Comment March 11, 2013

Lifecycle investing: some doubts

Chris Dillow

Lifecycle investing, whereby we invest less in equities and more in bonds as we approach retirement, is a bad way of building a big pension pot, according to new research. Javier Estrada at IESE Business School says the strategy is "suboptimal in terms of capital accumulation".

The reason for this is simple. Lifecycle investing means we hold lots of shares when we are young and poor. But this means rises in share prices do us little good. Imagine a 20 per cent rise in the stock market - the sort of thing that should happen roughly nine years in a 40-year investing career. Would you rather this came when you have £10,000 in shares and so gain £2,000, or when you have £100,000 in shares and so gain £20,000?

From the point of view of maximising wealth, we want more exposure to equities when we are rich, so that good years do us more good. Lifecycle investing, however, does the opposite of this. It is like a cricket team sending its best batsman in at the end of an innings when he has less chance of making an impact.

So much for the intuitive problem with lifecycle investing. Professor Estrada tested this by looking at how lifecycle investing would have performed in the past. He imagined a series of 71 UK investors saving £1,000 a year for 40 years, with the first doing so from 1900 to 1939, the second from 1901 to 1940 and the last doing so from 1970 to 2009. He compared two strategies. One was a lifecycle policy which began with 100 per cent in equities and nothing in bonds, gradually shifting to 100 per cent in bonds and nothing in equities at the end of the 40 years. The other was the mirror image of this, starting with everything in bonds and nothing in equities, and ending with everything in equities.

He estimates that the median lifecycle investor - the one who would have done better than half of other lifecycle investors and worse than the other half - would have made £83,000 in real terms. However, the median mirror investor would have done much better, making £130,200. The best a lifecycle investor would have made was £215,600 but the best for mirror investors was £256,800. The worst outcomes for the two strategies were similar - £33,800 for the lifecycle investor and £33,200 for the mirror.

These results are not merely a quirk of the UK's market performance. Professor Estrada got similar results in 18 other stock markets he studied, and for strategies that involved less extreme rebalancings, such as going from 80-20 or 60-40 equity-bond splits. Generally, lifecycle investing gives us lower retirement wealth than its opposite strategy, with less upside potential but similar downside.

Of course, lifecycle investing protects us from a big fall in our wealth later in life. But it achieves this at the expense - on average - of growing our wealth more slowly. Is this a good deal?

Well, maybe. There is something to be said for lifecycle investing.

As we get older we form an idea of our target level of wealth - the amount we'll need for a decent retirement. Once we have such a sum in mind, and if our wealth is close to it, then gains and losses become asymmetric. A fall of (say) 10 per cent would hurt us badly if it pushes us below the target, as it would jeopardise our dreams. But a 10 per cent gain doesn't give us an equivalent amount of joy because it gives us wealth we don't really need. If you're in this position, lifecycle investing makes sense because in cutting equity exposure it saves you from the danger of painful losses at an acceptable price - of missing out on inessential gains.

However, there's a complication here. If you are able and willing to postpone retirement - say, because you have a secure job you enjoy doing - then you can adjust to equity losses by working longer. For you, then, lifecycle investing isn't so appealing because you have another way of coping with equity risk later in life.

There's a second reason why lifecycle investing might make sense. If shares fall as you approach retirement, there's a good chance you'll suffer a double blow. Not only will your wealth fall, but so too might annuity rates. This is because many of the circumstances in which shares fall - such as increasing risk aversion or fears about economic growth - are also circumstances in which gilt yields fall. And lower gilt yields mean lower annuity rates and hence even lower retirement income.

In this context, shifting into bonds does more than merely protect us from falling share prices. Bonds also provide a natural hedge against falling annuity rates, because their prices rise as annuity rates fall. In this sense, they do a doubly good job of protecting our retirement income.

However, lifecycle investing does more than protect us from falling share prices and annuity rates. It also protects us from ourselves.

The beauty of lifecycle investing is that it is automatic - it takes asset allocation decisions without us having to think. This saves us from the many errors of judgment - cognitive biases - that cause expensive errors. Perhaps the most dangerous in our context is the recency bias, the belief that recent market conditions will persist. Logic tells us that high prices are usually a sign of low expected returns, so we should shift out of assets that have had a good run. But few of us do this, partly because of the belief - reinforced by wishful thinking and informationcascades - that the good times will continue.

Lifecycle investing doesn't necessarily protect us fully from this error. Right now, for example, it is shifting older investors into highly-priced bonds. But, on average, there's a roughly evens chance it will shift into the under- rather than over-priced asset. And anyway, it makes only gradual shifts so it at least avoids the biggest errors to which judgment-based asset allocators are prone.

Perhaps, then, there is a case for lifecycle investing. It's just not the one you might imagine.

MORE FROM CHRIS DILLOW...

Read more of Chris's comment pieces.

Chris blogs at http://stumblingandmumbling.typepad.com

View Chris Dillow's benchmark portfolio