

This is an original article written by Philip Loh; the edited version appeared in the Business Times 13 September 2006.

Baby Boomers' Land Mines

Inflation monster rearing its head

Do we still remember the era of high inflation in the 1970s and 80s? Probably not, as high inflation then may not have been particularly painful for most as it was cushioned by strong asset appreciation and excellent income growth when Singapore experienced rapid economic expansion.

Over the past 15 years, Singaporeans have become accustomed to low inflation. The cost of goods has been kept low with most things 'Made in China'. However, the tides are turning. China is now inflationary for the global economy. Cost-cutting by shifting production to China is increasingly expensive for most companies. Major cities in China are facing a shortage of skilled labour, fuelling wage inflation of over 10% a year. As China, "the factory of the world", gets more expensive, exacerbated by the surge in oil and commodity prices, baby boomers may find themselves retiring into an era of elevated inflation.

An active retirement requires heavier financing

For a growing number of Singaporeans in their 50s and 60s, retirement has become a time to reinvent themselves. Many people who plan to retire soon foresee themselves becoming more engaged in their voluntary work or charitable activities. They desire to spend their retirement years meaningfully without giving up the traditional pleasures of leisure travel and time with grandchildren. Golfing and gardening continue to be favourite past-time activities for many. Retirement has become a new chapter of an active lifestyle. Many who retire today are also much healthier than their parents were at the same age.

Financing the dream retirement remains a daunting task. For example, those who own a car before they retire hope to continue to drive when they retire. The financing cost of a simple Japanese vehicle could set a retiree back by almost \$300,000 over a span of 25 years. Supporting these longer and more active lives will require more savings as well as careful planning. Many pitfalls still exist to potentially thwart their retirement dream; I would like to highlight three potential landmines.

Land mine 1: Risk Profiling

The risk profiling test is a useful instrument to ascertain the risk appetite of an investor to help him decide on the right investment mix. However, over the years, I have learnt some painful lessons from relying on it to advise my clients. For example, some years back, I had advised some of my higher risk client (based on risk profiling test) to buy into a Technology Fund near to the peak of the market cycle, which ultimately caused them to suffer substantial losses. I had discharged my fiduciary duty all right as the fund recommended was in line with their risk profile. Yet somehow, at the back of my mind, something just did not seem right. I have, over the years, grown to understand the limitation of risk profiling. The underlying notion is that everybody, whether you are high or low risk taker, does not want to lose money.

Retirees may make costly asset allocation mistakes after doing the humble risk profiling test. For example, a highly risk averse investor who did a test two years ago may be advised to purchase a global bond fund, which over the period gives close to zero or even negative return.

Another interesting observation about risk profiling test is that the result for the same person may differ with changing market conditions. In a bearish market for example, most respondents would indicate their choice of risk aversion. In an environment where investors have been enjoying strong returns over the past years, the results would usually indicate a willingness to take more risks to achieve higher returns. Hence, we need to go beyond risk profiling test to effectively communicate with the investor, understand their objectives and study their investment patterns in order to arrive at a more accurate diagnosis of their risk preferences.

Land mine 2: Overly enthusiastic investment outlook

As the stock markets chalked up spectacular returns in 2006, investors are asking more from their investment advisors. In order to meet the clients' lofty expectation of 10-15% return a year, many advisors might recommend increasingly higher risk portfolio mixes. This strategy could severely backfire if the markets pull back sharply. Many retirees told me that their advisors are promising them 15% return a year with minimum risk. The general rule is that if the deal appears too good to be true, it probably is.

Contributing to a false sense of security of the current market conditions is the "forever optimistic" view of professional fund managers. Fund managers generally would never give a bearish view of the markets without running the risk of losing their jobs. For example, what would you do with your Asian Equity Fund if your fund manager suggests that the Asian markets are overvalued and may pull back 15-20% over the next one year?

Land mine 3: Over reliance on property investment

Most retiring Singaporeans still have an out-sized portion of their net worth tied to their property which would not be paying them very well over time. Based on my conversations with many property owners, the residential rental yield in Singapore is between 2% to 3% a year. Leasehold or newer property may command up to 4%. But, after compensating for the running down of the lease and the depreciation of the physical asset, the real yield is back to slightly above 2%.

The recent changes to the CPF property scheme dealt a serious blow to the property market. The spill over from the Medisave account which had been going to the Ordinary Account is now diverted to the Special Account. This change alone would reduce the Ordinary Account contribution of many Singaporeans by more than 25%. The Ordinary Account remains, of course, the primary source of mortgage financing. In other words, the purchasing power of many Singaporeans is significantly impaired.

My prediction is for property investment in Singapore to continue to deliver sub-par performance for quite some time. It is however, pretty difficult to influence the mindset of a generation of baby boomers who had benefited from the property boom from the 1970s through the 90s. It is perhaps pay back time now as property prices continue to revert to mean over the next 10 years or so. I suspect it will take a while

before Singaporeans would view the roof over their head as what it really is – a “roof”.

Conclusion

Having recently watched the classic “Mary Poppins” with my daughter, I realised that the concept of investment and compound interest is not new. The “giants of the banking world” as we fondly remember in the movie lectured forty years ago of how a few pennies could be compounded to do great things. Yet, the message is clear. Growing your wealth should be subordinated to living a good life. Retirement investing should be a tool to help realise your retirement goals and should never be an end in itself.