

Teaching Investors to Tell Time

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<http://researchmagazine.com/cms/research/monthly%20issues/Issues/2007/11/Columns/My%20Lunch%20with%20Research>

Prof. Bodie combines the easy charm of an accomplished public speaker with the intellectual vigor and clarity of exposition of a Harvard-MIT-trained professor. He is jovial and ebullient as we nosh on pastrami and stuffed cabbage at a deli near his home in Brookline, Mass. And why not? Following our lunch at Rubin's, he will be at the Royal Sonesta Hotel in Cambridge, the venue for this year's get-together of the Retirement Income Industry Association, where he will receive the association's first ever award for Lifetime Achievement in Applied Retirement Research.



Who: Zvi Bodie, Norman and Adele Barron Professor of Management, Boston University .

Where: Rubin's, 500 Harvard Street, Brookline, Mass., Sept. 17, 2007

On the Menu: Cholesterol-laden delicacies and defining risk.

However, as we peruse the menu he mentions his father was a prize fighter. You can believe it, and not only because Bodie is a big, burly man. When the conversation veers toward the financial advisory industry's treatment of the consumer, Bodie's eyes flash with genuine anger.

"Financial planning has always been approached from the point of view of practitioners in the field who are trying to make a buck," he says, clearly disgusted.

As a believer in capitalism, he says he doesn't mind when people who have products and services to sell make exaggerated or less-than-true claims. After all, nobody believes everything they hear during pharmaceutical infomercials. It is when those whom consumers are supposed to trust, such as the SEC, knowingly or unknowingly mouth the same untruths on their websites that he gets mad — both as an educator and finance professional.

"Every personal finance book says you have to start with a goal," he says.

The SEC, too, has a list of five or six different potential goals on its website, all of which are good examples. However, after listing a few of them, Bodie asks the obvious question: "If you have a goal, shouldn't there be a time horizon associated with this goal?"

If you're saving to make a down-payment on a house, you have a pretty good idea when you're planning to buy your own place. If your investment is supposed to provide tuition for your children or grandchildren's education, this too has a set time frame. And even if your goal is a prosperous or self-sufficient retirement, you can't avoid thinking of its approximate beginning and, alas, eventual end.

Defining Risk

Economists think of risk as volatility over time. The wider the price fluctuation, the riskier the asset. But in personal finance this definition of risk is not especially relevant, insists Bodie. Applied to a specific goal, he sees risk in far more commonsensical terms — as the probability that you're going to fall short of attaining your goal.

Volatility can be reduced by diversification — which is what financial advisors typically tell their clients. If you agree with Bodie, however, and assign a specific time period to your goal, diversification may not always work for you. There is no inherent reason in theory or in practice why most assets in your portfolio can't drop at the same time — which could be exactly the time when you have been planning to achieve your goal.

Or, if you insist on thinking of risk as volatility, Bodie proposes a more relevant measure of it. Typically, the change in the value of your portfolio is gauged against the S&P 500 index or other conventional benchmarks. However, unless your future goal is to buy units of the S&P 500, you really don't care about this kind of volatility. You need your investments to match the cost of your goal — for instance, college tuition.

While attacking the conventional wisdom of the financial advisory industry, Bodie proposes nothing novel or extravagant. On the contrary, his solution is more conventional than conventional wisdom, as it were. The right way of thinking of your investment needs is by using a basic principle of finance — matching your assets to your liabilities. Companies use long-term debt to fund large capital projects that pay for themselves over a long period, etc.

Once you think of investment in terms of a set time period, you should not diversify but gravitate toward just one type of assets — bonds. You need a set income stream and a specified maturity date — in short, a high degree of predictability which can only be attained in a fixed-income portfolio custom-designed with the specific needs of the particular investor in mind. This portfolio should be enhanced with guarantees such as the protection against inflation afforded by Treasury Inflation Protected Securities (TIPS).

Conventional Wisdom

Of course this flies in the face of investors' gospel, especially in the world of index fund investment which we now inhabit, namely that equities over the long run are better investments. Data over the past 200 years, analyzed for instance by Dr. Jeremy Siegel of Wharton, show that stocks returned 7 percent a year above inflation. Bonds returned substantially less, even taking into account a prolonged bull market in bonds that has lasted since the early 1980s.

Which is why, say financial advisors, clients should never panic when stock prices go down. That advice was relevant as we ate our lunch, since Wall Street was hemorrhaging and the U.S. Federal Reserve was getting ready to cut interest rates by half a percentage point.

Nevertheless, it is true. Whenever stocks do fall — such as in the early 2000s — they not only come back but reach fresh peaks. It takes a lot of chutzpa to argue against this evidence.

Bodie doesn't. Stocks are a good investment, he readily admits. All he says is that you can't structure a stock portfolio to obtain required results at a specified future time with any degree of certainty.

“Sure, stock prices always come back after a dip,” admits Bodie. “But if the dip happens when baby boomers are retiring, you're going to hear from them. They have been led to believe that stocks are an inherently safe investment.”

What? No Stocks?

Bodie's approach is based on goal-directed common sense, not blind preference for bonds over stocks at all times. He points out that bond mutual funds, even those which only buy TIPS, no longer fulfill investors' need for protection from risk as he defines it. By pooling fixed-income securities of various maturities, a bond mutual fund can no longer be structured, either, thus removing the whole point of providing guaranteed, predictable income.

Nor is Bodie opposed to stocks as an investment instrument — far from it. What Bodie advocates, and what he says financial advisors should be telling their clients, is that they need to take care of their basic needs first and foremost. They need to make sure that they meet their future financial obligations as they themselves define it, and with minimum risk.

“Then, if you have money left over, by all means, buy stocks. I believe in the capitalist system, which depends on taking risks.”

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