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A Financial Professional's Guide to Generational Risk Analysis in Stock Market Investing

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This article takes a look into the generational perception of the risk of investing in equities. It discusses solutions for financial professionals and educators to best help their clients or students understand the costs and benefits of long-term equity investing. It also suggests guidelines for financial professionals and educators in helping clients manage their emotions during times of extreme market volatility.

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INTRODUCTION AND OVERVIEW

The early years of the 21st century have been coined the "lost decade" for stock market investing. A collection of various events, catastrophes, and economic shifts has kept the stock market from any significant growth or stability. The tech/dot-com bubble of the late 1990's and early 2000's, the terrorists' attacks of September 11, 2001 and the largest recession in history during 2008 have all defined stock market investing. Unfortunately, an investment of $100 into the S&P 500 on December 31, 1999, would have been worth approximately $90 at the end of 2009 (Shell, 2010). This is certainly a disappointment when one considers the negative impact of inflation on purchasing power during the same period contrasted with the 15% average annual return of the S&P 500 in the 90's.

The challenges presented during this period have caused consumer confidence to fall to record levels. The Bloomberg Consumer Confidence Index for the period ending February 14, 2012 declined to minus 39.8 for only the third time since April 2008 (Kowalski, 2012). We have seen the markets react positively as confidence is increasing at the start of 2012. Gary Langer, president of Langer Research Associates LLC, which creates the Bloomberg Consumer Confidence Index, expresses that the recent confidence increase is a "key milestone in its struggle to dig out of its deepest, longest downturn in a generation" (Kowalski, 2012, p. 2). However, the stock market collapse of 2008 is still fresh in the minds of nearly every investor.

This article will take an in-depth look into the generational perception of the risk of investing in equities. It will discuss the following five generations: Greatest Generation, Silent Generation, Baby Boomer, Generation X, and Generation Y. The article does not intend to determine the exact time periods of when these generations start and end or how to best title each generation as much has already been written regarding this (Strauss & Howe, 1992; Lancaster & Stillman, 2002). There is not a governing generational source for time periods, which leaves room for various interpretations of start and end years for each generation. Table 1 is the time periods utilized in defining the generations being discussed. This article will discuss solutions for financial professionals and educators to best help their clients or students understand the costs and benefits of long-term equity investing. In conclusion, the article will set guidelines for financial professionals and educators in helping clients manage their emotions during times of extreme market volatility.

Table 1: Classification of Generations

Generation	Year of Birth	Age in 2012
Greatest Generation	1901-1924	88+
Silent Generation	1925-1945	67-87
Baby Boomer	1946-1964	48-66
Generation X	1965-1985	27-47
Generation Y	1978-1994	18-34

Source: (Strauss & Howe, 1992, p. 32; Gaylor, 2002; Brokaw, 2010)

THE GREATEST GENERATION

The title of the Greatest Generation originated from Tom Brokaw in his book *The Greatest Generation Speaks*. Brokaw describes this generation as "the American men and women who grew up in the Great Depression, who came of age in World War II and then devoted their adult years to the building of modern America" (Brokaw, 2010 p. X). Given the current age range of the Greatest Generation (88+) most are currently more concerned about health issues and the passing of their estates than the future of equities. However, all living generations can learn from the perceptions this generation had while they were both accumulating and distributing wealth. Many in this generation never really had a goal of retirement and worked as long as they could. Many that have retired have corporate pensions to rely upon for income (Drew, 1989). In addition, during their retirement years, starting in the 1980's, the interest rate environment was rising,

eventually reaching 18%. Markets and interest rates were much more favorable to those of this generation that did retire. If you have the opportunity to share a cup of coffee with someone from the Greatest Generation the time you spend with them may provide invaluable life lessons and amazing stories. Capitalize on this opportunity while you have the chance.

SILENT GENERATION

The Silent Generation consists of individuals in their 60's, 70's & 80's. The median retirement age for the Silent Generation is 61.8 with 75% retired by age 65 (Johnson, Butrica, & Mommaerts, 2010). This generation grew up during WWII and the civil rights movement. As the children of the Greatest Generation the Silent Generation learned the hardworking, frugal ideals of their parents, but also value their own independence and lifestyle.

In 2005 Metlife Mature Market Institute conducted a study of 1,012 individuals of the Silent Generation (Metlife, 2005). The study found the following significant trends and facts:

- Possibly the final generation that can depend upon company pension plans and Social Security benefits.
- Multiple sources of guaranteed income for retirement (pensions, annuities).
- Not focused or overly concerned about leaving an inheritance to their heirs.
- Confident about not outliving retirement assets, even though it's a serious risk.
- Concerned about costs of healthcare and stock market downturns.

The Silent Generation witnessed their parents nearly lose everything during the Great Depression. The 2008 recession brought back memories for these investors and they are naturally overly cautious and extremely risk adverse. This generation has learned to accept the low returns of guaranteed interest (ex. certificates of deposit, fixed annuities) and feel a sense of security in investing solely in fixed income/bond investments. Domestic equity mutual fund outflows from 2007-2011 totaled $408 billion. During that same time period bond mutual fund inflows totaled $792 billion (Halbert, 2012). Although bonds have done particularly well, with the current low rate environment the risk versus return is currently unfavorable. Unfortunately, most of the investors investing into bonds are looking at past performance and the safety that bonds have provided but not considering the potential pullback on bond prices as rates begin to rise and outflows begin to occur (Wu, 2012).

It is a challenge for the Silent Generation to accept the fact that they need a well-diversified portfolio to help weather any potential financial storms that could occur. In fact, a recent study by the Vanguard Group found that since 1926 the average real return of a balanced portfolio (50% stocks, 50% bonds) was 5.6% during expansions and 5.3% during recessions (Vanguard, 2011). The struggle is for the retiree to remain invested and avoid reacting emotionally and buying and selling at the wrong times. The recent market volatility and stock market losses have caused investors to be uneasy and worry about running out of money. It is difficult when an investor receives several statements in a row

showing declining balances especially while receiving regular distributions from the portfolio. It is important for investors to realize that the investment time horizon is not the day they retire, but the number of years left in their lifetime (O'Neill, 2009). In addition, it is important to recognize that current guaranteed rates are a net loss after inflation. For example, assuming a guaranteed interest rate of 1% and an average inflation rate of 3% the net return is -2%. Therefore, the investors of the Silent Generation need a diversified portfolio (equities, bonds, cash, alternative, etc.) that best fits their risk tolerance, goals and objectives.

BABY BOOMERS

The Baby Boomer generation consists of those born between 1946 and 1964. Approximately 79 million babies were born during this time period when many young men returned from WWII and started a family (Rosenberg, 2012). The oldest baby boomers are in their mid 60's and approximately 10,000 boomers a day will reach their mid 60's over the next 17 years (Cohn & Taylor, 2010). The number of senior citizens is expected to double between 2011 and 2050, from 40 million to 89 million (Gelinas, 2011). There are certainly many challenges facing our aging population.

Many baby boomers face much different decisions than their parents as a result of the previous decade of low investment returns. While most of the silent generation was already retired at the end of 2010, most of the baby boomers are just entering or considering retirement. The past 10 years along with the 2008 recession have caused baby boomers to rethink their strategies. Many have decided, whether voluntarily or involuntarily, to postpone retirement and work longer (Williamson, 2008). Our aging population is obviously concerned about retirement and uncertain of what the future holds. The constant dripping of media and political chatter regarding potential social security and Medicare cuts has the baby boomers rightfully concerned. Both the financial and economic crisis along with the collapse of the real estate market has added fuel to the fire.

As previously discussed, the days of higher interest rates and the ability to live off guaranteed interest are no more. The declining interest rates have reached a bottom with little room to drop any further (current fed funds rate: .25%). In addition, the 30-year bond bull market is most likely coming to a close. Given these economic conditions, one certain but generally unwelcomed fundamental to success for most baby boomers is to expand the working years and lessen the years spent in retirement. Alicia Munnell (Boston College professor and director of Boston College's retirement research center) expresses, "Working longer is key to a secure retirement for the vast majority of older Americans" (Gelinas 2012, p. 1). This is particularly challenging for this generation to accept given their high expectations of retirement.

The baby boomer's appetite for investment risk is not much greater than that of their ancestors. This generation has now experienced two major asset bubbles during their working careers (O'Neill, 2010). The double-digit growth of the 1990's came to a screeching halt and then was followed up by the housing bubble in the 2000's. This generation has already taken several investment risks and is not feeling as if they have seen any reward. The past disappointments have lowered expectations for future success. The need for prudent investment and retirement advice and a well-diversified portfolio is critical for this generation. Many are adjusting their risk based on emotions and buying

and selling different asset classes at the incorrect times (Luxenberg, 2010). As the previous analysis of fund flows indicated there are many more outflows of equities and inflows to bonds. This is disturbing as the consensus of financial experts indicates that stocks are relatively cheap and bonds are expensive (McGee, 2012). As this generation is hoping to retire sooner rather than later a well-diversified portfolio that includes risky assets of both international and domestic stocks, high-yield bonds, and alternative investments might be a better strategy.

GENERATION X & Y

Generation X has a current age range of 27-47, while Generation Y has a current age range of 18-34. These generations are compared together as they generally have 15+ years until retirement. Those less than 18 would fall into the category Generation Z. Assets of the Generation Z are primarily controlled by an older generation with custodial and college savings plans. Generation X grew up during the 1980's and 1990's and embraced both the culture and technology. Generation Y grew up in the 1990's and 2000's and were largely impacted by the growth of the Internet and global communication.

It is critical for both Generation X & Y to become educated and self-sufficient for their own retirement futures. The younger generations certainly can't rely upon social security and most will not have company pension plans. In addition, the inflation of general living needs and potential healthcare costs will continue to disrupt their pocketbooks. Stuart Ritter of T. Rowe Price expresses that, "The biggest threat to Gen Xers to being able to buy the things they want in retirement is inflation," "And historically the asset class that best keeps up with inflation is equities." (Mincer, 2012, p. 3).

The younger generations have mostly followed in the footsteps of their parents and lowered their equity exposure. According to a study completed by the Employee Benefit Research Institute for Smartmoney.com at the end of 2009, individuals from the age 30-44 only had 48% of their 401(k) accounts allocated in equities. In 2007 they had 55% allocated towards equities (Mincer, 2012). A T. Rowe Price survey found that only 45% of Generation X & Y investors intend on contributing to an Individual Retirement Account (IRA) this year (Mincer, 2012). In 2010 nearly 71 percent made a 2010 IRA contribution (FA News, 2012). The younger generations are investing less for their future and the money that they are investing is being weighted more towards less-risky assets. Generation Y and X have been primarily exposed towards a negative time period for U.S. Equities. Many have tuned in to the talking heads on television and the negativity of their parents and allowed this to influence their own investment decisions. With a long time horizon for these investors it might be best for them to heed the advice of one of the most successful investors of our time. "Be fearful when others are greedy and greedy when others are fearful." – Warren Buffet (Sears, 2012)"

GUIDELINES FOR FINANCIAL PROFESSIONALS

Market volatility has certainly impacted the mindset of all generations. Investors in both the accumulation and the distribution phases think differently about the manner in which they invest. Although the markets are ever changing and evolving, the disciplines and

strategies of the most successful investors have not changed. The remaining portion of this article will discuss strategies and disciplines that educators and financial professionals can utilize to best help their clients or students understand the markets and ultimately be a successful investor.

Time in the market, not timing the market

It is difficult for the average investor to understand the complexities of the markets and the volatility that takes place. Media coverage can sway investors' to act emotionally rather than rationally many times leading investors to buy high and sell low. With the S&P 500 trading around 1,400 (3/24/2012), the index has finished positive for four straight months, the longest positive stretch since September 2009 (Wang, 2012). Although U.S. stocks still appear to be attractive investments, there will likely be a correction at some point in time. Investors that have pulled out of the market are feeling comfortable again and may just now be getting back in. If a correction occurs these same investors may sell back out and find themselves in a cycle of emotional and financial loss. The annually published DALBAR study compares the average investor and investor philosophies to various market indices. From 1990-2010 the average annualized return in the S&P 500 was 7.81% while the average annualized return for the average investor was only 3.49% (DeFrancesco, 2012).

Most investors are busy with their careers while the market is open and don't have the time or experience to study various reports and analyze corporate conference calls. No one has a crystal ball to identify the best and worst days of the market. However, an efficient management process with a diversified portfolio over time has the best likelihood of outperformance of a blended benchmark (Kjetsaa, 2004). Generation X &Y have the advantage of a long time horizon until retirement. The younger generations can benefit by staying invested and receiving reinvested dividends to accumulate more shares at cheaper prices. An advisor needs to help a client understand the dedication, discipline, and time it takes to manage a portfolio and the importance of doing it as efficiently as possible. For a client that has the knowledge and experience, self-management may be appropriate. A client that falsely believes he has adequate experience could be a detriment.

Diversification Matters

It is important for investors to understand the importance of diversification. Investors that simply setup their own retirement plans often find themselves in one or only a few asset classes. Sometimes employees find themselves 100% invested in their company stock. One recent example of this is the employees of Enron who had all of their retirement savings in the company stock (Costello, 2001). In looking at the Convergent Wealth Advisors Periodic Table of Asset Class Returns large cap stocks returned 2.92% per year the past 10 years (2000-2011), while a diversified portfolio gained by having exposure to other asset classes such as small cap stocks (5.62% per yr.), fixed income bonds (5.78% per yr.), REITs (10.16% per yr.), high-yield bonds (8.86% per yr.) and emerging markets (14.2% per yr.) (Convergent Wealth Advisors, 2012).

Every year analyst forecast which asset classes are going to perform the best and which ones will be the worst. Perfection on these forecasts is impossible. The Greatest &

Silent generations should be diversified much more conservatively than Generation X & Y. The Baby Boom Generation should have a more moderate or balanced approach to investing. A client should meet with a financial advisor or conduct their own due diligence to determine the appropriate diversification for their particular retirement goals. Diversification within a portfolio provides negative correlation with asset classes moving in different directions at various times (Calio, 2004). Utilizing expert opinions to make tactical portfolio adjustment can add value, but never should an investor place "all of their eggs in one basket."

Portfolio Rebalancing

As asset classes increase and decrease an asset allocation strategy begins to drift from its original target. A rebalancing strategy helps minimize risk and reduce volatility. For example, in 2008 when the S&P 500 was continually dropping, a portfolio that was regularly rebalancing would have bought shares of stock at extremely low prices. Of course, during that time it was difficult for investors to stay disciplined in rebalancing.

The two primary forms of rebalancing include periodic rebalancing (monthly, semi-annual or annual) and drift based or trigger rebalancing. The periodic rebalancing strategy provides simplicity, but doesn't account for market performance impacting overall portfolio performance (Below & Kiely, 2009). The drift based or trigger rebalancing automatically adjusts the portfolio once a particular class varies by a set percentage positive or negative (ex. 3%, 5%). Drift based or trigger rebalancing is also easy to implement, but assets with higher volatility (ex. Emerging markets) will cause a portfolio to adjust more frequently. It is most important to implement a strategy in rebalancing to decrease overall volatility and to create systematic capture of portfolio gains and purchase of assets that are temporarily out of favor.

Dollar-Cost-Averaging

Considering that interest rates are at historic lows the consumer is not rewarded for having larger balances in cash. As consumer confidence increases more people may desire to get back into the markets. Dollar-cost-averaging is a strategy where the investor is not putting all his or her cash into an investment in one lump sum; rather they are investing a set amount in regular intervals. For instance, an investor that has $100K to invest may setup automatic investments of approximately $8,300 per month over a 12-month period. This provides for an average cost for the investor over the next 12 months and helps protect the investor from an unexpected market drop and helps ease them into an ongoing investing strategy.

Investors in the accumulation phase (ex. Generation X & Y, Baby Boomers) are currently capitalizing on the strategy of dollar-cost-averaging through company retirement plans. A DCA strategy can help an investor focus on the accumulation of investment shares with regular interval investments and dividend reinvestment. For the younger long-term investor a drop in the market allows the investor to accumulate more shares at cheaper prices. For example, in 2008 the S&P 500 ended the year down 37% and was down at one point 47% (Market Insights, 2011). An investor that was implementing dollar-cost-averaging and dividend reinvestment accumulated more shares at discounted prices.

Engage in your Future

In a market that is always changing it is important for advisors and educators to encourage investors to engage in decisions about their financial futures. Many investors hide from their investments when times are bad. Generations X & Y concern themselves with the value of the portfolio rather than the investment compounding opportunity. The Silent & Greatest generations are worried about their income rather than overcoming inflation. The Baby Boomers are concerned about a combination of both portfolio value and protecting income. Each of these concerns is valid. The times of uncertainty are the best times for clients to be implementing some of the strategies discussed. Advisors and educators can encourage clients to be involved in the planning of their future and not shy away from the uncertainties. Consumers must learn to avoid panic in times of extreme volatility, and capitalize on the opportunities that become available during these times. Advisors can best educate their clients by conducting regular client reviews. During these reviews advisors can establish, implement, and monitor strategies to maximize potential success for their clients, help them refocus on their investment goals, reassess personal risk profiles and determine practical next steps. The clients that can remain disciplined have the best opportunity in being successful in reaching their financial goals.

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