

Investment Education

Risk Tolerance and Time—Key Factors in Asset Allocation

By Rev. Morgan Barclay

As a minister, when you join the Association's pension plan you wonder which of the many funds to select as investments? Let us consider two key factors that will determine your investment allocations: how much risk are you willing to take; and what your time horizon is for saving based upon your life expectancy.

For this column we will be using information from the American Association of Individual Investors (AAII) and from the M & I investor education materials. AAII is an independent investor education group and for \$50 a year you can access solid introductory advice, which is not provided by individual investment vendors. M & I Retirement Plan Services, the Association's retirement fund administrator, also offers sound introductory educational materials online for our use in choosing our investments.

Risk Tolerance

Risk refers to the volatility of your investment portfolio's value. The amount of risk you are willing to engage is an extremely important factor to determine.

Investors who take on too much risk often panic when confronted with unexpected losses and abandon their investment plans mid-stream at the worst possible time. While some investors do become more risk-averse as they get older, risk tolerance is not necessarily a function of age; a conservative investor will cycle through several changes in asset allocation over a lifetime, as will an aggressive investor. Many individual investors settle on too little risk and thus sacrifice their returns over the long haul.

When I was in my 30's and 40's I worked at a university and invested in a retirement program. Not having any knowledge of investing at that time, I split my contributions between a fixed income annuity (with a 5% dividend) and a large cap stock fund. Had I taken on more risk during those decades, my nest egg would be almost double what it is today!

At the Association web site you can download the handbook for our investment program. On pages 12 to 14 there is a quiz to evaluate your investment risk tolerance. However, there is a difference between taking a hypothetical quiz and seeing your real investments rise and fall. Are you willing to take a 5-10% drop in value during a short period of time? This took place in our markets in the months of July and August of this year and yet the overall market is up

about 8% for the year. Are you willing to live through a multi-year downturn in the market? These are questions to consider as you determine your personal risk tolerance.

Risk and return are directly related. If you do not want to take on any risk and you invest only in CDs, you may earn a 5% return over time. With inflation at 2-3%, your real return would be about 2% a year. On the other hand, if you are willing to take on moderate risk the annual stock market returns on average have been 10% over recent decades. The 5% difference compounded over many years significantly impacts your returns.

Time

The length of time you invest in your portfolio is important because it can directly affect your ability to reduce risk. Longer time horizons allow you to take on greater risks in your asset allocation, with a greater total return potential. This is because some of that risk can be reduced by investing across diverse market environments. If your investment time horizon is short, you have greater liquidity needs. You want to be able to withdraw money and not have your portfolio undergo significant fluctuations in value. And although there is little chance of losing your investment principal with cash equivalent investments (such as money market securities), you run the chance of not keeping up with inflation because returns may be lower than the inflation rate. Stocks provide potentially higher returns but involve a greater risk of loss. In general, the longer you have before you retire the more risk you can tolerate. Retirees who depend on their investment

portfolio for part of their annual income may want returns that emphasize relatively higher and consistent annual payouts, such as those from bonds and dividend-paying stocks. Of course, many individuals may want their asset allocation to reflect a blending of the two—some current income, but also some growth to provide for the future.

There are really two time horizons to look at. When will you need to begin receiving monthly income from your Association pension plan? When will you begin taking Social Security and any other retirement investments you have available to use? Remember that your Association pension can be used as part of the manse allowance even after you have retired. So consider transferring other retirement funds to the Association plan if that is possible. See the Association web site for details on this alternative.

How long are you going to live? Unity people have the reputation of living longer than average, but I have no current data to document that. After the age of 60, life expectancy extends for another 15 years for most people. This is because you have passed the age markers for death by heart attack and other major illnesses. I suggest taking a few of the online longevity tests and discover your projected life expectancy based upon your age, health, lifestyle and family genes. One website to check out is: <http://www.poodwaddle.com/realage.swf> For example, according to the test I took, I will live to be 93.7 years. Right now I am 61 years old. That means my investments need to last 30 years beyond my retirement! As a result, I am now willing to take more risk in the stock

market as my investments will go through several more business cycles before I die.

Many people approaching retirement decide to remove all their assets from risk by buying bonds or CDs. This action does protect principle and provide some income. However, if your life expectancy is another 20-30 years, you may need to grow your retirement portfolio while at the same time you are drawing down a monthly pension. To accomplish this goal you may need to leave some of your investments in stock mutual funds. This may be particularly true for Unity ministers as many enter ministry later in life as a second career. Depending upon the existence of previous retirement plans before entering the ministry, you may be playing retirement catch up. This will require extra saving and a hard look at your willingness to take on risk to increase retirement returns.

Next Steps

Identify your tolerance for investment risk. Is it low, medium or high? The higher the risk, the higher the return, along with greater volatility of your retirement portfolio.

Determine your life expectancy. How long do all your assets have to last in light of longer life spans? What size portfolio do you require to maintain a prosperous, comfortable long life?

Be proactive in preparing for your retirement. Seek guidance, ask questions, get educated, and get involved.

Live long and prosper! Send questions to revmorgan@tds.net.

Blessings,

Rev. Morgan J. Barclay