**From:** Zavist, Thomas [mailto:TZavist@shdr.com]
**Sent:** Friday, November 10, 2006 6:45 PM
**To:** EBSA, E-ORI - EBSA
**Subject:** Default Investment Alternatives under Participant Directed Individual Account Plans

Department of Labor
Employee Benefits Security Administration

Re: "Default Investment Alternatives under Participant Directed Individual Account Plans"

Gentlemen:

Section D of the proposed regulation, "Default Investment Alternatives under Participant Directed Individual Account Plans," includes a request for comments. At your request, below are comments.

In general, the proposed regulation addresses a significant issue, and it is a helpful and well-written piece of regulatory guidance. One point, however, catches my attention. The three paragraphs of proposed §2550.404c-5(e)(5) describe two investment theories and two types of investment vehicle. In particular, they permit (i) an investment fund product or model portfolio that becomes more conservative with age, as well as (ii) one that does not. They also permit (iii) an investment management service that becomes more conservative with age, but they make no mention of (iv) an investment management service that does not become more conservative with age.

Here is the problem. The notion that an investor should invest more conservatively with increasing age is just a theory. It is an opinion. This theory, this opinion, may be wrong. The competing theory or opinion—that an investor's level of conservatism should be unrelated to age—is a plausible, defensible position.

Why should a regulation compel an investment management service to adhere to a dubious theory (especially when it does not similarly restrict an investment fund product or model portfolio)? Why not add a paragraph (iv) that bears the same relationship to paragraph (iii) as paragraph (ii) bears to paragraph (i)?

Here are a few criticisms of the theory that an investor should invest more conservatively with increasing age.

*1. The Wisdom of Investing in Bonds*
On average stocks outperform bonds by approximately 5% per year. Compounded over thirty years, a stock investment is expected to become more than *four times greater* than a bond investment. Arguably, therefore, stocks are a better investment than bonds. They are better than a mix of stocks and bonds, because they have a higher return.

One of the biggest risks for most people in retirement is longevity, *i.e.*, outliving their savings. One way to hedge against the risk of longevity is to have more savings in retirement. One way to have more savings is to earn a higher return each year. One way to earn a higher return each year is to invest totally in stocks. Investing totally in stocks, therefore, mitigates the financial risk of longevity.

A prudent investor may invest entirely in a diversified portfolio of stocks throughout a lifetime. In retirement the investor can live off the dividends or consume approximately 4% of total wealth each year. Investing entirely in a diversified portfolio of stocks is a reasonable, prudent approach to retirement savings.

*2. The Notion that Retirement Income must be Level*
A college graduate may go on to a successful career in business. Alternatively, the graduate may be compelled to accept a lesser job. At graduation, who knows? Likewise, a worker may suffer a financial hardship—a serious illness, *etc.* A business owner may succeed or may go bankrupt. Who can say when the business starts? In every case, society expects people to conform their lifestyle so as to fit expenditures within available income. Society expects people to cope with risk. Yet, when some theoreticians approach the topic of income in retirement, they presume retirement is categorically different from the rest of life. They suppose income needs are carved in stone at retirement at a fixed, immutable amount. Oddly, this fixed amount varies according to success while working, as if people are able to adjust to different levels of income (but only before age 65).

Consider a pensioner investing conservatively in bonds. All the monthly payments are specified years in advance. In theory, there is no risk. Yet, the pensioner is subject to all the financial vagaries associated with health. A serious illness could compel the pensioner to divert half the income stream in retirement. A greater misfortune could drive the pensioner bankrupt. Alternatively, the pensioner could enjoy good health and prosperity indefinitely. Likewise, there could be several years of high inflation, or there might be no inflation for several years. Given the intrinsic risk of everyone's situation in retirement, what is the point of investing so as to fix the income stream strictly in terms of nominal dollars (*i.e.*, to invest preferentially in bonds on account of increasing age)?

*3. The Wisdom of Deliberately Altering Investment Risk over Time*
Compare an investment that is expected to earn 10% for one year and 6% the next to an investment that is expected to earn 8% for two years in a row. The compounded expected return on the first is 16.6%. The compounded expected return on the second is 16.64%. The return on the second investment is four basis points greater than the first. To the extent return is a linear function of volatility (the Capital Asset Pricing Model) the volatility of the first investment can be expressed as $X + Y$ for one year, then $X - Y$ the second year, while the volatility of the second investment is X both years. Thus, the first investment has an aggregate variance of $2X^2 + 2Y^2$, while the second investment has an aggregate variance of $2X^2$. After two years, the first investment has a lower return and a higher volatility than the second. The point is that a prudent investor will endeavor to spread risk out evenly over time, in order to obtain a higher return and a lower volatility.

It is illogical to take greater risk in the early years of an investment, when you know that later you plan to take less risk.

*Conclusion*
Regulation is not the best forum to decide between competing theories. To the extent there is no consensus, why not permit every reasonable position? Why not add a paragraph (iv) that permits an investment management service that does not become more conservative with age?

Thank you for allowing the opportunity to submit comments. Any comments expressed here are my professional opinion and not necessarily the opinion of my employer.

Faithfully yours,

Tom

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