The New York Times
nytimes.com

March 18, 2003

Arguing Against Equities

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THE stock bubble has burst, and then some. But even amid the wreckage, the conventional mantra has continued: stocks are still the long-haul key to preparing for financial security in retirement.

But what, actually, if they're not?

Quietly, in obscure financial journals and actuarial conferences, some alternatives are being debated. So far, the ideas have received little public attention. But the concepts that the pension professionals are wrangling over may ultimately hold answers for America's savers — people who know they need to plan for retirement but can't imagine where to start.

The debate is broken down into two main camps. By far the larger of the two clings to the traditional faith in stock-market investing. The other camp, smaller but gaining advocates, especially in academia, is challenging what it terms the cult of equities, calling instead for a return to extremely conservative bond investments.

Retirement savers who are using these investments may no longer dream of riches, but at least they won't lose their shirts. If this camp sees a place for stocks in a pension fund, it is only if they are hedged with derivative securities — financial instruments that help protect against adverse price movements.

Not surprisingly, the first group includes most members of the financial establishment, corporate financial officers, asset managers, actuaries and others who are responsible for figuring out how much today's older workers will cost when they retire, how much money to set aside for them now and how to invest the money so that it grows enough to pay their benefits.

These professionals are well aware that the funds entrusted in their care have shriveled alarmingly in the last three years. Yet they still subscribe to the belief that if an investor's time horizon is long — as a pension beneficiary's generally is — history shows the investor will do best with a well- diversified portfolio, larded with stocks.

"These are long-term investors with a very long-term view," said Judy Schub, head of the Committee on

Investment of Employee Benefit Assets, a Washington group that represents corporate pension officials. "These are not people who say, `Oops!' and drop everything and change their strategy based on what's happening short-term in the markets."

If the opposing camp had a name, it might be something like "duration matching bond strategists," or "decumulation specialists." Off-putting terms, but behind them lies a body of thought that ought to be interesting to anyone fearful of having to park cars or flip burgers at age 87.

The duration matchers' first piece of advice is to stop chasing the average 10.7 percent a year that seemingly everyone says stocks have returned since 1926. That strategy, based on a statistical illusion, they say, is doomed to land those who pursue it on the shores of negative mortality, the grim term actuaries use to describe outliving one's resources.

It's not that stocks have not really returned an average 10.7 percent a year for much of the last century. That number is right, duration matchers say, but it's the wrong number for retirement savers to focus on.

Infinitely more important is "the time path of returns," said Zvi Bodie, a Boston University finance professor and an outspoken proponent of duration-matching theories, both for pension funds and individuals.

"Even if the average rate of return is high, one can run out of money long before one expires," said Professor Bodie, a co-author, with Michael J. Clowes, of "Worry-Free Investing," a book to be published this year that applies duration matching bond strategies to individual retirement planning. (Mr. Clowes is the editor of "Pensions and Investments," a trade publication.)

Instead of stocks, the authors propose an ultraconservative fixed-income portfolio composed of inflation-protected Treasury bonds. To avoid getting locked in at a single low interest rate, they also advocate buying bonds of different durations, with the maturities staggered in what is called a ladder.

If building a laddered bond portfolio sounds too boring after the casinolike thrill of the stock market, it's possible to add derivative-based bells and whistles to improve gains, much like professional fund managers do. But that's probably more complexity than individual savers want.

There may come a time when individual savers can buy packaged laddered bond portfolios, with the derivative hedges built in. It's possible even today to find prototypes of investment vehicles with some of these features. But you have to go looking for them.

"It's slightly premature right now," said Shane A. Chalke, a Middlebury, Va., actuary and annuity expert who operates AnnuityNet.com, a Web site offering services to fee-based financial planners.

Mr. Chalke thinks it's a chicken-and-egg problem. The public doesn't know about the duration matching bond concept so it doesn't demand these investments; financial-services companies don't offer them because there is no demand.

One reason for the lack of demand is that individual investors have had it pounded into their heads that stocks will eventually yield 10.7 percent, if people hold them for a long enough time period.

Mr. Chalke came by his opinion the hard way. In 2001, he devised an investment instrument called the Inflation Proofer, which would offer buyers a monthly pension check for life, indexed for inflation. He did it because the Bush administration was studying a Social Security overhaul then. He thought that if he created a retirement income plan that looked like Social Security and kept gun-shy people out of the stock market, the world would beat a path to his door.

His pitch line was, "If you like Social Security, here's where you can buy more of it."

Mr. Chalke located an insurance company, the Lincoln National Group, to underwrite the Inflation Proofer, but before they could start a marketing blitz, the stock market collapsed and plans to "privatize" Social Security were dead. Without legions of older Americans frightened of gambling their Social Security benefits on stocks, there was no market for the Inflation Proofer.

"On this site," he said of AnnuityNet.com, "we generally sell a couple hundred million dollars a year of annuities. But I don't think we've yet sold our first million of Inflation Proofer. The number is so small I don't monitor it." The Inflation Proofer is still available, through fee-based financial planners.

So far, there is only one big corporate pension fund showing the way for those who want to turn their backs on the cult of equities. In October 2001, Boots, a large British drugstore chain, announced that it had dismissed its pension manager, thrown out its equity-based asset-allocation plan and moved 100 percent into bonds.

Boots may be unknown to most Americans, but to pension managers it has earned a place in history. By selling its equities when it did — over 15 months in 2000 and 2001 — Boots generated enough proceeds to create a surplus in its pension fund. It then locked in the surplus by buying high-grade corporate bonds, carefully matching the durations to the maturity of Boots's obligations to its retirees. A sizable share of the bonds are inflation protected.

WHILE all this was going on at Boots, virtually every other large pension fund in Britain and America was holding onto equities and riding the bear market down.

Today, many of these companies are pumping large cash infusions into their pension funds. Boots, by contrast, has reduced its annual pension contributions by half. And because its bond portfolio is held passively, the drugstore chain has chopped its money-management costs from about $16 million to a thrifty $484,000 a year.

Despite all this evidence, most pension professionals still question whether the Boots model can be universally applied. They say that American accounting rules are different, that stock prices are too low to permit selling now, and that it is simply "not efficient" to invest in bonds.

Translated, that last argument means that as long as companies can argue they will earn 10.7 percent a year on stocks, they can save money by paying less cash into their pension funds than they would have if they had invested in bonds and measured their liabilities realistically. It's an appealing line of reasoning as long as it works — but the failed pension promises of Bethlehem Steel and US Airways reveal what happens when it doesn't.

Mr. Bodie and Mr. Chalke have also been devising a successor to the Inflation Proofer — a bond-based instrument that would offer not only a guaranteed, inflation-indexed monthly payout, but also an equity "kicker" that would use stock-index options to offer some of the market's opportunity without much of its risk.

The financial tools for such a product are well established, Mr. Chalke said. What is missing is a sense of the need.

"The public need hasn't reached a critical mass yet," he said. "We almost need to go through that cycle, where people will be retiring without pensions, and you'll have case studies of people running out of money. It's going to take some people running out of money for the demand to emerge."