



Some rules aren't meant to be broken

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July 12, 2010

If someone asked me to come up with the two defining characteristics of financial markets, my answer would be “opportunity” and “risk”. The opportunity to make a good return on an investment and the risk that an investment will diminish in value. Both have been well-illustrated in the past three years. Unchecked, opportunity and risk can take investors on a wild ride. Even with the best thought-out rules, rules that actually get followed, many investors will experience some volatility in their portfolios. But the right rules, followed and enforced, can make financial markets much more friendly. Breaking the rules almost always has consequences. Let’s apply this to planning for and funding retirement.

Financial market rules come in all shapes and sizes. Some are intended to encourage certain types of behaviour; some are intended to discourage other types of behaviour. Some rules are based on specific legal codes; some are mainly based on the scarcest resource of all - common sense.

Let’s spend a moment reflecting on some of the rules that were broken during the past three years – and the resulting consequences.

- Financial institutions (fortunately, not the ones in Canada) were lending money with no reasonable due diligence regarding credit risk, with the consequence of a slew of loans not being repaid and dire consequences for the lenders and borrowers. Securitization of these bad loans, followed by little or no transparency to the investors who purchased the securities, with the consequence of frozen credit markets and massive losses to investors.
- Sophisticated financial engineering intended to eliminate risk (which I believe is impossible) with the consequences of massive financial losses.
- Faulty risk assessment by credit rating agencies (essentially, assessment of the wrong risks in the wrong place) of supposedly sophisticated securities, again with the consequence of massive financial losses.
- Some governments running large annual budget deficits when they should not have been doing so, being less than truthful about the extent of these deficits,

and trying to finance them essentially out of sight, with the consequence of a crisis around government debt.

The list could go on and on. But you get the point. All of these unfortunate consequences were the result of some rule or other being ignored.

What is interesting in this context is what happened to those who didn't break the rules. One shining example is the Canadian banks, which successfully followed the quaint Canadian custom of checking potential borrowers' credit ratings before lending them money and following a number of sensible strategies. The result? For a time, the values of their shares took a hit, an overflow from the real problems in other countries. But basically, they came through very well and are poised for the future.

There are some fundamental lessons here for the economics of retirement. Knowing the rules and following them is much more likely to result in a good outcome than a bad one. Establish a set of rules around saving for, investing for and living in retirement, and follow them. The outcome? A much higher probability of avoiding financial grief, a much higher probability of achieving financial goals.

I am suggesting half a dozen such rules. I don't claim authorship of any of them. But, I think they constitute a set of rules that could form a corner stone for retirement planning.

1. Start early. In and of itself, this makes sense. But, in the real world, it gets tangled with the many other financial demands that most people are dealing with early in their careers. Some of these other demands, such as buying a house, raising children and just plain day-to-day living, are all perfectly valid places to spend money. I am not suggesting that any of these go by the wayside in order to start early on the retirement savings path. What I am suggesting is that starting early, even saving a little for retirement, has some huge advantages. One is that with even a little regular saving, the time value of money kicks in and can really help in achieving retirement goals. Second, it establishes a very good habit. Some of the academic research around behavioural finance notes the importance of really good habits in reaching financial goals. A third reason is that starting early may be helpful in establishing or raising consciousness about what sort of retirement a person wants. I have said in this column more than once that the hardest part of planning for retirement is envisioning what retirement should be. Saving early and regularly for retirement may at least help people give this very difficult question some thought.

2. Don't be (too) greedy. We all love shortcuts. Especially the shortcuts that would get us to our retirement savings goals more quickly and easily than the patient slog through thick and thin, good markets and bad. We have all been privy to conversations between clients and advisors, where the client wants to put all of their accumulated retirement savings into the 'hot stock' of the moment in the belief that it is a valid shortcut. The retirement landscape is littered with retirement savings plans trashed by such moves.

3. Be patient. Patience is a virtue that most of us don't have. A career takes place over a long period – often 30 or 40 years. So, saving and investing for retirement can – or should – occur over the same time span. A lot can happen in financial markets during that time, and not all of it good. But, it has been proven time and time again that having a long-term investment plan, and sticking to it, will yield the desired results.

4. Set realistic goals, related specifically to what you want your retirement to be. One of the problems with cookie-cutter retirement plans is that every individual is unique and so is every individual's vision of retirement. If a client does have specific retirement goals that are likely to be costly – such as extensive travel – saving for retirement may need to be ramped up to meet that specific goal. And, it may require an advisor-client conversation around possible trade-offs between consumption now and consumption in retirement.

5. Have a plan. Fidelity's research shows consistent evidence about the existence of financial plans for retirement in Canada: approximately one-quarter of people over the age of 45, not yet retired and saving for retirement have a specific written plan to get there. Approximately the same proportion have a specific written plan as to how they will generate the income they will need when they get there. To state the obvious, that means that approximately three-quarters don't. It is a virtual certainty that retirement plans will need to be updated and changed during the course of saving for retirement. But having a plan is like having an anchor. It keeps you in a steady place. And, it provides some perspective when it is necessary to change course.

6. Get advice. Fidelity's research shows that no matter how we ask the question, people who get financial advice are both better off and more confident about their financial situation and financial prospects than those who do not. Some of this may well be explained by the specific quality of advice that they receive, such as rates of saving, asset allocation, and choosing the most appropriate investments for a client's needs and circumstances. Some of it is no doubt the result of the advisor simply reinforcing that the client must think about, and act on, saving for retirement. Regardless, getting advice works.

There are many other rules that could be discussed here, but I think these cover the basics. Like the rules around financial markets, following them doesn't guarantee that there won't be bumps along the road. But they do make it much less likely that a personal retirement savings wipe-out will occur and most likely will result in a much better outcome than ignoring the rules. Of course to some, the rules I have outlined will seem bland and boring. They don't have the excitement of a hot investment. But, they will promote the likelihood of actually achieving retirement income goals and reduce the likelihood of severe client stress along the way. In other words, they reduce the risk and raise the opportunity.

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