Investing for retirement

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IN BRIEF

- Goals-based investing is the key to investing for retirement: Define and prioritize your goals, and align your investment strategy to meet those goals.
- Get invested, diversify, and stay invested, especially in long-term growth assets.
- Understand the trade-offs between spending today and meeting your goals for the future.
- Don't try to time the market. Consider your time horizon and make investments that are appropriate to those horizons.

INVESTING FOR RETIREMENT: A GOALS-BASED APPROACH

Planning and investing for retirement can sometimes seem overwhelming, but it doesn't need to. A simple process, which we refer to as goals-based investing, can help you every step along the way.

At any age, young, near retirement, or somewhere in between, you are likely to have several different financial goals. Often these goals may compete with one another. For example, you may want to buy a home this year and send your child abroad for college in two years, but you also aim to retire in 20 years and want to be sure you have enough funds set aside. How can you plan so that you are successful in meeting the goals that are most important to you—and not just drift from year to year, paying whatever expenses that come along and hoping that your nest egg will be there when you need it?

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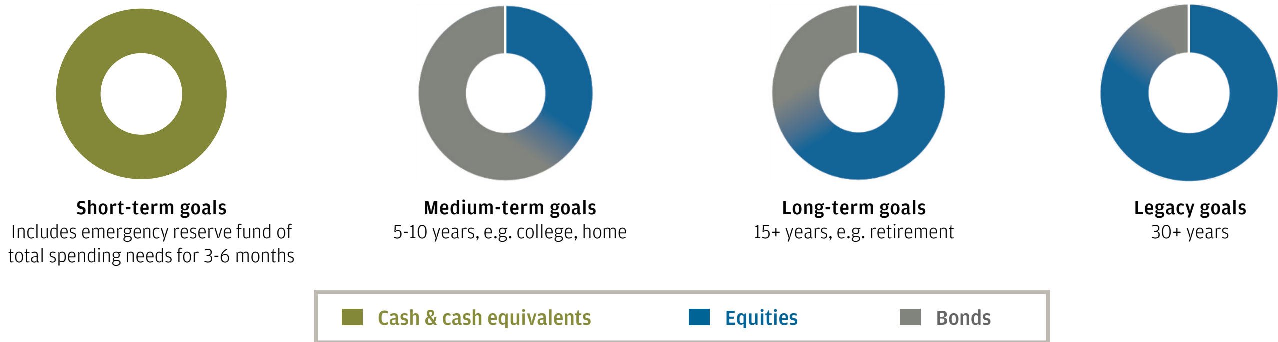
Define and prioritize your goals, and align your investment strategy to meet those goals

EXHIBIT 1: GOALS-BASED INVESTING FRAMEWORK



Source: J.P. Morgan Asset Management. For illustrative purposes only.

The answer is to plan for your long-term and short-term goals together and follow a goals-based investing approach. This process can be helpful:

1. Define your goals clearly (when will they start, how long will they last and how much will they cost) and divide them into different buckets based on their time horizons: for example, paying for a child's college expenses, buying a home, retirement and legacy planning.
2. Prioritize your goals: You may not be able to afford it all—setting your priorities can help you determine if trade-offs need to be made. Decide how much of your current assets and future savings to put towards your different goals based on their relative importance. If your child's education is a top priority, are you willing to delay your retirement or spend less in retirement if needed? Often trade-offs must be made.
3. Align your investment strategy by goal, based on risk tolerance and the investment horizon, so that you can use time to your advantage.
    a. For your short-term goals, you need liquidity, and that means cash, as it allows flexible access to your money and is not subject to the volatility of the market. You need cash to cover any emergencies and pay for upcoming large expenses without the risk of having to sell your investments at inopportune times.
    b. For your longer-term goals, you have time to take more risk and weather market cycles. In general, the more distant your goal, the more risk you can take to seek higher return. As **Exhibit 1** illustrates, someone 15 years from retirement can have quite a high allocation to equities (shown in blue) because over the long term, volatility is less of a concern.

This is what we call goals-based investing, and it can help you be more disciplined by giving you a mental accounting framework to plan your finances. This approach draws on a powerful behavioral finance concept: rules can influence behavior. Studies have suggested that when people segregate their money into separate accounts for different purposes they are less likely to spend that money for "unselected" purposes. This is because dipping into those accounts for an unrelated expense would effectively violate a rule, triggering a sense of guilt that would in turn make one think twice before acting. Some studies have shown that using a photo of the savings goals as a visual reminder can reinforce that sense of guilt[1].

Understand that there are trade-offs between spending today and meeting your goals for the future. For example, if you choose to fund your child's wedding from your retirement account, keep in mind that eventually you will need to either replace that money or expect to spend less in retirement. Withdrawing, say, HKD 300,000 from your retirement fund may seem a modest amount relative to your retirement nest egg. However, with the compounding of interest over time, the growth of this HKD 300,000 may mean an additional HKD 24,000 per year for you to spend in retirement[2]. You may decide that spending that HKD 300,000 on your child's wedding now, and thus potentially sacrificing the annual HKD 24,000 in additional retirement income, is a reasonable trade-off, but it is important to make an informed choice about both goals. You don't want to ignore the initial trade-off and be forced to live with the consequences decades later.

[1]Dilip Soman and Amar Cheema (2011), "Earmarking and Partitioning: Increasing Saving by Low-Income Households", Journal of Marketing Research, 48, S14-S22, available at http://www-2.rotman.utoronto.ca/facbios/file/earmarkingjmrPP.pdf

[2]This is based on the assumption that the amount of HKD 300,000 is withdrawn 10 years prior to retirement. If instead of being withdrawn, this HKD 300,000 is invested at 5% average returns per annum, the investment will grow to HKD 490,000 at retirement, providing HKD 24,000 per annum for 30 years in retirement.

Using goals-based investing, it becomes clear which goals have a shorter vs. longer time horizon. That's important, because you can use the time that you have for your long-term goals to make your savings work harder for you. This approach makes sure that you don't put everything in cash and lose out on the opportunity to let your savings grow to meet your long-term goals. Investing only in cash can make your long-term goals more costly to you because you will need to save more to reach your goal. Instead, by saving longer and at a higher return, you can make accomplishing your long-term goals less costly.

Retirement, of course, is a critical long-term goal. As we explain in the following sections, to reach this goal, you need to get invested, diversify and stay invested in long-term growth assets.

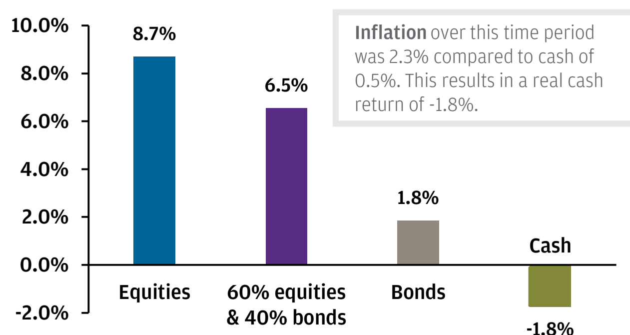
Get invested

Asian households tend to be good savers, but a large portion of their savings is in cash.

This has been especially problematic for more than a decade. In many countries across Asia, for example, cash has delivered negative real returns (returns after inflation).

Get invested in long-term growth assets

EXHIBIT 2: AVERAGE ANNUALIZED REAL RETURNS (ABOVE INFLATION) OVER THE PAST 15 YEARS (2003-2017)[3]



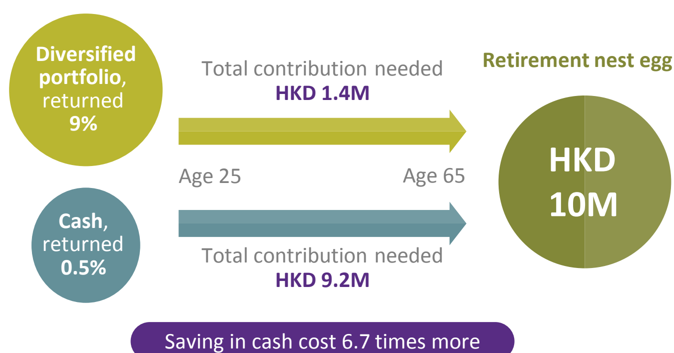
	Equities	60% equities & 40% bonds	Bonds	Cash
Real return in the best year:	40.0%	26.2%	6.9%	2.7%
Real return in the worst year:	-45.5%	-26.9%	-6.1%	-5.0%

Source: J.P. Morgan Asset Management. Equities represents 1/3 MSCI Zhong Hua and 2/3 MSCI AC World, bonds represents the Bloomberg Barclays U.S. Aggregate Total Return, 60% equities & 40% bonds portfolio consists of the aforementioned sub-allocations for equities and bonds, cash represents the Hong Kong bank deposit rate and inflation represents the Hong Kong Total CPI. Currency is HKD.

In Hong Kong and Singapore, the real returns for cash over the past 15 years have been -1.8% and -1.6%, respectively. Over the long term, an investor loses purchasing power by keeping savings in cash.

Saving in cash would require contributing 6.7 times more as opposed to investing in a 60% equities and 40% bonds portfolio

EXHIBIT 3: TOTAL CONTRIBUTION NEEDED TO REACH A HKD 10 MILLION[4] RETIREMENT NEST EGG AT 65



Source: J.P. Morgan Asset Management. For illustrative purposes only.

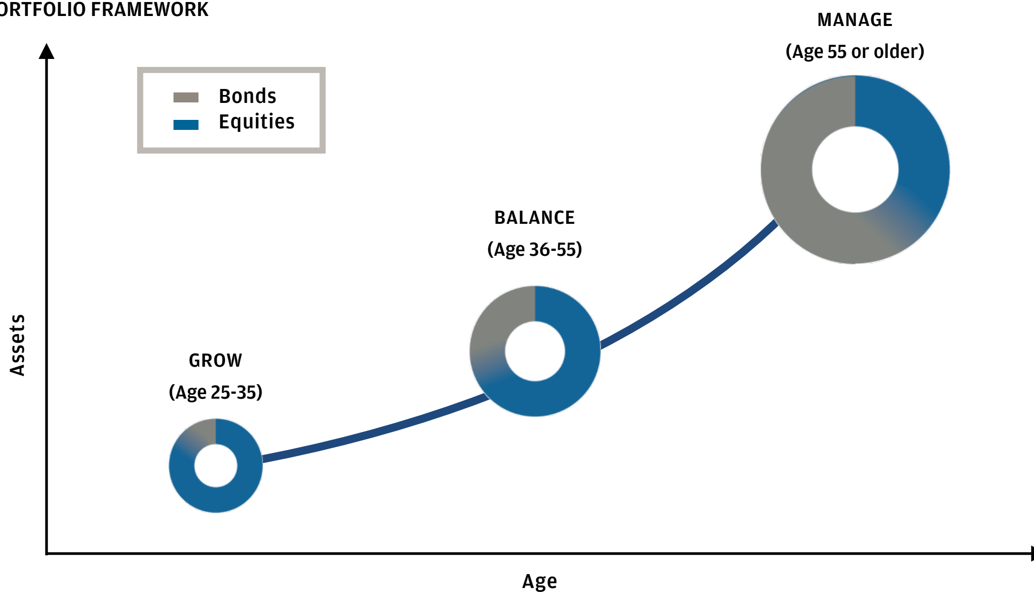
Having all your savings in cash means that you would need to contribute more to achieve the same retirement nest egg that you could have achieved with a 60% equities and 40% bonds portfolio (60/40 portfolio). Assume you started saving at 25 and accumulated HKD 10 million by 65, you would need to have saved HKD 9.2 million if you only had cash savings, as opposed to HKD 1.4 million if you invested in a 60/40 portfolio. In other words, you would need to save 6.7 times more if you relied only on cash savings[5].

[3]Data represented as annualized real returns, based on past 15 years' data from December 31, 2002 to December 31, 2017. Between 2003 and 2017, the best year for equities was 2009 and the worst year was 2008, for the 60% equities & 40% bonds portfolio 2009 and 2008, for bonds 2003 and 2013, and for cash 2003 and 2011.

[4]Source: Hong Kong Census and Statistics Department, J.P. Morgan Asset Management analysis as of March 2018. The HKD 10 million initial portfolio value is estimated based on the average household spending observed for a Hong Kong retired couple of the highest 25% household expenditure group.

[5]The annualized nominal return of the 60/40 portfolio and of cash in the analysis was 9.0% and 0.5% respectively, based on past 15 years' data from December 31, 2002 to December 31, 2017.

Dynamically invest over time for better retirement outcome
EXHIBIT 4: PORTFOLIO FRAMEWORK



Source: J.P. Morgan Asset Management. For illustrative purposes only.

Getting invested in growth assets is particularly important when you are young and have the greatest ability to take on risk. When you are far from retirement, you have a relatively modest amount of assets, so your money needs to work as hard as possible. As you have a lower level of assets at risk, and a longer time horizon ahead, you can afford to take on more risk. That means investing in a relatively high level of equities to participate in market growth. When you are nearer to retirement, it is important to shift to a more conservative strategy to protect the wealth you have accumulated while still seeking some growth during your remaining working years.

To sum up: getting invested, especially in growth assets, can help you keep pace with inflation and reduce the contributions you will need for retirement. Start young to use time to your advantage.

Diversify and stay invested

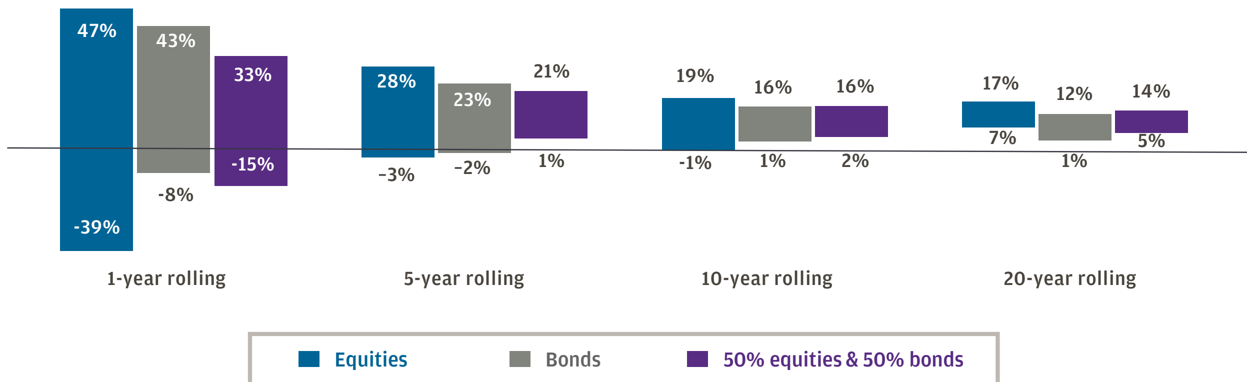
When markets are churned by geopolitical tensions and widespread uncertainty, it is only natural to want to pull out of a declining market to minimize losses. Often it is tempting to try to "time the market" by buying low and selling high. It rarely works, even for the savviest professionals. History shows that investors tend to herd into the market at peaks (especially right before a crash) and race for the exits at market troughs, just before a recovery is about to begin. Simply put, investors often buy high and sell low. These ill-timed moves are usually driven by emotions, and while emotions can't be eliminated they can be tamed if you stay focused on investing for the long term.

Rather than trying to time the market, consider your time horizon and make investments that are appropriate to those horizons. Staying invested for the long term can provide better risk-adjusted returns with lower volatility than making short-term trades that can pose significant risks. In addition, frequent trading incurs transaction costs that eat into your returns.

To protect your portfolio, it is important to diversify your investments (it will also have the benefit of restraining your impulse to sell when the market is down). As the saying goes—don't put all your eggs in one basket. Effective portfolio diversification may provide smoother returns over varying market cycles and help provide some protection against losses in periods of market turbulence. At the end of the day, it will give you greater peace of mind.

Diversifying and staying invested can provide better risk-adjusted returns with lower volatility over time

EXHIBIT 5: ANNUAL TOTAL RETURNS OF EQUITY, BOND AND BLENDED PORTFOLIOS (1950-2017)



Source: Bloomberg Finance L.P., FactSet, Robert Shiller, Strategas/Ibbotson, U.S. Federal Reserve, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2017. Equities represents the S&P 500 Shiller Composite Index and bonds represents the Strategas/Ibbotson Index for periods from 1950 to 1980 and the Bloomberg Barclays Aggregate after index inception in 1980. Past performance is not a reliable indicator of current and future results.

In the chart above, volatility is represented by the size of the bar. The diversified 50% equities & 50% bonds portfolio (50/50 portfolio) in purple is less volatile than pure stock or bond investments. And in the past 65 years, the diversified 50/50 portfolio has never experienced a negative return over five-year, 10-year or 20-year rolling periods. This reflects the fact that over a longer time horizon, you have time to weather market volatility and earn a solid return.

Conclusion

Whether retirement is five or 40 years in the distance, it's important to have a plan to meet your goals. We believe that a goals-based investing framework can help you create that plan and then, amid shifting markets and life circumstances, make sure that you stay the course. Getting invested—early and in growth assets—can help you keep pace with inflation and reduce the amount that you need to set aside for retirement. Besides, diversifying and staying invested can provide better risk-adjusted returns with lower volatility over time. Always keep in mind the trade-offs between spending today and meeting your goals for the future.

Goals-based investing works. Follow this tried-and-true approach and you can expect a better chance of making your retirement dreams a reality.

NEXT STEPS

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