10 *Questions*

WITH NOTEWORTHY PEOPLE

Zvi Bodie on Financial Planners and 'First, Do No Harm'

by Shelley A. Lee

Who: Zvi Bodie, Ph.D.
What: Professor of management, Boston University, widely published author of professional books and articles on pension finance and investment strategy, and author of *Worry Free Investing: A Safe Approach to Achieving Your Lifetime Financial Goals.*
What's on his mind: "It seems that our idea of financial literacy is to transfer risk from the corporate sector—the investment industry and financial professionals—to the consumer. It's a type of fraud."

It's hard to disagree with *BusinessWeek's* characterization of the 2000s as stocks' "loss decade." Or with Zvi Bodie's analysis that stock risk is dangerous even to investors with a 10-year or more horizon. Bodie, a professor at Boston University, has been engaged in a long-term campaign to get investors—and financial professionals—to invest based on the mantra "safety first." And it's all about using the science, he says. We talked with Bodie recently about "misleading" target-date funds, getting clients to retirement safely, and why a new business model for financial planners is imperative.

1 *How did you get interested in what you call the fallacy of conventional wisdom on equity investing, and what was your "aha!" moment?*

My doctoral dissertation at M.I.T. 35 years ago was on hedging against inflation, very appropriate for the early 1970s, when we were having a serious bout of inflation. It even had a national campaign—remember WIN, or Whip Inflation Now? All the standard economics literature and thinking at the time was based on equities being the best hedge against inflation. My mentor at M.I.T. was Paul Samuelson, who was a trustee of TIAA-CREF. He thought that CREF's strategy of a passive, low-cost strategy of equity indexing, primarily as a hedge against inflation, was a great idea but a classic example of doing the right thing for the wrong reason. Samuelson knew that using equities as an inflation hedge was fallacious thinking and he was a tremendous influence on me. He's written dozens of articles about this and he's said that nothing he's ever written has been more thoroughly ignored.

2 *And did your dissertation verify his thinking?*

Yes, I wanted to examine this topic based on the evidence. In the early 1970s, the stock market had declined by about 50 percent—basically the order of magnitude of our recent downturn—precisely at a time when inflation reached levels we hadn't seen since the end of World War II. It raised the question for me, if equities weren't a hedge, what was? I looked at all asset classes, including the almost perfect one that didn't yet exist in the U.S. I had just returned from living in Israel for five years, where almost everybody invested in inflation-protected bonds. You know, we didn't invent *everything* here in the U.S.! Irving Fisher, the

Talking Point

Risk and Reward

Zvi Bodie has said that financial planning has been approached "from the point of view of practitioners who are trying to make a buck." He also says that risk should be explained to investors in more common-sense terms and conventional benchmarks are meaningless to investors. Why should your clients care about how their portfolios have performed versus the S&P 500 if their goal is to pay for a child's college education?

What do you think? Is Bodie right when he says that your clients are being exposed to risk they're not even aware of and that planners are taking the easy way out by saying, "Don't worry, over time it will all be all right?" Are TIPs really the answer? Is "safety first" how you should be practicing? And what's wrong with trying to make a buck?

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pioneer of financial economics, was also a big proponent of inflation-protected bonds and also greatly influenced my work. I might add that Fisher was a big proponent of "narrow" banking, treating deposits as absolutely secure and not to be used for banks' risk-taking. Like Samuelson on equities as an inflation hedge, Fisher's thinking on banking was mostly ignored. If we truly had narrow banking in this country, we'd never have had our recent crisis.

3 *Why do you think much of the scientific-based thinking on economics and investing is ignored?*

It's a general problem in our society. Think about this analogy: there's a science of nutrition and yet there are all these fad diets not based on science. People ignore the science; people get bad results. It's just rooted in our human nature to want to believe certain things. Look at the advertising—much of it is bunk. Science should be used to distinguish what's true and what's not, *based on the evidence.*

4 *You've had a long-running debate, so to speak, with Jeremy Siegel, about equities. Doesn't he use a lot of hard data and evidence to argue* for *equities?*

Jeremy and I were doctoral students at M.I.T., both under Paul Samuelson. We're actually in complete agreement on everything, but Jeremy emphasizes the positive risk *premium* of equities and I'm focused on the risks of equities. My opposition, if you will, is not Jeremy. It's the entire investment industry that tries to persuade investors that the risks of equities are lessened in the long run. And what's being almost completely ignored when investors and professionals talk about the probability of a downturn in equities is the *severity* of what the downturn could be—as we saw in 2009, a loss of 50 percent is no longer just theoretical. To focus on the probability of success and leave out of the discussion on the risk and severity of failure is unconscionable.

5 *You recently said that the standard model financial professionals use to give investment advice is fundamentally wrong. What are they doing wrong and what should they use?*

The big mistake financial planners make is relying on the investment industry for investing expertise. They have the wrong science. I've been incorrectly painted as a person who says you shouldn't invest in equities—that's the sound bite version of my philosophy, the way others want to frame it. What I'm really saying is that the correct approach to investing is "safety first." Like the Hippocratic oath: first, do no harm. Isn't that the basic principle of any helping profession? Why isn't that the motto of financial planners? Of course, faulty science leads many of them to deny that they're doing harm.

I'm sure there are quite a few who now are adjusting their clients' portfolios toward "safe." But it shouldn't take a crisis to reach that conclusion. And it isn't just bonds they should be thinking about—conventional bonds aren't safe either. Financial planners should be recommending TIPs. It's my soapbox, and that soapbox includes why the profession doesn't understand that TIPs are a separate asset class—and the safest, most fundamental one. It really isn't that hard to understand that if you want to build a safety net for a client's retirement you need default-free securities of every maturity that are linked to the cost of living. Billions of dollars went into TIPs in 2009, but not necessarily for the right reasons. It could be that it's the bandwagon everybody jumped on.

6 *You recently said that this lack of "safety first" was perpetuating a kind of fraud on investors and that we had a sorry state of financial literacy in this country.*

The marketing message is drowning out science *and* common sense. Take a look at the SEC's Web site and the new video for consumers, produced by FINRA. First of all, they are confusing saving and investing.

But it's worse than that. The video is in a section called "Money Game." It's all under the guise of educating adults, but they don't even discuss the tradeoff between risk and reward. This is marketing material that has nothing to do with the public interest. There are many fine people at both the SEC and FINRA but the sad news is that they're not doing right by the public—and that, I'm afraid, is the state of financial literacy in the U.S. today.

7 *Is your own retirement portfolio 100 percent in TIPs?*

It is. The correct way to think about investing is as part of a comprehensive approach to life cycle planning. What are the risks you have at each stage of your life cycle? I'm 66; I don't want or need an exposure to equities and their risks. It's different for somebody in their 30s with a strong prospect for a good career, but even then you should be thinking safety first. If you know exactly what you'll earn for the next 30 years, sure, you can take some equity risk. When I talk about labor supply in the context of financial decision-making, I'm referring to your own earning potential and how much control you have over it. For most people that's the main story, unless you're very wealthy.

8 *But life cycle apparently means something very different to the investment industry, right?*

Yes, unfortunately the industry has co-opted that term. Used interchangeably with target-date investing, it's the new buzzword of the day. The industry has institutionalized the moldy rule of thumb about investing in equities equal to 100 minus your age, and adjusting as you get older. These life-cycle or target-date funds are terribly misleading and are being marketed to individuals as a conservative approach. Target-date funds are one of the default investment options for defined contribution plans [under Department of Labor rules for qualified plans], although that may change. I took a look at how target-date funds performed recently and those with a target date of 2010 lost more than 30 percent of their value, on average. Is that appropriate for people close to retirement? Why are these still a safe harbor option? It's insanity.

9 *Financial planners need a business model that allows them to make a living. How would your view of "TIPs-for-almost-everybody" allow that?*

No question that's the sticky issue. Many planners make most of their money from assets under management. That has to change. As long as their business model and earnings are based on that, they won't be giving science-based advice. So while many agree in principle with my views, they also say it would require a radical rethinking of their business model. So you could say the opportunity is for FPA and those of stature in the profession to be leaders on new business models. We've just had a crisis [because of] which, I would venture, many clients have been very disappointed with their advisers. The process of natural selection suggests that advisers who keep saying and doing the same things are not going to survive. Eventually, the profession will have to come around to a better approach. There's a lot of value to clients in being able to structure a ladder of TIPs with a small layer of equity exposure on top. It seems to me that's doing a better job taking care of clients than passing the money along to a mutual fund and taking 1 percent.

10 *Who inspires you? And, more specifically, who or what inspires you to maintain your crusade?*

President Obama inspires me. My students inspire me. In the fall semester, I co-taught, with my colleague Larry Kotlikoff, a new undergraduate course on how to apply economics to financial planning. Many students who take courses in economics think they're going to learn about financial decision-making; instead, they learn about curing inflation and unemployment, decisions that in most cases they'll likely never get to make. We spent a lot of time discussing psychology and how the framing of advice affects decision-making. My message to them was that if everybody in the investment industry frames everything in terms of the probability of success, steer clear. That framing of advice based on success is going to maximize the success of a professional putting you in the riskiest investments. The need to make huge improvements in financial literacy also inspires me—my next crusade is to improve the quality of financial education, starting with the lawyers who regulate the financial industry.

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