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# The Young and the Riskless

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Associated Press

Twentysomethings are seeking safety from market volatility at precisely the wrong moment in their investing lives. Here's how to get back on track.

Risk-taking is for the young—except, it seems, when it comes to investing.

The 2008 market panic, last year's "flash crash" and the latest burst of volatility are proving to be more than many young investors can stomach. As a group, people in their 20s and early 30s are less comfortable taking risk than they were before the financial crisis, according to recent surveys—leading them to hunker down with safe assets at a time when many financial planners say they should be rebalancing into risky ones.

"We had Depression babies," says Bill Finnegan, a senior managing director with MFS Investment Management, a Boston-based asset manager. "Now I think we have recession babies."

Mike Right

Investors who eschew risk at such a young age might be setting themselves up for disappointment. Without the compounding effects that come with investing in equities for a long time, stock-less investors might find it nearly impossible to accumulate a big enough nest egg to retire at all, let alone in their 60s.

"It's hard to build a lot of wealth without taking at least some risks in the markets," says Colorado Springs, Colo., financial planner Allan Roth.

The good news is that even the most traumatized young investors can take steps to ease back into the stock market and improve their long-term chances for success—while limiting the risks that made them so nervous about equities in the first place. The key is to take measured risks based on job security and other factors.

Of course, it won't be easy for these investors to forget the tumult of the past four years. A 27-year-old who started investing right out of college has seen a 0.5% annualized gain from a Standard & Poor's 500-stock index mutual fund—less than the 1.85% returns of an ultrasafe money-market fund.

It's little wonder that such investors are dialing back on risk. According to a June MFS survey, investors in their 20s held 30% of their non-401(k) portfolios in cash—four percentage points higher than the average for all investors. The survey found that 40% of investors in their 20s agreed with the statement: "I will never feel comfortable investing in the stock market."


The late-summer market storm only increased the worries. An October MFS survey showed that young investors held 33% in cash, six points higher than the overall average, while 52% agreed that they would never feel comfortable investing in stocks. Only 29% of investors of all ages agreed.

When younger investors do venture into the markets, they do so cautiously. Only 31% of investors under age 35 were willing to take above-average investment risk, according an October survey by the Washington D.C.-based trade group Investment Company Institute, compared with 39% in 2008.

As the market grew choppier in August, Max Dufour, a 34-year-old financial-services consultant for large investment banks in Boston, moved $50,000 from high-yield bond funds to lower-risk assets such as money-market mutual funds. After losing roughly half of his investments in 2008, Mr. Dufour says he has learned a lesson.

"I'm less willing to gamble," he says.

Likewise, Dan Manges, a 26-year-old chief technology officer for a financial services company in Chicago, overhauled his $100,000 investment portfolio in July, moving from 60% stocks to 30%, with 30% in bonds and 40% in cash.

"A lot of the events we are seeing now haven't happened before," Mr. Manges says.

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Some economists worry that young people's risk aversion could be long-lasting. In a study published this year, Ulrike Malmendier of the University of California, Berkeley, and Stefan Nagel of Stanford University found that people who have experienced low stock-market returns throughout their lives are less likely to invest in stocks and are pessimistic about future returns. Young people were especially prone to making decisions based on recent events.

## *Persistent Fear*

If young investors' fear persists, financial advisers say, the result could be leaner retirement funds later in life.

Advisers often urge young investors to put most of their retirement portfolios in stocks. Young people who take less risk will likely have to make up for it in other ways or suffer the consequences of a late or nonexistent retirement.

"Even if you think equity returns will be lower than in the '80s or '90s, you have to do something," says Chicago-based financial planner Leisa Brown Aiken. "Just because you can't count on something doesn't mean that you just stay away from stocks and carry on the same in the rest of your life."

Although investors haven't seen much of a payoff from stocks over the last 10 years, over longer periods, equities have a much better track record. Over the last 20 years, large-capitalization stocks have returned more than 9% annually, and over the last 30 years, they have returned almost 11%, according to Ibbotson Research.

In fact, in the late 1990s, some planners worried that investors were being too risky. In 1998, when the market was booming, 52% of people age 33 and younger said they were willing to take above-average or substantial risk—the most risk-hungry of any age group, according to an ICI study from that year.

Just as they were too aggressive then, young investors may be too conservative now.

"Neither great nor horrible times last forever," says Mr. Roth, the Colorado planner.

Some academics have gone so far as to say that young investors should borrow money to invest extra in stock indexes early in their lives. A young investor could, for example, open a low-cost margin account and use it to double his or her stock exposure, while paying an annual margin rate of between 1% and 2%, says Yale University economist and law professor Ian Ayres.

By doing that, investors' portfolios wouldn't be overly affected by how the stock market performs in the last decade of their working lives, after they've already built up a sizable nest egg, he says.

Critics of Prof. Ayres's approach note that borrowing money to invest in stocks carries fees for the margin loan. They also say it is a difficult plan for investors to stomach since they can see their money disappear very quickly in down markets.

But generally, experts have agreed that younger people should allocate most of their retirement savings to the stock market to reap the rewards of taking on more risk. A typically recommended portfolio for a 25-year old investor might include a 90% allocation to stocks, with a quarter of that devoted to international stocks, says John Ameriks, head of investment counseling and research at Vanguard Group. The remaining 10% would go into bonds.

Of course, no two investors are alike. There are a number of other important factors besides age to consider when choosing an allocation, from the person's career choices to their psychological resilience to losses.

## *'Salary Volatility'*

Most young people's biggest asset isn't in their investment portfolio—it's their future earnings power, says York University finance professor Moshe Milevsky in Toronto. A newly minted doctor might have only a few thousand dollars in his 401(k)—but a career that could bring hundreds of thousands of dollars in additional savings down the line.

That makes it important for young people to consider the risks and returns of their future careers before trying to come up with an asset allocation for their portfolios, Prof. Milevsky says. "This is a much bigger picture than just looking at investments."

The one-size-fits-all portfolios of yesteryear, which were based solely on time horizon, are starting to look antiquated, say advisers. Even so-called target-date funds, which dial back on risky assets as investors approach retirement age, are blunt instruments.

Instead, young investors need to adjust their stock allocations to account for the volatility of their salaries in addition to their risk appetites.

For example, tenured professors and government employees, who typically have defined-benefit pensions and job security after time on the job, have relatively safe earnings streams over time.

On the other hand, real-estate agents or stock brokers, who are paid on commission, might see their earnings rise or fall dramatically with the economy. For them, it's probably wise to keep most of their money in safe assets like bonds and cash, says Prof. Milevsky, and slowly take on more risks as they get closer to retirement.

*Choosing the Right Allocation*

Most jobs will probably fall somewhere between the "safe" and "risky" extremes. If you're unsure, go to the tool at http://on.wsj.com/nmployed and look up the unemployment rate for your occupation. If you graduated from college and see a rate much higher than 5%, err on the conservative side.

Once you have a better sense of your job security, pick the investment approach that best fits your situation.

**The standard approach:** A 30-year-old with a job that is relatively stable can put 75% of his portfolio in low-cost stock index funds. About 50% should stay in a U.S. stock fund, such as the Fidelity Spartan Total Market Index fund, says Mr. Roth, which carries an expense ratio of only 0.10% and includes investments in mid- and small-cap companies.

About 25% can go into a total international-stock fund, such as Vanguard Total International Stock Index, which is also low-cost and includes a stake in emerging markets. Having international exposure will help your portfolio grow even if the U.S. market enters a long spell of low returns, says Mr. Ameriks.

Finish off the last 25% of the pie with a bond index fund, such as the iShares Barclays Aggregate Bond index exchange-traded fund, which has an expense ratio of just 0.22% and tracks the investment-grade U.S. bond market. Keeping a stake in bonds will help reduce volatility, says Mr. Ameriks.

Index funds carry the benefits of easy diversification and ultra-low costs. The average index mutual fund had an expense ratio of 0.73% in 2010, compared with 1.45% for the average actively managed stock fund, according to investment-research firm Morningstar.

Over time, the difference can be profound. For an investor with $50,000 at age 30, every 0.25% in extra costs annually can mean a worker has to wait 1.3 additional years to retire while keeping the same living standard, Mr. Roth calculates.

**The aggressive approach:** Young people in relatively safe professions, like teachers or police officers in strong unions, can invest more aggressively. In fact, for such people under age 30, an argument can be made to put 100% of their portfolio in stocks, says Mr. Ameriks.

For a slightly less volatile portfolio, consider keeping at least 10% in a bond index fund, says Mr. Ameriks. The remaining 90% can be split between the U.S. stocks (60%) and international stocks (30%), Mr. Roth says.

**The conservative approach:** Young people in high-risk professions might want to step back their total stock allocation to 60% or lower and keep a larger portion of it in U.S. stocks, which tend to be less volatile, says Mr. Roth.

If there's a good chance that you will lose your job in the next couple of years, consider investing retirement money in a Roth IRA, after grabbing all of your employer's 401(k) match. Roths offer a big tax advantage in that the earnings aren't taxed when the money is withdrawn.

What's more, Roth IRAs let you withdraw your contributions later without a penalty, which could come in handy during a long spell of unemployment.

Be warned that with a more conservative asset allocation, you'll probably have to save more money to make up for lower returns. Ms. Aiken, the Chicago planner, recommends that young people save 20% of their income, if possible.

"It's hard," she admits. "But when you're young, what can you really change? You can only make that savings rate decision."

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