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The Perils of “Star” Gazing

A few tips on saving for retirement from Scott Evans, TIAA-CREF’s Executive Vice President of Asset Management.

As the chief investment officer of a financial services company that manages more than \$430 billion in assets (as of 12/31/07), one of the questions I’m asked most often is, “How can I make the most of my retirement savings?”

Over the years, I’ve learned that what the questioners really mean is, “How can I turn that straw in my backyard into gold?” That’s why I no longer take personally the disappointed looks I get every time I offer my answer. Because the truth is, there are no magic tricks or secret formulas for maximizing retirement savings and meeting financial goals.

I happen to subscribe to an unexciting but effective investment philosophy based on a pair of simple, time-tested principles. If closely followed, I believe they can put investors in the best position to reach their long-term goals.

Principle #1: Diversify and rebalance.

If we all had nerves of steel and certainty that the future would look like the past, we would put all our long-term savings into stocks. However, the plain truth is that few of us have the stomach to watch our life savings rise and fall dramatically with the market’s all too frequent dips and spikes. Instead, build a portfolio based on your risk tolerance and the time period you have to invest that covers a broad range of asset classes, like stocks, bonds, real estate and money market, as well as a broad set of investments within each class. This collection of assets will go up and down at different times, giving you a smoother investment ride to retirement.

Base the target percentages you set on your savings goals and personal financial situation, not on what the market is doing at a moment in time. To minimize the impact of unexpected bumps along the way, stay properly diversified by rebalancing your portfolio regularly. Remembering to readjust your holdings every year on your birthday will improve your ability to maintain the target allocations best suited to your goals. *(Of course, you should remember that diversification and rebalancing do not guarantee against potential loss or that you’ll meet your goals.)*

Principle #2: Don't chase yesterday's returns or gaze at stars too long.

Many investors read too much into the short-term performance that's often reflected in "stars" and other fund ratings. It's counterintuitive, but the fact is, when a fund has had blockbuster performance in a given year or two, you simply cannot — and must not — assume it will stay hot the following year.

That's why you see the disclaimer on securities sales literature noting that past performance doesn't guarantee future returns. It's also why many reputable rating organizations are careful to ignore truly short-term price movements. But these warnings get ignored far too often.

In fact, the opposite is often true. It's not unusual to hear of equity funds that achieve a "five-star" performance rating in one year only to sink dramatically in the years after receiving that top grade.

When you look at performance over three, five or 10-year horizons, you get a very different picture. Most funds tend to hover pretty close to the average of their peers, funds with similar investment strategies.

With such small differences in performance over time, fees become a key differentiator. All else being relatively equal, low-cost investments are better because they don't gobble up the little bit of difference in performance you might get from a higher cost investment. (Note, however, that lower expenses do not necessarily translate into higher returns.)

A fund's history, however, can tell you a great deal, like whether the manager stuck to the investment objectives and maintained consistent returns over time. Consistency is important. Unfortunately, though, history cannot tell you much about a fund's ability to produce chart-topping returns in the future. The truth is nothing can.

In fact, it's generally best to avoid trying to pick the top performer. Instead, look for funds that are pure, meaning they stick to their game plans. For example, growth funds should hold growth stocks, not seek short-term performance boosts by loading up on other securities that might be performing better temporarily.

Also, be sure that your fund is fully invested. Some funds try to get a short-term boost by staying out of the market and hoarding cash when the securities they're supposed to be buying are out of favor. The danger is that these very same funds risk missing out on gains that historically come in bursts.

My advice in a nutshell: Look for low-cost, pure and fully invested funds with the potential for consistent performance over time. They might not turn your straw into gold, but they may give you a good shot at reaching your savings goals.

Others might try to make successful saving sound more complex, but the reality is you can generally do well if you diversify, rebalance and avoid chasing yesterday's returns.

I can see the disappointment on your faces already.

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