

Life – Cycle Investing


Portfolio Management
for Financial Advisers

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As investor goes through the life cycle periods (youth, maturity, middle age, retirement) **the ratio of discretionary wealth** (i.e. difference between implied and tangible financial assets and implied and tangible financial liabilities) **to total assets dictate the optimal level of investment risk.**



Determining appropriate investment policy

Wealth category	Young	Middle Age	Retirement Age
Very wealthy	Agressive	Agressive	Agressive
	Can maintain discretionary wealth at high levels for entire life cycle		
High net worth	Balanced	Agressive	Balanced/Agressive
	Relative lower dicretionary wealth resulting from liabilities for housing, savings for children college, etc.	The proportion of discretionary / total assets increases	Investor moves from employment and net savings to retirement and net spending, strategy should back to the balanced
Prosperous	Conservative	Balanced	Conservative
	Low discretionary wealth due student loans, housing payments	Discretionary assets grow	Discretionary wealth declines; strategy returns to conservative approach
Average	Conservative	Conservative	Very Conservative
	Inable to accumulate enough discretionary wealth keeps strategy from moving beyond conservative. Additionally, without sufficient discretionary wealth to take on greater investment risk, and with retirement age looming, the investment strategy should be very conservative during retirement phase.		



Determining appropriate investment policy

- Negative shocks to discretionary wealth require investors to reconsider what they must earn or can afford to spend. The desire for flexibility in employment earnings, spending, etc. complicates portfolio investment process

EXAMPLE: An investor who initially requires \$100k a year in annual spending might consider living on 80% of that amount in an emergency

- This type of flexibility represents a form of option, which has option value
- As sudden and negative shocks are painful to consumption, covering this shortfall by planning for it and saving small amounts over a longer time horizon is easier than trying to cover the shortfall over a short period time
- This type of flexibility favors young investors as he or she has a longer time horizon to work with and can also take on a more aggressive investment allocation



Determining appropriate investment policy

Outliving one's asset = Risk to all investors except those very wealthy

- An investment option that addresses this risk is an **annuity**. However, in order to determine whether an annuity is appropriate or not, one must consider the price paid for the annuity, factoring in the taxation on the distributions of the annuity
- Without the annuity, **an investor can mitigate the risk of outliving one's assets by planning on a life span longer than actuarially expected**
- Another alternative is to **include risk in the optimization process by assuming that this retirement liability is a short position with a risky return**. Effect: an investor is more conservative in his investment approach.

Uncertainty regarding life-span ➡ more conservative investment approach



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CASE STUDY

Jesse Zaragoza, CFA, is an investment advisor. Jesse recently acquired a new client named Joan Smith. Joan is a young lawyer who has had a prosperous career since her graduation from law school two years ago. Joan has a large student loan balance. Additionally, Joan has just purchased a home and has a sizable monthly mortgage payment. Joan's monthly fixed payments currently account for a significant portion of her income.

YOUR TASK

Based on Joan's stage of life and wealth category,
what is Jesse's best recommendation?

CASE STUDY

Solution

Wealth category	Young	Middle age	Retirement age
Very wealthy	Aggressive	Aggressive	Aggressive
High net worth	Balanced	Aggressive	Balanced/Aggressive
Prosperous	Conservative	Balanced	Conservative
Average	Conservative	Conservative	Very Conservative



Taking under consideration Joan's age and low discretionary wealth, she should choose a conservative approach



THANK YOU!