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FINANCIAL PLANNING FOR SENIOR EXECUTIVES (PART 2)

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Senior executives often face conflicting financial goals in their personal lives. This article introduces a 4-stage financial planning process that harmonises their goals.

The article is broken into 2 parts: Part 2 is found in this issue and Part 1 the previous. You are advised to read Part 1 (Issue No. 96) before Part 2. The article is written in a style as to address the senior executive directly.

How Long Can You Expect To Live?

Singaporeans enjoy the highest life expectancy in the world today at 84.8 years (2018)[1]. There're several contributing factors, such as the country's excellent healthcare system and its people adopting a healthier lifestyle. Given that it has been increasing steadily over the years, one expert believes that life expectancy will reach 90 in the foreseeable future[2].

Many use the life expectancy number to determine how many years they need to cater for retirement. So a person retiring at age 65 should plan for twenty more years of living – till 85. Unfortunately, the method is flawed.

Life expectancy is just an average number. What it means is that half a chosen cohort will not survive to that age... but the remaining half will. Which translates to a 50% chance a person using just the number alone will end up without enough money for the remainder of his life. A casual observation is enough to prove that many people do in fact live longer than 85 years. Possibly... quite a bit longer.

Statistics show there are 1,300 residents in Singapore today who are 100 years old and more[2]. This number is expected to rise: 16,500 residents are within the age range of 90-99[2]. Percentage-wise, at least 2.0% of males and 5.7% of females alive today will live to 100[3]. These percentages should continue to rise in tandem with the growing life-expectancy trend.

Given the statistical facts – what age should you plan up to – such that you don't outlive your money?

Much will depend on your situation. The following are good predictors of longevity: age, gender, health, family history, whether you smoke, active lifestyle including regular exercise and mental stimulation, and the level of social interactions and support[4].

Considering these factors, do you expect your life span to be average when compared with those in the same age group? A "yes" would put you in the 50th percentile.

Depending on your assessments, it may be higher or lower, accepting that it's not quite hard science. The important thing is to come up with a reasonable percentile, then add in some buffer.

Armed with the percentile, you can now determine the age that you should plan up to. The Department of Statistics has a useful tool that you can access: How Long Can You Expect to Live?[3]. Using the tool, a 50 year old man should use 92 as the age to plan up to – if he puts himself in the 80th percentile.

A final point. Beside planning for enough money to last, you must also prepare against contingencies. The flip side of living long is an increase in the number of years spent in poor health. Of the 84.8 years in life expectancy, 10.6 would be spent in poor health[1]. These include major illnesses but also age-related disabilities. So these contingencies don't seriously deplete your resources, you should ensure enough insurance covers against them – both for yourself and your family.

Stage 3: Plan Implementation

Let's go back to Joe: Joe needs a return of 4.6% to reach his goals. To achieve this return, a portfolio comprising stocks and bonds is constructed. Their respective weightings will depend on several factors. One is the assets' historical long-term returns: 9.5% for stock[5] and 5.8% for bond[6]. Another factor is costs – the fees incurred to set up and maintain the portfolio. Based on these factors, Joe's portfolio may consist of hypothetically – and only hypothetically – 50% stock and 50% bond.

Several important principles are to be observed when constructing the portfolio. The first is **diversification**, a case of "not putting all your eggs in one basket". Diversification helps to reduce risk, defined here as volatility or a range of possible outcomes. The higher the risk, the greater is the range of possible outcomes. Which means that at the time when money is needed... say to pay for your child's university fees... the value you get from your investment may be significantly higher – or significantly lower – than that expected.

To mitigate the risk, you can progressively replace the stocks in the portfolio with bonds. The aim is to have a big portion of the portfolio comprised of low-risk assets such as cash and high-quality short-term bonds by the time needed.

Unlike the education portfolio however, your retirement portfolio has no definite timeline; it could potentially last thirty years or more. As such, there's less need for you to reduce the risk. As an option, you could separate your retirement fund into two pots. One that is conservative to cover fixed expenses such as food and utilities, the other less so for lifestyle enhancements like a nicer holiday.

As is apparent, a person with diverse goals – such as education and retirement, even dynastic and/or philanthropic – may concurrently have several portfolios, each differing from the others in their asset blend. So it's really not a case of "one size fit all" – a single portfolio based solely on the person's risk tolerance – as is commonly practised. Factors that help you determine the blend in your portfolio are the following: (1) your objective (2) its time frame (3) the starting capital and (4) your ability to tolerate the fluctuations.

Another key principle in investment is **cost minimisation.** Costs can significantly erode your returns when compounded over time. While a 2% difference in costs doesn't sound very significant for a portfolio generating a net 6% return – over 25 years – you would actually have forfeited half your total gains[7]!

Management fees paid to fund managers constitute a big portion of the overall costs. Much of these go towards research and trading expenses[8]. All well and good if you get high returns in exchange. Except that most fund managers under-perform when compared to the market[9]. Either because they fail to pick winning stocks consistently enough – or the gains don't adequately cover their costs.

That this is so is in fact supported by a ground-breaking piece of research by Eugene Fama in 1970. His thesis shows that you just can't beat the market consistently[10]. It's therefore not too surprising that – notwithstanding the collective 'brain power' residing in him and three other fellow Nobel laureates... in addition to several other highly notable colleagues[11] – their fund strategy is not to attempt to pick winning stocks at all.

Rather, they buy practically every stock available. Doing so not only allows them to **capture market returns**, it also significantly lowers their management fees – since they're now able to largely dispense with the costs associated with research and trading.

Thus far we've covered several important investment principles: diversification, cost minimisation, and capturing market returns. Let's now see how you can apply these principles to populate a portfolio with products.

The first step is obviously to decide on the appropriate blend of stock and bond – based on your goals. Property, cash (CPF, annuity) and other asset classes may also be added; such diversification further reduces risks. Diversification is also applied within each asset classes.

Many investors have a home bias – a tendency to invest only in those areas they're familiar with. So a Singaporean may invest only within Asia, especially given the oft-repeated message that "Asia is the future". Yet many of the best corporations in the world are outside the region. Names that we come across daily: Apple, Amazon, Microsoft, Visa and the like. By investing only in Asia, we're missing out on the opportunity to invest in some/all of these great companies.

Furthermore, a focus on Asia concentrates the risk. Excluding Japan, Asia represents around 10% of total global capitalisation. It's not uncommon for Asia to be doing badly while many other parts of the world are doing well. By also exposing yourself to these other areas – beside capturing the opportunities available there – you're also reducing the risks in your portfolio. As the song goes, "There's a whole world out there waiting for you."

Home bias also explains why an investor only sticks to an industry he's familiar with. Or he may predict a particular sector will do well, such as... life sciences. Just remember what Nobel Laureate Eugene Fama has found, that it's very difficult to get things right – even for seasoned professionals like themselves.

The conclusion of the matter: Ensure your portfolio is well diversified across asset classes and also within them. Globally and across multiple industries. Select fund managers that invest in wide swaths of stocks or bonds to capture market returns, delivered at a low cost. Avoid those managers who rely on their predictive power to pick winning securities; they're likely to disappoint.

Stage 4: Monitor and Review

This final stage is where we help you to buy low and sell high... consistently. We're serious; it's a process called **rebalancing**.

Let's go back to Joe's hypothetical portfolio to understand how it works. Suppose over time stock grows faster than bond. The result is now more stock than bond in the portfolio, say 60/40, not the original 50/50 intended. So Joe would stay on track to achieving his goals – the portfolio must be rebalanced back to 50/50. Joe will sell 10% of excess stock – the result of growth from 50% to 60% of portfolio. He then uses the proceeds to buy bond which has declined from 50% to 40%. In so doing, Joe has in effect bought low (bond, 40%) and sold high (stock, 60%). Conversely, if there's more bond than stock, Joe will sell the excess bond to buy stock.

Here's another way to appreciate rebalancing. By selling excess stock, you're locking up the gains that have been made. This keeps you from losing it all back in a market reversal. Also, when stock falls, bond price tends to rise. Coupled with the additional bond units bought earlier when you rebalanced – higher price times more bond units – this helps cushion the fall.

When times are normal, rebalancing is easy to execute; its logic is clear. It becomes much harder when you've headlines in the newspapers screaming, "MARKET HITS RECORD HIGH!", "HOUSING MARKET BOOM!", "SELL STOCKS NOW!" Such news affects the investor profoundly and influences his behaviour. The result is that he makes decisions that are often to his own detriments.

When the market is buoyant – he buys so as not to miss out on the wave... only for it to then crash. Or when the market sinks and stock looks dead – he sells to cut losses... just before the market rebounds. Few are immune to these powerful market noises – not even one with millions and millions already in his account.

Against logic, such an investor buys high and sells low. Yet you can't really blame him. Often the very real emotions of greed and fear – because it concerns his hard-earned money – are just too overwhelming. As John Bogle, Founder of the Vanguard Group and another proponent of low-cost index funds, once remarked, "the greatest enemies of the investor are **expenses** and **emotions**."

So the investor doesn't act against his own interests – a financial adviser can help lend him much needed perspective at such times. One way is to remind him of his objective for investing in the first place... say retirement in fifteen years' time. So while the client doesn't like the current falling value, he should just ride through it until it recovers.

A useful analogy is the house he lives in. Over the years its value goes up and down. But he's not bothered. It only matters that the value is up at the time he decides to sell the house. Until then, it's just paper loss.

The value an adviser adds to the client at times like these has in fact been quantified to be 1.9% a year in extra return[12]. Another 1.6% come from helping the client avoid the costs of getting it wrong – such as in the construction of an inappropriate portfolio. Both combined add up to 3.5% a year in extra returns – on top of the returns derived from the investment itself. Other value-adds from the financial adviser include variable returns from rebalancing and financial planning.

And these are additional returns from purely technical expertise. The emotional support and guidance an adviser offers throughout a client's investing journey are arguably far more valuable. Joe, for instance, wasn't even sure he could afford to retire before engaging me. But now he's confident he can do so earlier than hoped. He's even gone on several holidays with his family... without the associated guilt arising from feeling he might have over-spent.

Like Joe, you too can enjoy the benefits of clarity, confidence and peace of mind when you engage a trusted financial adviser. It will free you up to devote your time to your career, family and hobbies!

ABOUT THE AUTHOR

Moses Lim is a licensed financial practitioner. He holds the ChFC, CLU and FChFP designations.

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5. Source: MSCI. Based on average of rolling 20 year periods of MSCI World Index (net div.) from Jan 1970 to Apr 2020. Past performance is not a guarantee of future results.
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