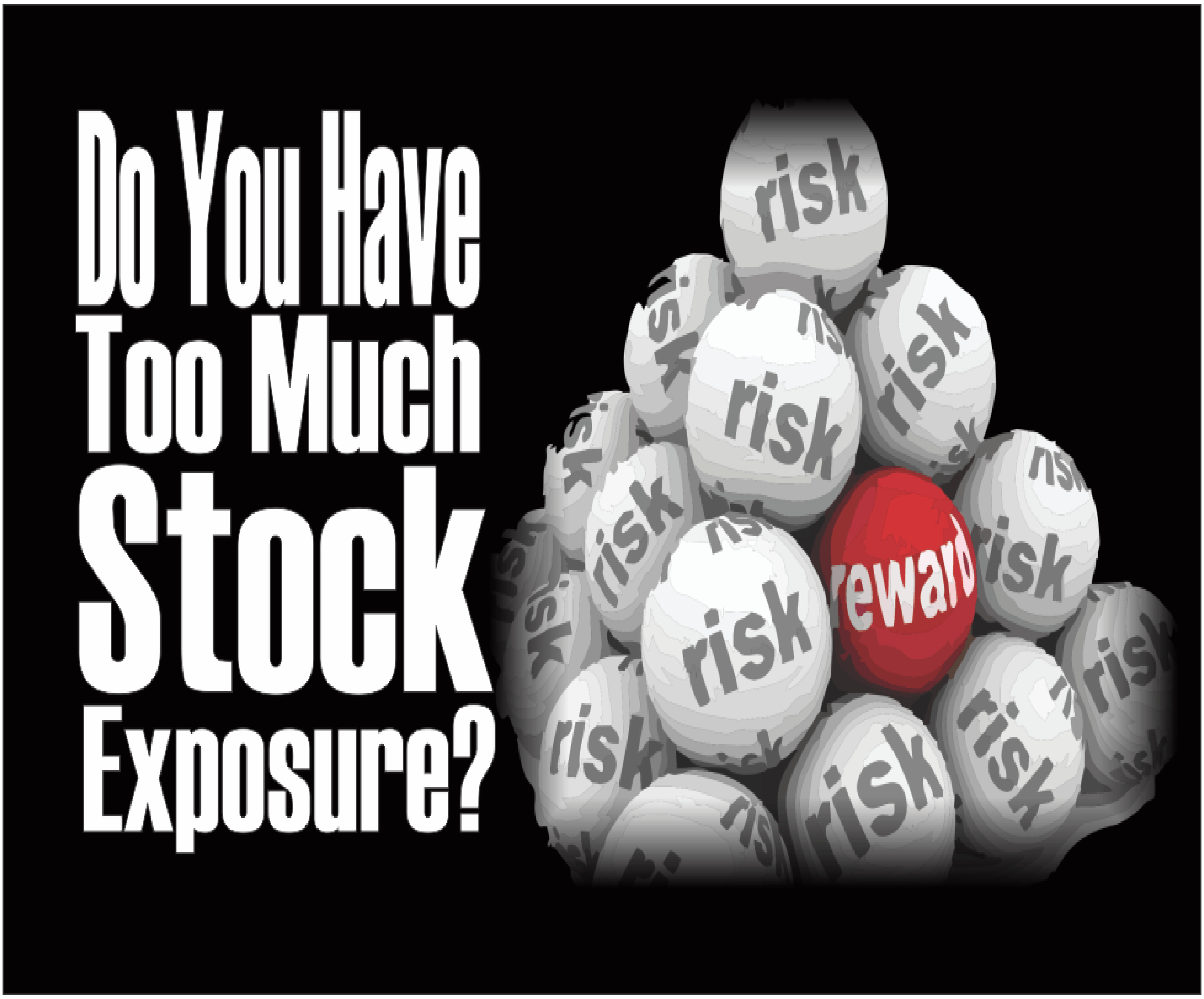
# Do You Have Too Much Stock Exposure?




If you?re retiree trying to use your saved capital to generate income, you?re basically trying to construct a pension for yourself. And that means you should think about how Jeremy Gold understood pensions. Gold, who died recently (here are his obituaries in in the *New York Times* and the *Wall Street Journal*), made the first arguments that public employee pensions were more radically underfunded than most people thought. One of the questions he raised was why the payments pensions make, which are obligations, are funded with securities that are not obligations (stocks). Shouldn't payment obligations be funded with investment obligations (bonds)? People complain that pension return estimates (or discount rates) are too high, which lowers the amount that needs to be saved today to fund future payouts. But why, Gold asked in articles like this one with his frequent collaborator Ed Bartholomew, pick securities whose returns need to be estimated in the first place?

> *?Risky assets (like stocks) are of course expected to return more than default-free bonds. If that weren?t true, no investor would hold risky assets. But expected to return*

> *more doesn?t mean will returns more,? Gold wrote. Indeed ?[r]isky assets might well earn less than default-free bonds, perhaps much less, even over the long term ? that?s what makes the risky. And if that weren?t true, no investor would hold default-free bonds.?*

These are all questions for retirees trying to generate income to ponder. It's hard for most people to estimate how much equity exposure they should have in an income-generating portfolio. Perhaps Gold?s suggestion of 0% for pension funds is too severe. What retirees should understand for their own accounts, however, is that they might not be able to take as much risk as they think they can. Moreover, as Gold says, risky assets might earn less than risk-free assets even over the long term. That?s especially a possibility now with stock valuations so high. It shouldn?t shock anyone if bonds outperform stocks over the next decade given the starting valuations of stocks (current Shiller PE of 32). Gold also tacitly seems to deny that risk is volatility. He speaks simply of stocks not performing as well as government bonds, not about whether stocks might be justified or not on a volatility-adjusted return basis. Retirees need to think about both definitions of risk ? simple underperformance, even over a long period of time, and volatility. I?ve shown in a previous post that an asset class that has a slightly higher compounded average annual return can also inflict greater damage to a portfolio in distribution phase than an asset class with a slightly lower compounded annual rate of return, but lower volatility. Should retirees trying to convert their assets into income lasting the rest of their lives own any stocks at all? Maybe they should own some. After all, even Gold says if stocks weren't expected to return more than bonds, nobody would own stocks. But Gold?s arguments should make someone asserting confidently that longevity demands a lot of equity exposure blanch. Gold once had a discussion with finance professor Zvi Bodie, where Bodie repeated his famous thesis that stocks don?t get less risky over the long run if you try to insure against their delivering a loss with a put option. The option gets more expensive as you try to insure over a longer period of time. Bodie didn?t deny that the longer you go out in time, the lower the probability of a shortfall from stocks relative to a government bond. But he asserted that this lower probability of underperforming a government bond is offset by the fact that the worst possible outcome becomes worse. What Bodie calls "severity" increases over time. Investors using their assets, saved over a lifetime of hard work, should think harder about how much stock exposure is enough. If you need help understanding your risk tolerance and constructing an appropriate asset allocation in or before retirement, please click this link.