We are witnesses to inexorable change in how retirement assets are managed and who is responsible for them. Indeed, private retirement asset management soon will dominate.

As evidence, look no further than the decline of traditional pension plans, from 114,000 in 1985 to only 31,200 in 2004. By 2030, Social Security is estimated to make up less than 27 percent of a retiree’s income, down from 38 percent in 2005. The decline of employer-sponsored defined benefit programs and government-sponsored Social Security as dependable retirement assets exposes challenges and opportunities for investors and financial professionals.

Indeed, future retirees must assume individual and sole stewardship of their personal retirement security. Successful retirees will be those who evolve and master their understanding of retirement. We in the financial services industry must stand ready to help.

One way we can help is by helping investors to realize that their behavior is fundamental to long-term financial success. We need to educate (and then frequently and sternly counsel) clients that

- wealth is created by concentrating risk, but
- wealth is maintained by managing and diversifying risk.

Unfortunately, the very behavior and talent that creates wealth, either for businesses or for investors, is the same behavior that can destroy wealth in retirement. Our job as financial advisors is to help our clients change their risk-seeking behaviors so they can protect their retirements. I call this managing client-based risk.

When Switching Industries, Please Hire an Expert

Retiring business owners and others who have created wealth during their working years indeed can be their own worst enemies in retirement, as shown in figure 1.

What best accounts for this dreadful performance? When investors transition into retirement they have switched industries. Upon retiring, they transition from full-time careers as successful and expert owners of business assets into part-time novice liquid-asset managers. And should anyone really expect an untrained amateur to do well?

And, the more successful the prospective retiree, the worse the situation. Those attributes that made these people wealthy aren’t the same attributes that will keep them wealthy. The behavioral traits that helped them amass wealth in the first place actually may become handicaps in retirement.

Among prospective retirees’ most costly common blunders is their failure to hire qualified independent financial advice. Having switched to a new industry—retirement—they need assistance managing the risks and returns on their portfolios. They need to hire experts who can help protect them from themselves.

Wealth-Creating Behaviors

High Tolerance for Risk

A common—and absolutely necessary—personality trait of successful business owners and wealth creators is their ability to tolerate high levels of concentrated risk. Data show that the majority of business owners are certain to taste failure. Data indicate that most business start-ups will not last long—and that only a fraction of businesses succeed. According to a June 2006 study by the Small Business Association:

- more than 33 percent of business start-ups do not survive two years.
- more than 56 percent of business start-ups do not survive to their fourth anniversaries.

This information indicates that business owners have familiarity with risk and tolerance for it. Logically, surviving business owners also tend to have elevated levels of confidence in their abilities to outsmart (or at least outlast) adverse conditions. Self-made investors often have a strong sense of personal control over the risks that they assume.¹
Poor risk calculation, overconfidence, and an inflated sense of perceived control are classic problems for individual investors generally. Successful business owners, however, are especially susceptible to these problems.  

Self-Reliance and Avoiding Delegation
Business people tend to “go it alone.” It is estimated that business owners work an average of 52 hours per week, compared to the average worker’s 34-hour work week. That’s a 53-percent longer work week. Fifty-seven percent of small business owners work six days a week; and 20 percent work seven days a week. Also, business travel accounts for 16 percent of all travel and 55 percent of all business trips are made by people aged 30 to 49—or, the typical age of those raising a family.  

Such self-reliance not only reduces the likelihood of delegating to more-qualified professionals, but it also can create an unhealthy intimacy with wealth: “Nobody cares more about this money than I do.” But just as a parent’s love for a sick child cannot transform that parent into a competent physician, one’s love for hard-earned money cannot transform him or her into a qualified asset manager. If anything, such an intimacy denotes a conflict of interest that should be grounds for recusal.

Wealth Maintaining Behaviors
Prospective retirees should ask themselves, “Am I that good, or did I just get lucky?” Unfortunately, few individual investors are inclined to ask—much less answer—this question. And far too often, the investment “acumen” of retail investors is little more than the good short-term performance of a popular investment.  

As an advisor, you need to apply a lesson from Investing 101. Admonish clients that no asset class or investment strategy will stay permanently best. Indeed, if something has performed well recently, the competitive forces of the market will take away those excess returns. The peak of performance often is where investors fall into a self-laid investment trap.  

My firm has a 70-year history of managing market-based risk. The most dangerous source of risk, however, likely will be client-based risk—the client himself. The advisor is positioned to understand the unique constraints and needs of a client and has the capacity to restrain a client from self-inflicted investment wounds through managing the long-term risk—return balance of a liquid portfolio.

Manage Risk, Not Luck
The sad reality is that most investors (by themselves) will find it nearly impossible to consistently differentiate between actual long-term investment skill and short-term luck. Our firm uses three tools to them protect themselves and their portfolios.

Tool #1: A multi-asset strategy. Because no asset class will stay permanently best, asset allocation is the initial step in portfolio construction and arguably is the most important decision an investor can make. Asset allocation assumptions set the investor’s risk budget because they determine what percentage of a portfolio will be income generating (less risky) and what percentage will be dedicated to capital appreciation (return seeking) (figure 2).

For all investors, risk is the currency of the realm. The more return that an investor wants, the more risk he has to pay. For a given risk budget, asset classes then are selected. Our multi-asset platform allows financial advisors to decide from among multiple asset classes across varying degrees of risk to attain optimal diversification. This process sets a policy allocation that should be neither too aggressive nor too risk averse. While this point can be difficult to locate and maintain, in the absence of a financial advisor it can be even more difficult.

Tool #2: A multi-style strategy. Figure 3 shows a long-term view of style and capitalization effects, which shows how outsized returns in any given area of equities over any given time eventually are competed away by the market. The large dot in the middle of the graph shows reversion to the mean—evidence that capitalization and style premia indeed are competed away by market forces.

So don’t make large style or capitalization bets based upon short-term performance because they don’t tend to pay off. This is why we use a disciplined, multi-style approach (that builds upon the multi-asset foundation) to further diversify client portfolios. This is important to risk management because it minimizes large tactical bets on any particular style. Instead, our firm seeks to minimize these tactical
bets by employing multiple styles within each asset class. This ensures that no single style dominates a portfolio, resulting in a network of complementary styles that together reduce the volatility of the respective asset class.

**Tool #3: A multi-manager strategy.**

Just as no one asset class or style will be permanently best, the odds are against any single money manager beating the benchmark consistently over time. Therefore, once multiple assets and multiple styles are in place, our firm utilizes multiple managers within each style. This is not to say that any given manager will have lost their skill; it is to say that you should not bet your entire portfolio on only one manager because markets tend to cycle around investment styles.

The multi-manager strategy offers an additional opportunity to manage investment risk and potentially can add incremental return. Though large bets on asset allocation/style tend to work against investors, security selection tends to be the most consistent way to beat the benchmark. In any profession a minority of practitioners will prove themselves more skilled than the rest. Figure 4 illustrates the multi-manager approach. The premise is that it is possible to identify better-than-average money managers. Logically, then, the longer an investor can stay in the top half of that distribution, the better the odds of beating the market average while also trying to control for market-based risks associated with holding that portfolio.

This is a total portfolio management approach which accounts for the fact that investment styles, asset classes, and investment managers can go in and out of favor over time. This constant change inevitably leads to portfolio volatility; combining multiple assets, styles, and managers attempts to manage this market-based risk, while seeking to achieve consistent and sustainable returns over time.

These tools are designed to minimize short-term luck as the driver of performance and to emphasize risk management and security selection by skilled money managers as the critical components to achieving portfolio excellence.

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**Endnotes**

3. Ibid.