AUGUST 2016

Retirement Investing and Stock Selection: Q&A with Professor Wai Mun Fong

With his study of threats and opportunities facing investors who are saving for retirement, Dr. Wai Mun Fong (Associate Professor at National University of Singapore) won the Brandes Institute's 2015 Call for Papers contest. This article features comments from Dr. Fong and explores some key findings from the winning paper, which has been published in the Summer 2016 edition of The Journal of Investing.

From the rule of thumb suggesting the ideal percentage to allocate to equities is 100 minus your age, to the proliferation of target date investment funds, the concept of lifecycle investing takes many forms and helps guide the asset allocation of an increasing share of aggregate savings. According to an Investment Company Institute study of America's 401(k) plans, "the percentage of participants that were offered target date funds increased from 42% to 75% between 2006 and 2013, and the percentage of assets invested in target date funds increased from 3% to 15% during this period."[1]

Lifecycle investing refers to the theory that an individual investor should hold fewer stocks and more bonds as he or she gets older. But does it work?

Put simply, lifecycle investing refers to the theory that an individual investor should hold fewer stocks and more bonds as he or she gets older. The main idea is to put the critical but difficult task of allocating between stocks and bonds on a form of autopilot that follows an established "glide path" as the years go by, simplifying each investor's quest to build and maintain a nest egg that lasts through retirement.

But does it work?

In his research study, "Dividends, Profitability and Lifecycle Investing," which won the Brandes Institute's 2015 Call for Papers contest, Associate Professor Wai Mun Fong points to a potential vulnerability underlying not just the lifecycle approach, but also the broader practice of investing in stocks via market indexes.

"If investors rely on the market portfolio as the main component of their equity portfolio for retirement, most investors appear to be in dire straits."

– Professor Wai Mun Fong

"Under realistic assumptions about earnings, savings, and desired levels of wealth at retirement age, glide paths with broadly diversified market portfolios are unlikely to meet even modest target wealth requirements," Fong writes. The professor also raised this caution in an interview with members of the Brandes Institute. "If investors rely on the market portfolio as the main component of their equity portfolio for retirement," he said, "most investors appear to be in dire straits."

Fong's study focuses on a hypothetical individual who starts investing at 25 and retires at 65. This person's annual income rises and falls with the Social Security Administration's (SSA) projections for a typical worker,[2] and he or she invests 4% of each year's earnings – near the current average savings rate in the United States. The investing follows a lifecycle-guided stock allocation that stays at 90% until age 40 and then declines 2% annually to 42% at age 65.

[1]Source: https://www.ici.org/pressroom/news/15_news_brightscope

Using historical stock returns over the half-century from 1963 through 2013, as well as a wide range of simulations of the future, Fong studies how this hypothetical investor could expect to fare. In general, the outcomes leave something to be desired: in more than 70% of scenarios, for example, total savings were not sufficient to provide an annual retirement income of two-thirds of what the investor was earning just prior to retirement.

Investors can boost their odds of retiring comfortably by increasing their savings rate beyond the 4% assumed in the study.

On a more positive note, Fong puts forth some potential solutions. For starters, investors can boost their odds of retiring comfortably by increasing their savings rate beyond the 4% assumed in the study. This is not impossible; in fact, the article notes that the average savings rate in the 1960s was more than double what it is today.

Another solution involves the stock portion of investor portfolios. What if that portion was not invested in a broad market index such as the S&P 500 Index, but in a strategy that could outdistance the S&P 500 considerably?

Because market indexes are weighted by market capitalization, Fong says, "The most successful and largest firms have the largest weights." This gives more weight to stocks with growth-type characteristics such as higher price-to-book ratios and higher betas – and historically, such stocks have tended to underperform their counterparts with lower price-to-book ratios and lower betas.

After poring over the historical data, Fong suggests investors consider abandoning broad market indexes in favor of stocks of highly profitable companies that offer high dividend yields. These "Profitable Dividend Yield" or PDY stocks[3] outperformed the market (as represented by the Center for Research in Security Prices (CRSP) Value-Weighted Stock Index) dramatically in the past – and for a variety of reasons explored in his article, Fong believes they will continue to do so.

Simulations show that glide paths with PDY stocks generated "…superior median wealth, lower shortfall risks, and greater resilience to a low-return environment than glide paths implemented with market portfolios," Fong's article concludes. See Exhibit 1 on next page.

[2]The SSA publishes age-specific "scale factors" which, when multiplied with the projected average earnings, gives a vector of forward-looking earnings that rises through age 51 and then falls off to age 64. See the Clingman and Burkhalter article, "Scaled Factors for Hypothetical Earnings Examples Under the 2014 Trustees' Report Assumptions" https://www.ssa.gov/oact/NOTES/ran3/an2014-3.pdf. In short, it is assumed that a 25-year old employee in 2013 earns $28,300. His/her earnings peak at $94,850 at 51 and decline to $68,600 at 64.

[3]Past performance is not a guarantee of future results. Performance described is for the period 06/01/1963 TO 12/31/2013. The universe for constructing the PDY portfolio consists of all ordinary common stocks traded on the New York Stock Exchange (NYSE), American Stock Exchange (Amex) and Nasdaq, from the Center for Research on Security Prices (CRSP). REITS, financials, foreign shares, ADRs and closed-end funds were excluded. Also, stocks with market capitalizations in the bottom quarter and those with prices below $5 were eliminated. PDY stocks were those in both the highest quintile by dividend yield and the highest quintile by gross profitability-to-assets ratio. See Fong, Wai Mun. "Dividends, Profitability and Lifecycle Investing" for more details.

THE BRANDES INSTITUTE

Fong suggests investors consider abandoning broad market indexes in favor of stocks of highly profitable companies that offer high dividend yields.

Exhibit 1: Simulation Results Based on Historical Returns (1963 to 2013)

	Market Index	PDY Portfolio
Mean Wealth	$ 983,003	$ 5,959,508
Percentiles		
10th	$ 398,487	$ 1,244,051
25th	$ 549,127	$ 2,085,912
50th	$ 812,638	$ 3,839,051
75th	$ 1,230,493	$ 7,482,413
90th	$ 1,782,296	$ 13,098,747
Percent of Last-drawn Earnings	**Shortfall Probability**	
25%	27%	1%
50%	71%	8%
67%	85%	15%

Source: Fong, Wai Mun. "Dividends, Profitability and Lifecycle Investing." Past performance is not a guarantee of future results. No investment strategy can assure a profit or protect against loss. One cannot invest directly in an index. This hypothetical example is for illustrative purposes only. Does not represent the performance of any specific investment. Actual results will vary. This table includes statistics of simulated retirement wealth at age 65. The "Market Index" results reflect the CRSP Value-Weighted Stock Index. The "PDY Portfolio" was formed yearly by intersecting stocks in the highest quintile by dividend yield and stocks in the highest quintile by gross profitability-to-assets ratio. Shortfall probability reflects percentages where, after 1,000 simulations, accumulated wealth fell below targets of 67%, 50% and 25% of last-drawn earnings.

When asked about the performance of PDY stocks "in times of big market dislocations" such as the significant downturn in 2008, Fong replied that outperformance seemed consistent in both up markets and down markets, and that returns for specific periods could be worthwhile to examine in future research.

In short, how could one describe the PDY approach? Could it be called value investing? Growth? Growth at a reasonable price, a.k.a. GARP? Or maybe none of the above?

Fong said high-dividend stocks, by themselves, tend to be considered value stocks – but PDY also includes the shares of high-*profitability* firms, which lends the strategy more growth-like characteristics. "So in short," he said, "PDY is a hybrid of value and growth."

Shane Finneran contributed to this article.

Examples are hypothetical and for illustrative purposes only. They do not represent the performance of any specific investing. Actual results will vary.

This material was prepared by the Brandes Institute, a division of Brandes Investment Partners®. It is intended for informational purposes only. It is not meant to be an offer, solicitation or recommendation for any products or services. The foregoing reflects the thoughts and opinions of the Brandes Institute.

The views of Wai Mun Fong do not necessarily represent the views of the Brandes Institute or Brandes Investment Partners.

The information provided in this material should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any security transactions, holdings or sectors discussed were or will be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance discussed herein. Strategies discussed herein are subject to change at any time by the investment manager in its discretion due to market conditions or volatility.

Please note that all indices are unmanaged and are not available for direct investment.

Past performance is not a guarantee of future results.

No investment strategy can assure a profit or protect against loss.

Diversification does not assure a profit or protect against a loss in a declining market.

The S&P 500 Index with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy. The CRSP Value-Weighted Index gives the value-weighted return of all firms incorporated in the United States and listed on the NYSE, NASDAQ and the NYSE Arca Exchange with available shares outstanding and valid prices in the current and previous periods, excluding American Depositary Receipts.

The Brandes Institute
11988 El Camino Real,
Suite 600,
P.O. Box 919048
San Diego
CA 92191-9048
858.755.0239
800.237.7119

Get the Latest Research and Ideas: