

Perspectives

APRIL 2010

ARE EMOTIONS SABOTAGING THE RETIREMENT INCOME SECURITY OF 401K PARTICIPANTS?

By William J. Militello, CIMA, AIFA and Mark D. Mensack, AIFA, AWMA

Imagine planning for a party where we would like to serve lobster which generally sells for \$12 a pound. If we walked into the supermarket and lobster was selling for \$24 a pound, how much would we buy? Alternatively, let's say lobster was priced at \$6 a pound that day... I'll bet we might buy more.

In just about everything we do, we like to get our money's worth. We like to know that we got a good deal; that we received value for our purchase. Intuitively, assuming it's an item we desire, getting more for less is a good value proposition.

So what is the one obvious exception to this intuitive rule? Investing in the stock market! When it comes to investing in the stock market, most American 401k participants are their own worst enemy and violate the most fundamental rule of investing: "Buy low, Sell high!" In a volatile market, the emotions of fear and greed take over. When the market is on "sale" they sell, and when market values are at a premium they buy.

Removing the emotional component to investing for retirement would go far in improving the retirement income security of American 401k participants.

Feeding the fire

Conventional wisdom dictates that an investor should use various methods including questionnaires to determine how much risk or volatility an investor can withstand. Human emotions are fickle and what you can withstand varies daily. Likewise, your tolerance for risk changes frequently and has no bearing on your

ability to achieve your retirement objective. For example, most Americans scored pretty high on the risk tolerance quiz in the late 1990's, right thru to March of 2000. Conversely, most of those same Americans scored pretty low in March 2002 (right through March 2003 five months after the market began to recover!) This emotional inconsistency is no different than other aspects of your life. When you've been recommended for a promotion you feel positive about your skills and abilities. If your officemate gets laid off unexpectedly, you might suddenly question your skills and abilities. And if you get laid off, you're likely to doubt your skills and abilities. Just as each of these occurrences affect how you feel about your skills and abilities, many factors can affect your risk tolerance, and none have any relevance to replacing your income at retirement.

Paradigm Shift

A paradigm shift is when we begin to look at something from an entirely different perspective. Retirement planning must be viewed as an unemotional, mathematical equation. There are many variables in the retirement income replacement equation such as expected return $E(r)$, years until retirement, amount previously saved, salary deferral amounts, employer contributions and profit sharing. And there are others which you clearly have little or no control over such as the stock market, the economy, and the costs to administer your company's retirement plan.

For this equation, let's assume a 50 year old earning \$75,000 a year needs to have saved

\$1,125,000 (15 x \$75,000) at age 65, but can only afford to contribute \$10,000.

\$250,000	Current retirement savings
\$10,000	Annual contributions including employer match
x%	Expected return
15	Years until retirement
\$1,125,000	Sum estimated to support retirement income.*

Given these facts, this participant requires an expected return of approximately 8.28% in order to meet his objective. Notice the word "requires." Unlike the whimsical "risk tolerance" approach to retirement planning, the "expected return" approach requires that the participant choose a portfolio with a specific end in mind.

What does the equation above have to do with the participants risk tolerance? Well, let's assume that a conservative portfolio has an expected return of 5%, a moderate portfolio has an expected return of 7.5%, and an aggressive portfolio has an expected return of 10%.

Whether this participant has a low or moderate risk tolerance is immaterial. Assuming he invests in a conservative portfolio, he misses his objective by \$378,000 or he could work an additional 7 years. Assuming he invests in a moderate portfolio, he misses his objective by \$104,000 or he could work an additional 18 months. The point is, the expected return of his portfolio is the driving factor in determining whether or not he reaches his objective. **(over)**

William J. Militello, CIMA, AIFA



William J. Militello experienced Wall Street first hand as an institutional equity trader with Knight Capital Markets in New York, and currently serves as the Managing Principal of Piedmont, an SEC registered investment advisor. Mr. Militello has consulted for the Securities & Exchange Commission and is a graduate of the U.S. Naval Academy in Annapolis, MD, and received his MBA from Boston University. He is a Certified Investment Management Analyst (CIMA) and a member in good standing with the Investment Management Consultants Association (IMCA). Additionally, Mr. Militello is an accredited Investment Fiduciary Analyst (AIFA) and Piedmont serves as an Independent Fiduciary and ERISA 3(38) manager to corporate 401(k) plans.

Piedmont
INDEPENDENT FIDUCIARIES, INC.

19455 Deerfield Avenue / Suite 307
Lansdowne, VA 20176
703.729.8333 phone
703.729.8355 fax

Fighting for the rights of your “Future-self!”

Many would argue that risk tolerance is an appropriate measurement for financial planning; however, your 401(k) is not a financial planning tool but rather, by law, it is a trust which mandates certain duties and obligations. As a trust under ERISA (Employee Retirement Income Security Act), the first consideration must be the retirement income security of its participants and beneficiaries. While you might think this is you and your spouse, more precisely, it is your future-selves. In other words, the reason the 401(k) exists, and what it mandates, is to provide and secure the retirement income for your future-self. How will your future-self evaluate your present-self's performance when he doesn't have enough to retire, or worse yet, depletes his retirement savings when he's 78? Will he fault you if you made sound decisions and stuck to the fundamentals? Or will he fault you if you made emotional decisions that violated those fundamentals?

An ERISA 3(38) Fiduciary constructs professionally managed model portfolios, each designed to control the economic output or expected return E(r). A 401k plan utilizing an ERISA 3(38) Fiduciary might have five model portfolios each with an expected return of between x and y. A participant merely has to plug the appropriate expected return into his own scenario (aka: equation) and then the 3(38) Fiduciary has the obligation to manage that portfolio with the objective of achieving that expected return. The participant's emotions and likelihood of sabotaging his future-self's retirement income security are minimized.

Additionally, most ERISA 3(38) Fiduciaries utilize institutional mutual funds, and a passive, low turnover index strategy which is much less expensive than the actively managed, retail mutual funds found in most 401k plans.

Many investors want to retain their power to choose or self-direct their own investments, which might be appropriate for their personal assets.

However, for assets in trust where there is a fiduciary obligation to your future-self, it is not appropriate to self-direct.

A Medieval Knight was also known as a champion; someone that would do battle for another's rights or honor. An ERISA Fiduciary is something of a “Prudent Champion” doing battle to achieve consistent expected returns with low cost investment options and fighting for the participant's right as was intended—a real chance at accumulating sufficient assets to provide for the necessities of life and the opportunity to retire with dignity.//

*As a general rule your minimum goal should be to accumulate a sum no less than 15x your average salary at retirement, although 20x is ideal; however, depending upon your time horizon inflation could cause this number to be significantly higher.

Featured below is a table of performance figures. The figures represent a comparison between the investment performance of Piedmont's managed model portfolios versus well-known stock market indices (i.e.: the S&P 500 and the MSCI EAFE). I continue to believe that managed portfolios that are broadly diversified, low-cost and follow the tenets of Modern Portfolio Theory will perform better than an unmanaged index and individually managed discretionary accounts.

Periodic Performance
Monthly: 05/1998 - 03/2010; Default Currency: USD

Data Series	1 month	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years	Volatility/ Risk
Piedmont Ultra Conservative Portfolio	1.46	1.83	2.79	12.73	4.10	4.91	6.47	4.62
Piedmont Conservative II Portfolio	2.97	3.33	5.26	24.58	2.12	4.73	6.33	6.95
Piedmont Balanced Portfolio	3.73	4.08	6.59	31.04	1.19	4.68	6.25	8.59
Piedmont Growth & Income Portfolio	4.51	4.80	7.75	37.77	0.00	4.50	6.18	10.32
Piedmont Growth Portfolio	6.03	6.28	10.33	51.78	-2.37	3.99	5.79	13.97
Index S&P 500 (U.S. Stock Market)	6.03	5.39	11.75	49.77	-4.17	1.92	-0.65	19.18
Index MSCI-EAFE (European Stock Market)	6.31	0.94	3.18	55.20	-6.55	4.24	1.68	17.13
Index One-Month US Treasury Bills	0.00	0.01	0.05	0.17	1.99	2.91	2.85	1.07

Performance Disclosures

- The results portrayed are model results for the period 4/1/07 to present. Results prior to this date are hypothetical. There are limitations inherent in model results, particularly the fact that such results do not represent actual trading and that they may not reflect the impact that material economic and market factors might have had on the adviser's decision-making if the adviser were actually managing clients' money.
- The results portrayed are net of investment advisory fees. A fee of 1.5% per annum was used to calculate the net of fees results. The fee schedule is in Part II Form ADV.
- The results portrayed reflect the reinvestment of dividends and other earnings.
- The models are compared to the S&P 500, One-Month US Treasury Bill Index and the MSCI EAFE (gross div.). The S&P 500 index is a non-managed selection of equity securities, which assumes reinvestment of dividends and has no trading costs, management fees or expenses, which would reduce the return. The S&P 500 is widely used as a benchmark and is widely recognized as representative of the broad general market for domestic equities. The MSCI EAFE Index is recognized as the pre-eminent benchmark in the U.S. to measure international equity performance. The One-Month Treasury Bill Index is a market value-weighted index of public obligations of the U.S. Treasury with maturities of one month.
- For various reasons (tax, personal preference, restrictions, etc.) some clients of the adviser may have had investment results materially different from the results portrayed in the model.
- The portfolio models are allocated among a group of mutual funds consisting of equity and fixed income funds depending on risk tolerance. The asset allocation for each model is available upon request.
- The conditions, objectives or investment strategies of the model portfolio did not change materially during the time period portrayed.
- Some of the mutual funds used in these model portfolios may be different than those offered by your plan or used by your advisor. Ask your advisor or Plan Administrator for details.
- It is not our intention to indicate that past performance is any indication of future results. As with any investment, returns will vary and there is a potential to lose money.
- The volatility/risk column displays the standard deviation of the funds since inception; the higher the number, the bigger risk associated with that fund.