beat inflation with a median annualized real return of 5.7%.

The strategy for the 55-year-old investor with a 10-year time horizon showed the greatest volatility, but all periods produced positive returns. Only one in five of these 10-year periods failed to outpace inflation.

Note that as time horizons lengthen, the variation in returns among the periods is reduced and the chance of incurring unsatisfactory results is lowered.

### Equities Have Outperformed

Even over 10-year periods, maintaining substantial exposure to equities improved results more than 80% of the time compared with investing only in bonds. Of course, stocks are more volatile than bonds.

Indeed, equities have outperformed bonds not only in more than 80% of all rolling 10-year periods since 1950 but also in all of the 20- and 30-year periods. There is no assurance, though, that past trends will continue.

The study underscores the importance of maintaining a disciplined strategy and of keeping recent performance trends in perspective.

Bonds can help dampen the downside of equities, and equities can help increase the return potential of an all-bond portfolio over time. That’s the real benefit of diversification, and that’s why it is wise for investors to avoid extreme approaches investing in any asset class.

In general, investors seeking to sustain an income stream that keeps up with inflation over many years of retirement should maintain a meaningful equity exposure in their portfolios prior to retirement and throughout retirement because of the superior performance of equities over most long-term periods. Of course, investors also should always consider their risk tolerance and the time horizon of their goals when deciding how much to invest in stocks.

As for those who have been shifting from equities to bonds in recent years, there has been a protracted bull market in bonds—but, with historically low interest rates, that’s not likely to continue for long. The key to investing is to avoid staring into the rear-view mirror too narrowly: Don’t just look at performance over one period and believe it represents all of history and the future.

### Table 1. Annualized Portfolio Returns for Various Rolling Periods

<table>
<thead>
<tr>
<th>Time Horizon</th>
<th>30 Years</th>
<th>20 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of periods</td>
<td>31</td>
<td>41</td>
<td>51</td>
</tr>
<tr>
<td>Median return (%)</td>
<td>10</td>
<td>9.8</td>
<td>9.8</td>
</tr>
<tr>
<td>Best period return (%)</td>
<td>12.9</td>
<td>15.3</td>
<td>16.5</td>
</tr>
<tr>
<td>Worst period return (%)</td>
<td>8.9</td>
<td>6.4</td>
<td>1.9</td>
</tr>
<tr>
<td>Percentage of periods beating inflation</td>
<td>100</td>
<td>100</td>
<td>80</td>
</tr>
<tr>
<td>Number of losing periods</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Percentage of periods</td>
<td>0% to less than 5%</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>5% to less than 10%</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>10% to less than 15%</td>
<td>17</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>15% to less than 20%</td>
<td>0</td>
<td>2</td>
</tr>
</tbody>
</table>

The table reflects the historical performance of various portfolios of stocks and bonds based on the respective time horizons of three hypothetical retirement investors. Performance is measured over all rolling 10-, 20- and 30-year periods since December 31, 1949, calculated on an annual basis. The portfolios follow a 30-year asset allocation program that has the following stock/bond allocation at the beginning of each period: 90% stock/10% bonds for 30 years, 78%/22% for 20 years, and 67%/33% for 10 years. The equity portion of each portfolio is reduced by 1.17 percentage points per year so that each has 55% stocks/45% bonds at the end of the period. Maintaining a significant equity exposure generally enhanced returns in most periods. The best 30-year period ended December 31, 2004, while the worst ended December 1984. The best and worst 20-year periods ended December 1998 and December 1981, respectively. The best and worst 10-year periods ended December 1991 and December 2008, respectively. Stock and bond returns are based on the S&P 500 index and the Barclays Capital U.S. aggregate index. Past performance cannot guarantee future results.

Source: T. Rowe Price Associates.
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