

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## What is your Time Horizon?

*By Gil Hanoach, April 5, 2006*

Your time horizon has a significant impact on how you can invest your money. You probably heard two general statements about time horizon:

1. Young people in their twenties, with enough income to cover their expenses, have a very long time horizon for their savings, and therefore can take large amounts of risk.
2. People near retirement have a very short time horizon, because soon they will not have earned income and they will be financially dependent on their savings.

This article presents an approach to evaluating the time horizon of any person regardless of their age.

Your time horizon is the time until you will need to use your money. Each person may have several time horizons for different parts of their savings.

The first sentence is the basis for the claims in the two examples above. The second sentence states that you should not lump all of your savings into one time horizon. You can optimize your financial security by listing the expenses you might face in the future and specifying the time until each amount is needed.

A few cases might help exemplify this approach:

1. A 22 year old person starting a new job may have a short time horizon for amounts he might need to live off of, in case he loses his job. The period considered should be a conservative time period needed to find a new job in case of a recession. Other amounts may have a long time horizon.
2. A 65 year old man that is about to retire and has no guaranteed income other than social security, has a short time horizon for amounts he will need in the next few years to complement the social security income. Additional amounts that will not be needed for many more years have a long time horizon.
3. A 65 year old woman, with a guaranteed retirement that should fully cover her expenses, has a long time horizon for all of her savings. Be cautioned that if there is any risk to the "guaranteed" retirement income, some savings should be kept for possible short-term needs.
4. An 85 year old woman, with a need for \$100,000 per year, \$5,000,000 in the bank and no other sources of income, has a short time horizon for amounts that are needed for living expenses in the next few years and a long time horizon for the rest of the money, which is most of the \$5,000,000.

The difference between these cases and the two cases presented above is the separation into several time horizons based on the different financial needs. Specifically, not all young people have a long time horizon and not all retired people have a short time horizon. In addition, stating a short or a long time horizon for the total individual's savings creates injustice in most cases. Most people have a short time horizon for certain amounts and a long time horizon for other amounts.

**Why is this important?** Amounts that you may need in the next few years should be invested conservatively outside the stock market, since any stock portfolio can decline significantly for several years. The price you pay for conservative investments is lower expected returns than stock returns. The investments may even lose value compared to inflation, but it is a price that has to be paid.

Amounts that you can leave untouched for several years can be invested in a diversified stock portfolio. This is based on the assumptions that you will not sell the portfolio at a decline and you can wait enough years for a recovery from long declines. The reward for this patience is higher expected returns.

Because of the tradeoff between low volatility and high returns, you want to make sure that you minimize the risks of amounts you need in the short run, and maximize the returns of amounts you need in the long run. The best way to do this is to categorize the savings into individual amounts based on the future needs of the money.

**Caution!** The process above can help you determine the optimal investment approach for the disciplined and systematic investor. It assumes the following:

1. You periodically review your savings to make sure you have correct allocations for short-term and long-term needs.
2. You invest your long-term money in a way that is likely to grow in the long run. This means that you avoid trying to choose specific stocks, since any single stock can decline irrecoverably. It also means that you buy and hold onto the investments without trying to time the ups and downs of the market – another behavior that may lead to irrecoverable losses. If you have the urge to choose specific stocks or time the market, do so with amounts that you are willing to lose altogether (infinite time horizon).
3. You are committed to hold onto your long-term investments through all declines. The reason you can afford to invest in the stock market is your ability to wait for recoveries. If you suspect that you might sell your stock portfolio after a decline because of a fear of no recovery, you would be better off avoiding the stock market altogether.

### **To Summarize**

Time horizon is a critical element in investment decisions. By correctly identifying the time horizons of your savings, you can maximize your financial security in the short run and the long run, without any conflict between the two.

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