IFB312: Achieving Optimal Investment Balance for Different Age Categories

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Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we have episode 312. Today we have two fantastic, very thought provoking questions that we're going to unpack for everybody today. And so I guess without any further ado, let's go ahead and dive on in. So here we go. Best efficient portfolio breakdown management for different age categories. And this is from Nami. So we got this from Spotify.

Dave [00:00:24]:

So is a great question. So Andrew, I'm going to serve it over to you to get us started on this fantastic question.

Andrew [00:00:30]:

Yeah, Nami, thanks for the question. The first thing I would say is maybe take a listen to the episode we did very recently. It should be live by the time this episode is live. We did it with Laura Adams, and she really talked about how you can apply personal finance and the way that you would structure your investment philosophy based on where you are in your personal finance journey. So as an example, she used the example of accumulation versus I can't remember the words she used, but basically harvesting. So it's like for a big portion of your career, you're probably going to be in accumulation mode, trying to save and invest as much as you can. At a certain point, you start to look towards retirement and start to harvest all of the hard work and accumulation you've done and the investment philosophy, the type of investments you do, the way you think about your investments, all of that changes the closer you get towards the harvesting phase. So I would almost even say maybe not so much age categories per se, but where are you on that accumulation to harvesting timeframe and start to structure your portfolio that way? Would you agree with that? Disagree, have a different perspective?

Dave [00:01:47]:

No, I think the way that Laura broke it down and the way you're breaking it down, I think is probably the best way to think about it. And I think one of the things that probably is skewing some of this and maybe changing how people think about this is the simple fact that we're living longer than we used to. And a lot of the air, quote, time tested ideas and philosophies, especially around portfolio management and retirement. And as you get closer to that breakpoint, break even point or breakpoint, however you want to define that is changing. Back in the day when the 60 40 rule was kind of the, I guess the standard portfolio breakdown times have changed and now we're living longer. And so in those days, maybe the average age range of retirement and how long you had, why you were in retirement was maybe 510, 15 years. And now it could be up to 30 years. And so the need for money for longer probably skews how you want to think about the accumulation phase.

Dave [00:02:50]:

For example, maybe you push that farther in. Depends on when you're going to retire and how close you I think there's certainly other paradigms to think about, but I think for me, I think that's the best way to think about it is you have this long runway that you want to accumulate as much stuff as you can money. And then as you get closer to retirement, you want to think about maybe switching from that accumulation phase and maybe being more risk on and then as you get closer, thinking about more risk adverse. But how you want to play that is going to have some bearing on your health and also how much you've been able to accumulate up to that point. But I think that just kind of that general breakdown is probably a great way to start thinking about how you want to set up your portfolio when you're starting to invest.

Andrew [00:03:38]:

So maybe you can explain what's the 60 40, which like you said, has kind of been the traditional asset allocation that a lot of financial advisors have used as a framework in the past. So what does that mean? 60 40?

Dave [00:03:51]:

The easiest way to think about it is the 60 40 breakdown equals 60% in stocks and 40% in bonds. And the reasoning was that you would go with 60% of stocks that are air quote riskier and are going to have better returns, but then the 40% in bonds would help manage the risk of having that much exposure to equities. And the idea was by having that kind of ideal air quote ideal balance, you could get optimal returns without having to have a lot of risk. And that was kind of the standard portfolio for a very long time. And a lot of financial advisors there was lots of back tests that were done. A lot of financial advisors would work with their clients to help them set up those kinds of structures. And over time, that has kind of morphed. That was kind of the standard 1020 years ago.

Dave [00:04:45]:

That was kind of the standard portfolio.

Andrew [00:04:47]:

And before that, obviously, we understand stocks can be a little bit more riskier but have higher returns and then bonds a little bit less of both. What is it about that makes it better than like 100% stock portfolio, for example?

Dave [00:05:01]:

Well, it really comes down to, I guess, your risk tolerance and there's back tests done on everything, every kind of portfolio you can think of and there's lots of ways to argue each way the harder part about allocating your funds. That way it comes down to your risk tolerance. That's going to be kind of the first idea, I guess. And then it really comes down to how much risk do you want to have and how long do you want to try to accumulate. And that's kind of what Laura was getting at. And if you are 24 and you're just starting out, putting 40% of your money in bonds at that stage of your life as you're investing in theory and will probably harm your returns is not necessarily robbing you of. Money, but it could be putting some brakes on how much you could earn over a longer period of time, because compounding needs long periods of time to compound. And the more money that you can put in that can compound, the better it's going to help you.

Dave [00:05:59]:

So I think looking at a 60 40 portfolio, while it's not horrible and it's not the worst thing ever, I would argue that if you are 24, 30 years old, 35 years old, that's probably not the best strategy to go with. Unless you're just super risk averse and the thought of having money in a lot of stocks or your portfolio in stocks just keeps you tossing and turning at night. You have to have more conservative, maybe air quote safer investments like bonds or money market funds or T bills or treasury bills or something like that to help alleviate some of the stress of investing in Apple or Microsoft for example. And that's kind of the way I think about that. And having those portfolios, I think they had a time and a place but I think that time and place has probably come and gone.

Andrew [00:06:48]:

What about for somebody closer to retirement?

Dave [00:06:50]:

Well, that's where it gets a little more interesting. And that's where I think probably rotating towards something like that is probably a safer and better idea. Simply for the fact is, the closer you get to retirement, the less opportunity you have to overcome a downturn in the market. And nothing would be worse than to work your whole life super hard and have a great, fantastic portfolio, be all set up to retire, and then the pandemic hits and you lose all that portfolio and not have it rebound like the stock market did. That whole drop and then rebound is unusual in history. Generally they don't happen like that. It usually sees a down period for a couple of two, three years and then a gradual upbeat, not a drastic downturn and then a month or two later drastic rebound. So that's unusual.

Dave [00:07:45]:

So if you're going with the historical averages, if you're a year or two from retirement and you see a market downturn like.com bubble or the great financial crisis, that would suck majorly because then you have to choose okay what am I going to do here? And if you started allocating more money to safer investments, whether it's safer stocks or whether it's bonds or treasury bills or money market accounts, real estate, I mean there's just a litany of things you could try anyway. My point is though is that as you get closer you want to start to switch to that because it reduces your risk of a big downturn and having to try to recover that as you go into retirement because that's a harder place to be and I wouldn't wish that on anybody.

Andrew [00:08:29]:

I think that's very well said. Part of the 60 40 is, let's say that does happen, which I think happens more than a beginner to the investing world might realize. I mean, every ten years or so, it seems you have a pretty big drop off in the stock market. Let's say you're ten, 510 years from retirement. If you have 60% in stocks, 40% in bonds, what's nice about that is if your stocks drop, your bonds will generally drop less. So let's say your stocks cut in half. And maybe you have, just to make it simple, the bonds didn't really move much. So maybe now, because your stocks have cut in half, you have like 50% in stock and 50% in bonds because your bonds didn't move, but your stocks got cut in half.

Andrew [00:09:12]:

However the math works out, what's nice about that is you could sell some of your bonds, put that into stocks, go back to the 60 40, and basically what you've done is bought low, been able to buy more stocks with money that was kept safe. And as you do that over a 510 year period, you can get a lot more smoother returns. And depending on which market environment you're in, that you could actually outperform somebody who's 100% stocks. And so if you have somebody who's maybe at $10 million and the difference between 10 million and 15 million doesn't mean much, but the difference between 10 million and 5 million means a lot, the 60 40 could make a ton of sense. And so to Dave's point, I think it really depends on where you are in that accumulation versus harvesting lifecycle. I'd kind of push back maybe a little bit on the idea that 60 40 is dead. I think that's people overreacting to an unprecedented drop in the bond market, which I could go down a rabbit hole of interest rates, but nobody wants me to do that. So we'll just say it was unprecedented.

Andrew [00:10:19]:

Bonds really fell like we haven't seen. And so to think that the idea of shielding yourself from volatility by having some conservative investments outside of stocks as you're close to retirement, I don't think that idea will ever go away. I think a lot of this 64 of these dead stuff is a lot of noise. But to your point also to be so risk averse that you do that when you're first starting on your accumulation journey, I think it's also a very big risk in that I think a lot of beginners are naturally risk averse. And I think that's good, but I think it's not intuitive. It doesn't necessarily come easily. This idea that I'm losing a lot of money by not putting it in the stock market, when you start to do a compound interest calculator and you see the power of just the difference of a couple of percentage points a year, it's massive if you talk about a long enough time frame. So the longer away you are from retirement, the more you're leaving money on the table by not saying buy all the risky stocks in the world, but saying to have enough risk tolerance to be in the stock market.

Andrew [00:11:30]:

I think it's a huge mistake to be too conservative and think about 60 40 for those first few years.

Dave [00:11:36]:

That's great advice. And I think one of the things that I think people need to realize is that when they start out investing, like Andrew said, it's natural for people to feel like they're going to be more risk averse. The thing is that I think a lot of people sometimes when they invest, they either fall into this like super risky or not risk enough. And there can be a happy medium. And investing in companies like Dividend aristocrats companies like a Johnson Johnson or a utility or a telecom or something like At T Verizon. This is not me advocating for you to invest in those specifically, but what I am saying is that you can find very stable dividend paying, not huge growers, but also not super risky stocks, just like you can with bonds. And so there's different flavors of things. I mean, you can buy something like Tesla, which is a super volatile company, up and down, very erratic, kind of like its owner, so very erratic.

Dave [00:12:37]:

But you can also buy something that's a lot know, I guess boring, if you will air quote boring like Johnson Johnson, which is one that kind of comes to mind. I'm not saying it's a bad investment, but it doesn't have the same kind of volatility that a Tesla would or crypto or any of those kinds of things. So you don't have to go super crazy to accumulate. You also don't have to go super risk averse to not have some growth in your portfolio as well. And so you can find a happy medium across the board of different opportunities to invest in that can help you sleep well at night, but still get the returns that you need, especially as a younger person, because you want to think about that snowball. The bigger and faster you can get it, the faster it's going to roll down the hill and the bigger it's going to be at the end of the hill. So if you start off I'm not saying that you don't have to start with a big box, but if you start investing too conservatively, that pebble that starts at the top of the mountain is not going to grow as fast as you want. So to kind of Andrew's point earlier, instead of having maybe a million five to retire with, you may only have 400,000.

Dave [00:13:43]:

And if you think about $400,000 may sound like a lot of money, and it is. I'm not saying it's not. But if you think about having to live off of that for the next 30 years, for example, if you retire at 65, and let's say you live until you're 95, you got to live off of 300 years or 30 years off of $400,000, that's about $13,000 a year. That's not a lot of money. And so just to kind of put it in perspective, I'm not saying that to scare people. I just want you to understand the power of compounding and the power of the choices that you make early on can affect something that could happen 30, 40, 50 years from now. And we don't want people to get into that situation. We're also not advocating that you go out and buy the riskiest stuff out there, but you need to understand the balance and understand the different opportunities and options that you do have that can help you get where you want to go.

Dave [00:14:34]:

But I think overall, maybe we could kind of tie this together for Nami. Would you say? Generally from younger to mid 40s, maybe early 50s is probably a safe time period to be in the accumulation phase. And then once you start to get beyond the maybe mid 40s, early 50s is when you need to start thinking about the more harvesting period.

Andrew [00:15:00]:

Yeah, I think in general, that's a really great framework. There's also something called the 4% Rule, which could keep you in stocks for the rest of your life. And the way that works is if you have enough of a nest egg, you can just sell 4% of your portfolio every year, but that 96%. That rest of that nest egg, if you keep it in the stock market, over time, on average, it grows. And so even though you're withdrawing 4%, your money is making money in the market, you actually keep your nest egg intact. And I think it actually grows a little bit on top of that too. So that's a very interesting way to think about it. So I would say, yeah, in general, you want to start to accumulate, maybe start transferring over the less risky stuff as you get closer to retirement.

Andrew [00:15:49]:

But to your point, the whole idea of retirement is changing. The way we work is different than it was 20 years ago. You could find something you love to do, and you could be working way longer. So I think there's a lot of benefits to kind of keeping an open mind as well and thinking through all your options. If I was 25, I would just keep it simple and just get into the stock market, whatever that means for you. And as you learn more and more about your options every day, you can kind of figure it out from there.

Dave [00:16:15]:

Yeah, I agree. I think the best advice we can give anybody is start now. Start in the accumulation phase today. Don't wait till tomorrow. Don't wait till Monday. After you're done listening to this, go open a brokerage account, put $50 in there and buy something today. Please do it. Your life will be immeasurably better once you start.

Dave [00:16:34]:

And I think once people can get past the inertia, then they'll find out how great this is. And the sooner you start accumulating for that snowball, the better you're going to be. So start now, today. Turn off the podcast. Well, maybe don't do that, but start now.

Andrew [00:16:49]:

Do it.

Dave [00:16:49]:

All right. Okay. So let's move on to the next question. So told you these are thought provoking today. So here we go. Why do you choose to invest in individual stocks instead of buying ETFs and sitting on a beach? Now, this is not directly from somebody, but one of our followers on Twitter, Imran, sent me this message and said he thought this would be a really good question for us to answer on the podcast. It was from somebody else on Twitter. So, Andrew, I'm going to throw it over to you to take first.

Andrew [00:17:17]:

Right. All right. Imran first serve on the volume on that. To take the idea quite literally, the reason why I don't sit on the beach and choose to work is because I find purpose in it and it's fulfilling, and I love what I do. I know that's not how everybody views work, but that's how I view work. Curious how you view the idea of, like, I guess we're also a little bit different in that we kind of look at stocks for a living. So how do you view it?

Dave [00:17:45]:

I view it the same way. I mean, I love what we do, and I love to do what I do because it gives me purpose and it makes me feel like I'm helping people and trying to better society as well as the world. And in some small little way that we can help somebody out there that's maybe struggling with trying to figure out what to do and how to get where they want to go. And the opportunity that the podcast gives us to reach out to those people is what gets me up every morning. It helps me read, helps me go through some of the boring stuff that I have to read to learn and to become a better investor for myself so that I can try to help pass that on to other people. That's why I choose to do it. Instead of, like they said, buying ETFs and sitting on a beach. There are some days where that does sound appealing, but it drives me.

Dave [00:18:37]:

The other thing that for me is it's an intellectual pursuit, and it tweaks the curiosity driven brain that I have. I am curious like a cat, and I want to know everything about everything. And so the stock market to me is an endlessly, fascinating, I guess, industry. And just the fact that I get to sit here and learn all the ins and outs of Amazon and what drove Jeff Bezos to do what he did, the decisions that he made, the history and how the company does what it does. Even though it's not a company I invest in, I still find it endlessly fascinating and the psychology behind why we choose to all invest in prime. Yes, I finally bit the bullet, and I am a prime member. And so I think there's two of us now in the United States left now that are not. But anyway, there's so many interconnected parts to the market beyond just the stock picking part of it that I just find endlessly fascinating.

Dave [00:19:36]:

And it's an intellectual exercise that keeps my brain going and makes me excited every day to get up to do this, because it's kind of a flywheel. The more I learn, the more excited I am to talk about it, and the more I want to try to help people, and the more that we can help people, the more that I want to learn, and it just becomes a flywheel. And that's why I find it interesting and why I choose to do what I do. So what are your thoughts?

Andrew [00:20:00]:

Yeah, when you look at some of the fund managers who have done really well, or even somebody like Buffett or Munger, they've hung around so long past their ninety s, and I think it was Irving Khan. And I can't remember there's somebody else I read about recently, and also John Templeton. I think he continued investing till very old age. So you wonder if there's some sort of correlation I'm so far from like a doctor, scientist, whatever, longevity expert, but you wonder if there's some sort of correlation there between having that intellectual stimulation and that endless curiosity in a world that is constantly changing. And if that does have longevity side effects too, who's to say? I mean, you don't have to be managing $100 billion to get the same type of intellectual stimulation. You could be managing your own portfolio and feel just as tap dancing to your little desk to read Ten KS just like Buffett does. There's really nothing saying you can't do that through retirement or even up to retirement, right?

Dave [00:21:11]:

Yeah, for sure. I just think that there's so much involved in the stock market that you could find the history of it endlessly fascinating. And that could be something that just keeps you interested and keeps you intrigued for a very long time, because it's kind of a never ending subject, and there's so many different aspects of that that you can look into. And kind of the same with the number part of it. There's just so much endless fascination and depth that you could go into analyzing that. And you don't have to pick 100% individual companies either. You can do this. You can invest in ETFs, and then you can go.

Dave [00:21:49]:

I am super curious about Netflix and how do they do what they do? How did they get there? What is the story behind Reed Hastings? And you could spend the rest of your life studying Netflix if you want, and that could be the only individual company you buy, and you could still get a great return and you have a lot of fun along the way. I think sometimes people think about stock market is a job and investing is a job for sure. There's no question about it. But I think you also have to remember what drove you to play it. It's kind of know sometimes every once in a while. Well, perfect example is the movie with Tom Cruise and Cuba Gooding Jr. Where they were talking about in the movie, they're talking about money and how important money is. And Tom Cruise asks Cuba Gooding, do you remember when you first started playing football and how much fun it was? And Cuba Gooding gets this little smile on his face, and then it kind of fades because then because the money becomes such a big thing.

Dave [00:22:43]:

But he was trying to remind him of how much fun football was to him when he was a youth. And to me, that's kind of what investing is fun. It's exciting, and there's lots of different things about it that I find fun. And I think sometimes people think of, I can only get into investing if I'm super serious about it. No, there's a lot of different ways you can go to do it, and you just need to find what's going to work best for you and what you find intriguing and what will keep you coming back every day.

Andrew [00:23:10]:

The movie you think about is Jerry Maguire.

Dave [00:23:12]:

Thank you.

Andrew [00:23:13]:

Show me the money. Show me the money.

Dave [00:23:16]:

Yep, that's it.

Andrew [00:23:18]:

So on a logical perspective, though, I mean, it's know to be all fun and games, but show me the money. Right? Right. So why can somebody pursue stock picking? And what would be some basic ideas of why that could do better than just buying ETFs and sitting on the beach?

Dave [00:23:37]:

Well, I guess the first idea is index funds. ETFs are designed to mimic or match the index or the fund that they are matching. And so they're designed by nature not to beat the market. So just in general, that's the way they're supposed to work. And that's not a negative. That's just what they're designed to do. So if you go into an index investing or investing with ETFs and you expect to beat the market, you're going to be sorely disappointed. So just understand that they are not designed to beat the market.

Dave [00:24:12]:

They're designed to match or mimic whatever returns the S and P 500 gets, for example. So that being said, if you want to beat the market, then you have to use some sort of combination of individual stock investing. And that's really the only proven way that I'm aware of that you can do that. And the advantage that we have as individual investors, as opposed to the people that are managing funds, whether they're ETFs or whether they're hedge funds or that kind of thing. The one super big advantage is a we can buy whatever we want, so we have no preconditions or any ideas forcing us to concentrate on one particular thing or idea or theme. We also have a much longer time horizon that's available to us. And that is probably the biggest advantage that we have as individual investors, because the longer that you invest, the more chances you have of beating the market. And the longer that you can invest in particular companies, then the better advantage you have.

Dave [00:25:17]:

Because those other managers, unfortunately for them, the majority of them are driven by their returns, and their investors demand that they beat the market on a regular basis. And to do that, they have to move in and out of companies far more than you and I have to do. And so we can withstand a drawdown of 50% of Berkshire Hathaway and still come out in the long run, whereas a fund manager doesn't have that advantage. And so those are a couple of things that kind of come to mind when I think about, show me the money. Why would I do this as opposed to that? I'd love to hear what your thoughts are.

Andrew [00:25:50]:

I think there are times when it's better to invest in an index fund, and I think there are times when not investing in an index fund and maybe picking stocks is better, and that fluctuates depending on what's in the index and what's comprising the index. I mean, right now we're recording this 2023 top three companies in the SP are Apple, Microsoft, and Google. I find that very hard combo to try to beat, and I'm kind of sad I only have two of three of those in my portfolio, but at other times, I remember Tesla being a big part of the S and P 500. It still kind of is. Other stocks have had super high PES and become big parts of the S and P 500. And even the big oil companies were a big part of the S and P 500 at the time. So it's interesting how concentrated the S and P is becoming and how these ETFs are becoming. You're getting that kind of exposure through an ETF and over a long enough time period, it's not going to do much but a couple of percentage points a year.

Andrew [00:26:49]:

Again, to kind of go full circle with what we were talking about before, if you can increase your annual returns over time, what you're doing is you're taking that snowball, and basically, the higher the return, the steeper the hill that your snowball goes down, and it really mushrooms and becomes exponential. And so that is why if you can become skilled enough and have the right knowledge base, the right emotional maturity, the right behavior of being able to manage a portfolio and do the right thing for your portfolio, you can generate serious wealth that is multiples above what you could do in just an ETF, if that's what you're going for. And so, again, that's going to. Be different for everybody, because maybe somebody has 15 million, and whether they have 15 or 20, they're still on the beach, right? But maybe for somebody else earlier in the accumulation phase, that can make a huge difference. And so that's kind of where I kind of look at it, and it's such a cop out to say it depends, but it really does. And the market changes every day, the indexes change every day, and that's what makes it fun. But there's also time periods where you can generate alpha. And for some people, in some circumstances, some situations, they can create a lot of wealth for themselves and for others.

Dave [00:28:09]:

Yeah, I think that's the perfect answer.

Andrew [00:28:11]:

Okay, I'll wrap it up.

Dave [00:28:13]:

Okay. All right, folks. Well, with that, we will go ahead and wrap up our show for this week. Don't forget to subscribe to the show on your preferred podcast app. If you enjoyed our little show, and if you would kindly consider giving us a review, a five star would be fantastic. It greatly helps our show. And don't forget to browse the incredible materials we've created for you@einvestingforbeganners.com. Lastly, continue growing your knowledge as an investing for Beginners insider with insights and educational tips delivered right to your inbox for free.

Dave [00:28:41]:

Sign up today. And with that, we will go ahead and sign us off. You guys go out and invest with the margin of safety. Emphasis on the safety. Have a great week and we'll talk to you all next week.

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