FINANCIAL TIMES **Guides**

SAVING AND INVESTING FOR RETIREMENT

THE DEFINITIVE HANDBOOK TO SECURING YOUR FINANCIAL FUTURE

YORAM LUSTIG

FT PUBLISHING
FINANCIAL TIMES

ALWAYS LEARNING

PEARSON

Praise for *The Financial Times Guide to Saving and Investing for Retirement*

'A complex set of vital concepts written in an easy to follow and comprehensive way. Really useful.'

Richard Butcher, Managing Director, PTL, award-winning professional pension trustee

'Yoram Lustig's work provides a comprehensive framework for savings, investment and consumption in the real world during different phases of one's life-cycle. A must-read for every individual.'

Professor Narayan Y. Naik, Professor of Finance and Co-Head of Finance Department, London Business School

'An invaluable and very comprehensive guide to help in making such a crucial lifestyle decision.'

Nigel Stapleton, Chair of Trustees, National Grid UK Pension Scheme

'Clear, concise and erudite. Yoram Lustig cuts through the noise to give you the practitioner's insight on developing and implementing a robust financial plan.'

Nick Bartlett, CFA, Director of Education, CFA UK

'It seems that the investment and savings' landscape gets more complex by the day, so there is a clear need for Yoram's excellent book. Anyone that is serious about their financial health should read this guide.'

Professor Andrew Clare, Chair in Asset Management, Cass Business School

'Millions of savers look forward to retirement but don't look forward to the prospect of planning for their retirement. This book provides a superb digest of all the key elements anyone who takes their retirement seriously needs to consider. It covers them with great balance explaining the nitty gritty but still making the challenge one which ordinary people can tackle. I'd recommend anyone whether they are 20, 60 or 80 to read this book. It will make their retirement much more financially enjoyable.'

Lawrence Gosling, Founding Editor of Investment Week *and Group Editorial Director of Incisive Media, publisher of* Professional Pensions

CHAPTER 7
LIFECYCLE INVESTING
The investment objectives at different phases of life

'The journey of a thousand miles begins with a single step.'

Lao Tzu

The life journey of each person is unique. However, some phases in the path can be stylised, having similar investment objectives and constraints across individuals. Lifecycle investing can aid envisaging your financial goals during different phases of life and formulating an appropriate strategy.

We break the life cycle into three broad phases:

1. Accumulation.
2. Consolidation.
3. De-accumulation (decumulation).

Accumulation phase

The accumulation phase normally lasts from young adulthood (age of 25) to about 10 years before retirement (45 to 55, depending on your retirement age). In this phase, you are working, earning an income, investing and accumulating wealth. Some of this wealth should be saved for retirement.

The accumulation phase is divided into **early accumulation** and **late accumulation**.

Early accumulation

Early accumulation usually starts at young adulthood (25), lasting until early middle age (40). During this phase, the primary financial objectives focus on immediate needs, such as housing, car and starting a family. Emergency cash is important for large expenses, such as a car, education or a deposit on a house.

Net worth is small, but income is growing as you progress from a junior to a more senior job. A primary consideration is debt management, such as taking a mortgage for a house and repaying student loans. Children's private childcare and public school education could be a major expense, perhaps above mortgage payments.

You may have savings goals, like travelling, nice car, deposit on a house, education and retirement. However, retirement seems so far away, living expenses are high and income is low, so contributions into pension savings are relatively modest. You may be unable, or uninterested, to take advantage of your long-time horizon to start saving early.

Return objective

Your return objective is aggressive growth, beat inflation, target an annual average **excess return** (return above cash) of 5%, 6% or higher. Return objective should be linked to inflation, such as inflation or cash plus 5% or 6%.[1] An 'inflation plus' or 'cash plus' objective targets long-term *real* capital growth.

Alternatively, your return objective can be to maximise potential growth; not targeting a specific return. Adopting a strategy of investing only in equities, for example, does not target an explicit return. It depends on risk tolerance, utilising the long time horizon and low liquidity needs, which are satisfied by income from work. This is the phase to take investment risk.

Risk objective

Given the long time horizon and low liquidity needs from pension savings, risk appetite can be relatively high. An annual excess return of 5% to 6% should be aligned with an annualised volatility of about 10% to 12%, assuming Sharpe ratio of 0.50.[2]

A 1% risk-free rate is low, matching the current low-yield environment. A 'normal' level of risk-free rate is 3% to 4%. When risk-free rate is higher, the required risk level can be lower, as cash deposits generate better returns. However, it may coincide with higher inflation as the BOE tightens monetary policy. So, the total return objective might be higher as well (inflation + 4% equals 6% when inflation is 2%, but 8% when inflation is 4%).[3]

Investing only in equities requires a risk level of annualised volatility above 15%. This means accepting a possibility of losing over 20% in a single year.

Some investors should consider a conservative, low-risk strategy in their first few years of investing. Sometimes called the **foundation phase**, it aims to avoid bad investment experiences that might discourage you before you accumulate investment experience, building up your risk tolerance.

Tolerance for liquidity risk is high. You can invest in illiquid assets, reaping the liquidity premium.

Time horizon

Time horizon is typically between 15 and 20 years.

Liquidity

There are no liquidity needs from the pension. Income from work and cash reserves outside the pension should satisfy liquidity needs. The pension is inaccessible until the age of 55 anyway.

ISAs can be accessed. However, you need to return the withdrawal back into the ISAs in the same tax year to reset the tax-free allowance.

Investment strategy

The strategy is *aggressive* long-term real capital growth. This strategy can include only equities or a mix of mostly equities and other assets, including illiquid ones.

Late accumulation

Late accumulation usually starts at early middle age (40), lasting until about 10 years before retirement (45 to 55 as retirement age is typically between 55 and 65). During this phase, debt management gives way to wealth accumulation. The mortgage is shrinking, although you may still support your children and finance their education and, perhaps, their wedding.

Income from work should be higher than in the early accumulation phase. Net worth is growing. The primary goal is saving for approaching retirement. Time is flying fast. With increased income, you can, and should, significantly contribute into your pension. Consider a strategy of escalation of contributions: making small contributions initially and as salary rises increasing their proportion.

Return objective

Your return objective is growth, beat inflation, target an annual average excess return of 4% to 6% or higher. Return objective may be lower than that of the early accumulation phase, since contributions can grow the pension. But it is not necessarily so. Targeting high returns may still make sense since time horizon is sufficiently long and you may be more experienced and comfortable with investing. Having additional assets outside the pension can justify higher risk tolerance.

Risk objective

Time horizon is shorter than that of the early accumulation phase, but still long. Liquidity needs are low from pension savings. Anyway, the pension is inaccessible. Annualised volatility between 8% and 12% is aligned with the return objectives.[4]

Whilst you may keep a strategy of investing only in equities, consider shifting to a more diversified mix of assets, reducing downside risk. The time horizon may not suffice to recover from a severe market crash as this phase's end approaches.

Whilst tolerance for liquidity risk is still high, gradually start reducing the exposure to illiquid assets over time.

Time horizon

Time horizon is typically between 5 and 15 years.

Liquidity

There are no liquidity needs from the pension. Income and assets elsewhere should suffice.

ISAs can be accessed (see restrictions above in early accumulation).

Investment strategy

The strategy is long-term real capital growth. Focus on real return (beating inflation). Whilst still growth-oriented, strategy should be less aggressive, emphasising more on mitigating downside risk than in the early accumulation phase.

Consolidation phase

The consolidation phase usually begins 10 years before retirement (45 to 55) and ends at retirement. You have already accumulated assets in the pension. You have finished paying most of your debt, such as mortgage and tuition fees for children. Income from work is still high and expenses are lower, so maximise pension contributions.

This is the last stretch of the marathon. Make the most of annual allowances, aspiring to reach the lifetime allowance. Actually, most people can contribute the most into their pension during this phase.

With 10 years to go, start gradually de-risking the portfolio with a terminal asset allocation in mind. This process is called a **glide path**.

Terminal asset allocation is the asset mix you aim to hold at retirement. Whilst labelled 'terminal', it is not the journey's end since, after retirement, parts of the portfolio should remain invested. However, it is the end of the accumulation and consolidation phases.

For example, terminal asset mix can include 25% in cash to take as a tax-free lump sum. You may wish to purchase an annuity with, say, another 25% of the assets to provide a steady, secured income stream for the rest of your life. It is a way to mitigate longevity risk and satisfy minimum required needs. You should hold 25% in long-term gilts a number of years before retirement to do so.

Bonds and annuities share similar risks. When interest rates move down, annuity prices move up (and annuity rate down). Buying long-term bonds before retirement hedges changes in annuity price, in particular when bond yields are high.

Part of the portfolio can end up in income-generating assets for post-retirement. They target a yield benchmarked to annuity rate with the flexibility of selling them when requiring lump sums. An annuity lacks such flexibility. The trade-off is that investing for income requires taking investment risk, unlike an annuity.

Life expectancy is usually long after retirement. Hold some growth assets to preserve capital and keep pace with inflation. Retirement does not mean ceasing investing, but that needs, risk tolerance and strategy are likely to change.

The de-risking glide path should be gradual, avoiding selling assets after a drop, close to a trough, or buying assets after a rally, close to a peak. Doing it gradually over time averages buying and selling prices – so-called **dollar-cost averaging**.

A simple glide path linearly moves from current to terminal asset allocation. This mechanical approach does not need discretion. However, applying high-conviction discretion can help to opportunistically sell and buy assets after big price movements.

Another reason for de-risking the portfolio is sequential risk (timing of drawdowns). Overall average return can be good, but right returns in bad order can be detrimental. Nasty returns in the final ten years before retirement can hurt when portfolio size is big. A dynamic de-risking glide path can mitigate the impact of sequential risk.

Dollar-cost averaging

Dollar-cost averaging is buying or selling a fixed monetary amount of investments on a regular schedule, regardless of price. More investments are purchased when their price is low and fewer are purchased when their price is high. The price is averaged over time, minimising the risk of buying or selling at the wrong time.

Table 7.1 Illustrative linear glide path

Asset	T-10 %	T-9 %	T-8 %	T-7 %	T-6 %	T-5 %	T-4 %	T-3 %	T-2 %	T-1 %	T %
Equities	100	90	82	72	64	55	47	37	29	20	11
Long maturity bonds	0	3	8	11	16	19	23	27	31	34	39
Short maturity bonds	0	1	1	2	2	3	3	4	4	5	5
Corporate bonds	0	1	1	2	2	3	3	4	4	5	5
High yield bonds	0	1	2	3	4	5	5	6	7	8	9
REITs	0	1	1	2	2	3	4	4	5	5	6
Cash	0	3	5	8	10	12	15	18	20	23	25
Total	100	100	100	100	100	100	100	100	100	100	100

Note: T-n is n number of years before retirement (T)

Table 7.1 illustrates a linear 10-year glide path, moving from current 100% equity strategy to a strategy dividing the portfolio into four equal parts:

1. 25% cash for a tax-free lump sum.
2. 25% long-maturity bonds to purchase an annuity to satisfy minimum required income.
3. 25% flexible income-generating asset mix (one quarter equity, one quarter long-maturity bonds, one quarter high yield bonds and one quarter Real Estate Investment Trusts – REITs).
4. 25% growth-oriented asset mix (20% equity, 30% long-maturity bonds, 20% corporate bonds, 10% high yield bonds and 20% short-maturity bonds).

Return objective

The return objective is dynamic, shifting from current return target to annual excess return between 3% and 4%.

During the consolidation phase, the portfolio is transitioned from a growth outcome to income and growth outcomes. Accumulating cash for taking a cash lump sum and bonds for buying an annuity is a liability-hedging outcome.