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Rethinking investing for income vs wealth

Prof. Robert Merton | DFA | PortfolioConstruction Forum Conference 2013

In this Thought Piece, filmed exclusively for and released at PortfolioConstruction Forum Conference 2013, Robert Merton – Nobel Laureate in Economics & School of Management Distinguished Professor of Finance at the MIT Sloan School of Management and Resident Scientist with Dimensional Fund Advisors – discusses the fundamental change in thinking needed when moving from a wealth goal to an income goal for the retirement phase of an investor's lifecycle.

I've been studying lifecycle investing for over four decades and it's just as exciting as it's ever been. The big difference now is that the challenges are much greater, but so are the opportunities.

Investing for the lifecycle is part of a broader set of trends which we call goal-based investing, where we target a particular goal we are trying to achieve with an investment strategy. In the case of the retirement part of the lifecycle, it's fairly clear what the goal is – it's to get people a good retirement. Most of us would say that's a stream of income that allows us to live the way we want to live. If it's going to be standard of living, it has to be protected against inflation. And, if it's going to take care of us completely through retirement, it's going to have to be for life. So that becomes the goal, and that drives the investment process.

This has a term within retirement investing – it's known as liability driven investing – where the liability is a good standard of living. But, the key focus with this particular goal is an income goal. That's well understood in the world of defined benefit plans where people define what they need in terms of income and manage money to that goal.

But in a defined contribution world, it's not how the money is typically managed. Instead, money is managed as if it were a wealth goal – we ask ourselves: 'if we follow this strategy, what's the distribution of how much wealth we'll have when we retire at age x?'

Classic portfolio theory was applied to wealth goals and it certainly has brought us a long way from where we were before it was developed. But, to move forward and take advantage of all the technology we have to do this better, we need to recognise that a wealth goal and an income goal are not the same thing – and, if you manage to a wealth goal and the reality is an income goal, it's going to be very hard to do a good job.

If I told you that you had a million dollars and I invested it for you in very safe assets (Treasury bills or whatever), you'd say "Oh, well, that makes your wealth very safe" so that's a safe investment for a wealth goal. But what about for an income goal? Interest rates, at least in the US where I come from, are probably 20 or 30 basis points. How much income does

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that translate into? $2000 or $3000 dollars a year. You can't live on that. So, I've preserved your wealth, your million dollars is absolutely safe - but, unfortunately, if your goal is an income goal to live on, it's a disaster. The flip side of that is, if I had bought you a long-term bond - full faith and credit protection so no credit risk - I could get you a very stable income of $40,000 or $50,000 a year, every year, no matter what happens. On the other hand, interest rates change, so the value of that bond would change very dramatically.

Goal-based investing forces us to make decisions. If we have an income goal, we have to measure risk in terms of income. If we have a wealth goal, we have to measure it in terms of wealth. But we can't have both. We can't have both stable income and stable wealth. It's one too many conditions.

So, as a consequence of having an income goal versus a wealth goal, practitioners that manage for the retirement part of the lifecycle are going to have to change their investment process.

A next generation solution for the retirement part of the lifecycle has five key elements:

1. It should be individualised - each individual within the pension or retirement plan should have not only their own account, but they should have their own individual goals based on age and income and so forth. And, those goals should change in response to personal information.

2. When we look at the retirement goal, we need to take account of all the assets of the individual that are dedicated to retirement, not just the block of assets that happens to be managed by whomever is making the decisions. So we need to consider the safety net from government as part of the retirement assets. We need to consider if there are any defined benefit programmes or if employers have offered that. Most importantly, we need to consider future contributions as an asset. Particularly for the young, the vast bulk of their retirement assets when they're young are their former/future contributions. It's not only important to take account of these because of their size, but also because of their risk. You combine those together with whatever they have in their defined contribution account, and then we can decide what's sensible to do with their defined contribution account in the context of their total portfolio of all assets.

3. You have a dynamic strategy by which you focus on achieving the income goal and you manage to that in a very focused way, instead of having again some mechanical rule that says "I'm a certain age, I take this asset allocation, when I get older I take a different asset allocation." Contrast this with the way it should be done in any good plan designed today: you re-examine what has happened to markets, to interest rates, etc and you revise the goals in terms of personal salary, personal income, and you combine those two pieces of information to come up with the optimal allocation for the next play of the game. This kind of real dynamic asset allocation, for each individual account, is feasible to do on a cost efficient basis with modern technology.

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4. Whatever system is installed, it cannot have as a lynchpin the engagement of the individual. We tend to go for long times when we don't even think about retirement – we say we're going to think about it, but it's a little bit like the person that signs up for the gym, goes for a month and then doesn't go for a long time after. It's never reliable, and people hate doing personal finance even if they knew how to do it. So an effective system must be one that works well without any engagement from the individual.

5. The last piece is that if you can get them engaged in a good way, they can improve their performance. To have them engaged in an effective way, only give them meaningful information, and meaningful short pieces. So, what;s meaningful information? Telling them what their chances are of achieving their goal, letting them know when the chances aren't good, and then telling them when there are things they can do to improve their chances such as save more, work longer, or take more risk. Those are choices they can relate to, they are meaningful. If they decide to save more, then their pay next month will be smaller. If they need to work longer, they think about carrying those bricks for another year. And taking more risk, they can understand that there's a greater chance that they may not get as much income as they need in retirement.

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