Practical Applications of

The Glidepath Illusion: *An International Perspective*

Practical Applications
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Overview

In this ***Practical Applications*** report, **Javier Estrada**, a Professor of Financial Management at **IESE Business School**, draws on inspiration from recent retirement funds research to urge pension savers to adopt less-conventional investment strategies.

Practical Applications

- **Invert the glidepath.** Investors are more likely to accumulate larger pension pots if they invert the traditional glidepath, which has target-date funds investing more aggressively in a saver's younger years and more conservatively as he or she approaches retirement.
- **Redefine risk.** Inverting the glidepath lowers the risk faced by investors if risk is thought of not as volatility but as downside potential. Inverting the glidepath means investing more conservatively while young and more aggressively while nearing retirement.
- **The only way is up.** Contrarian strategies—those that invert the traditional glidepath—have significantly higher upside potential than traditional lifecycle strategies but typically have a more limited downside potential. This suggests the uncertainty regarding volatility is about how much higher, not lower, investors' wealth is expected to be when following a contrarian strategy.

Practical Applications Report

Many people travelling to Las Vegas have their sights set on blackjack, nightclubs and Britney Spears, but **Javier Estrada**, author of ***The Glidepath Illusion: An International Perspective***, went to Sin City in April for a very different reason. Javier's motivation was to present his article on retirement funds (published in the Summer 2014 issue of ***The Journal of Portfolio Management)*** at the **Chicago Quantitative Alliance** conference. "It seemed to me the presentation and its underlying messages were very well received," he says.

Javier Estrada

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Javier is a Professor of finance at **IESE Business School** in Barcelona, Spain. His areas of expertise include wealth management and portfolio management. Javier holds an MS in finance and a PhD in economics from the University of Illinois at Urbana-Champaign, and a BA in economics from the National University of La Plata in Buenos Aires, Argentina. He is also a regular visiting professor at institutions including Hanken School of Economics in Helsinki, Finland; Torcuato di Tella University in Buenos Aires, Argentina; and the University of Montevideo in Montevideo, Uruguay. His previous positions include stints at the economics and finance departments of Carlos III University of Madrid, Spain.

Javier is the founding editor of ***Emerging Markets Review***, where he continues to serve as an associate editor. Javier, who is a keen runner and sportsman and a former tennis instructor, is also a partner and financial advisor at **Sports Global Consulting Investments**, which specializes in providing wealth management advice to professional athletes. As of this writing, he was travelling in the US, Argentina and Uruguay.

Key Definitions

Target-date funds

Retirement funds that periodically cut their allocation to stocks and increase their allocation to bonds and cash as the saver approaches retirement.
—Javier Estrada

Glidepath

The relationship between a fund's asset allocation and the investor's age, or number of years to retirement.
—Javier Estrada

Lifecycle strategy

An investment strategy in which investors invest more aggressively when they are young, putting more money into equity, and more conservatively as they approach retirement, putting more money into bonds. This strategy implies being aggressive with less capital and conservative with much more capital.
—Javier Estrada

The inspiration for Estrada's research came from a short research note by **Rob Arnott** in the September 2012 issue of ***Fundamentals*** the newsletter published by **Research Affiliates**. Arnott argued that investors should follow a strategy opposite to that executed by target-date funds.

"I had been thinking about saving strategies for individual investors and happened to come across Arnott's brief note on the subject," says Estrada. "I found his main point interesting and immediately thought that I could expand on that by considering both more strategies and more markets."

Arnott suggested investors should make their portfolios more aggressive near retirement, contradicting the conventional wisdom that pension savers should be more aggressive when they are younger and more conservative as they age. Arnott and his co-authors expanded on the idea in a 2012 JPM article, ***The Glidepath Illusion…and Potential Solutions***, in which they argued that investors should follow a strategy opposite to that executed by target-date funds.

THE DEBATE

Arnott's proposal sparked a debate in the broader media. ***Barron's*** picked it up with ***Retirement Blues: The Wrong Target? Financial Advisor*** followed the debate with ***Arnott Defends Glidepath Conclusions***, as did ***MarketWatch*** with ***Why Target-Date Funds Could Miss the Bull's-Eye***.

"My point, as well as that made by others, including Arnott and **Robert Shiller**, is that the glidepath of target-date funds is exactly the opposite of what would be ideal if the ultimate goal is to maximize your nest egg at retirement," Estrada says.

"That is a big if, to be sure, but I do make that point clear in the paper. If you want to maximize the amount of capital with which you retire, target-date funds are not the way to do it. To be fair, that is not what target-date funds aim to do."

Rather, Estrada explains, target-date funds are designed to periodically adjust their risk allocation as the saver grows older and is less able and willing to tolerate volatility.

Estrada's first point—previously highlighted by Arnott—is that using a strategy opposite to that implemented by target-date funds increases the likelihood that a saver will retire with a bigger nest egg. "This means that, instead of reducing the proportion of equity (and increasing that of bonds) as you approach retirement, you should do the opposite," he says.

Second, Estrada found that if an investor defines risk as downside potential, rather than as volatility, "the strategy pursued by target-date funds is riskier than a strategy that has an inverted glidepath."

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>
> **—Javier Estrada**

MORE STRATEGIES, MORE MARKETS

Examining data from 19 countries, including the US, over a 110-year sample period, Estrada discovered strong evidence supporting these two points. Arnott’s sample differed in that it covered US savers and 141 years of stock and bond market returns.

Estrada analyzed five lifecycle strategies and compared them with 10 alternative strategies. For the purposes of the research, Estrada defines alternative strategies as those not following the traditional glidepath. The alternative strategies comprised five contrarian strategies (which mirror lifecycle strategies that contain the opposite proportions of stocks and bonds), three equity-driven and two balanced.

On average, across the 19 countries in the sample, the alternative strategies offered higher mean and median terminal wealth, higher upside potential, more limited downside potential and higher uncertainty about their terminal wealth. But the uncertainty is mostly attributed to how much better investors are expected to fare with these strategies, Estrada asserts.

LET THE MARKET DECIDE

So far, the research has been well received, including by its inspiration. “I think his paper is wonderful,” says Arnott. “It’s the fastest that any academic has ever picked up on any of my ideas, to test it out of sample in other markets.” Other supporters of the inverted glidepath include authors **Anup Basu, Michael Drew** and Shiller, whose work is cited in Estrada’s paper.

Estrada does not expect most individual investors to implement the strategy he proposes; rather, he hopes that the industry eventually provides funds that implement it automatically, much like target-date funds implement lifecycle strategies nowadays.

“I started thinking about this in terms of individual investors, but I admit that most of them will not implement the strategy recommended,” Estrada concedes. “It takes a careful annual rebalancing of the portfolio,” he says. “Nothing that an ordinary investor couldn’t do, but something that most investors probably wouldn’t do.” Most informal evidence shows that individual investors are very lazy when it comes to rebalancing their portfolios, even if they have to do it only once a year, Estrada notes.

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IN THE WORKS

Estrada is currently working on two articles about risk assessment—both of which have been accepted for publication.

The articles propose to assess risk not on volatility but on what Estrada refers to as lower-tail terminal wealth. This is a measure of downside potential. “It leads to interesting conclusions, such as that, under some conditions, stocks are less risky than bonds, value stocks are less risky than growth stocks, and small-cap stocks are less risky than large cap stocks,” he explains.

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