
CORTE INTERAMERICANA DE DERECHOS HUMANOS
INTER-AMERICAN DEFENSE BOARD
INTER-AMERICAN INSTITUTE FOR COOPERATION ON AGRICULTURE
OAS
ORGANIZACIÓN DE LOS ESTADOS AMERICANOS
INSTITUTO INDIGENISTA INTERAMERICANO
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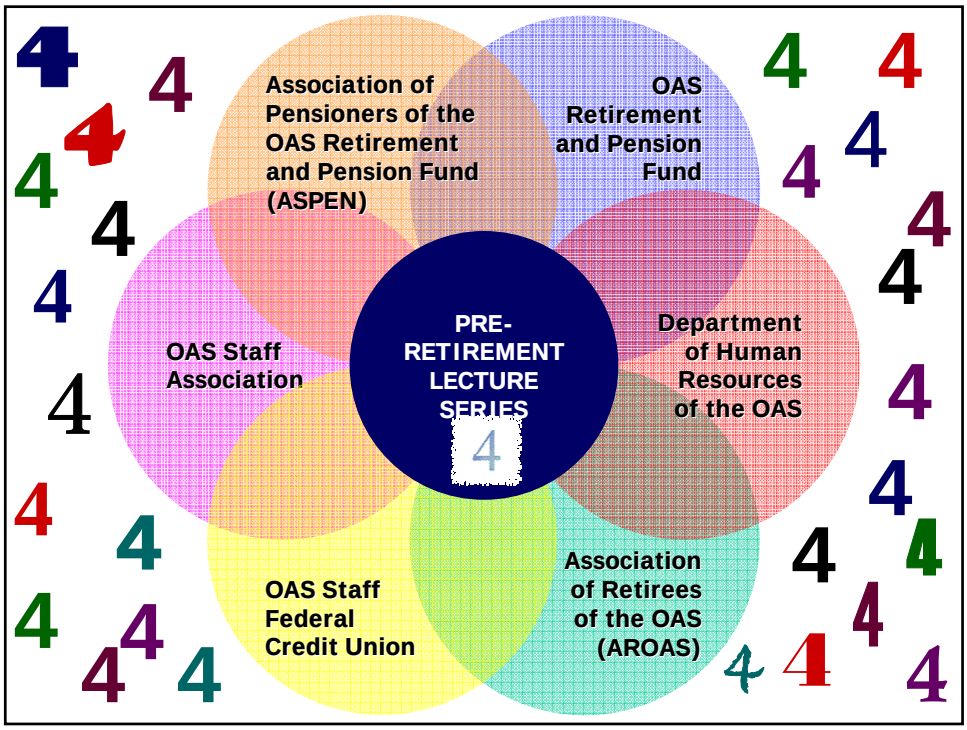
-OE A-
CATIE Centro Agronómico Tropical de Investigación y Enseñanza


Association of Pensioners of the OAS Retirement and Pension Fund (ASPEN)
OAS Retirement and Pension Fund
OAS Staff Association
PRE-RETIREMENT LECTURE SERIES
4
Department of Human Resources of the OAS
OAS Staff Federal Credit Union
Association of Retirees of the OAS (AROAS)

For participants
close to retirement

Pre-Retirement Lecture Series :
IV. Investment of financial resources received at retirement

Presents:

OAS Retirement and Pension Fund

and Association of Pensioners of the OAS Retirement and Pension Fund

December 7, 2006

Washington, DC

Assets and its Characteristics

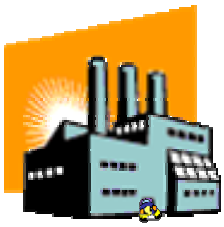
Assets Classification

STOCKS	Domestic	Small Caps	Medium Caps	Large Caps
	International			
BONDS	Government	Short Term	Intermediate Term	Long Term
	Corporations			
	Agencies			
REAL ESTATE	Industrial	Commercial	Residential	
CASH	Savings, Checking	Money Market		

Asset Allocation

- The asset allocation depends on several parameters, including the age of the investor
- Generally, all the assets previously seen are used in different proportion to provide diversification and to balance advantages and disadvantages

Stocks



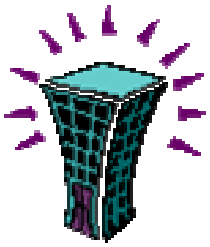
- When the investor buys stocks, he/she is becoming owner of a part of the company (shares)
- Stocks provide growth and protect against inflation
- If the company does well, its capital grows, the investor earns through capitalization of his/her shares and the dividends the company pays

Bonds

- When the investor is buying a bond, he/she is actually lending money to a government, company or agency
- Bonds provide income through the interest they pay and provide for portfolio stability

Real Estate

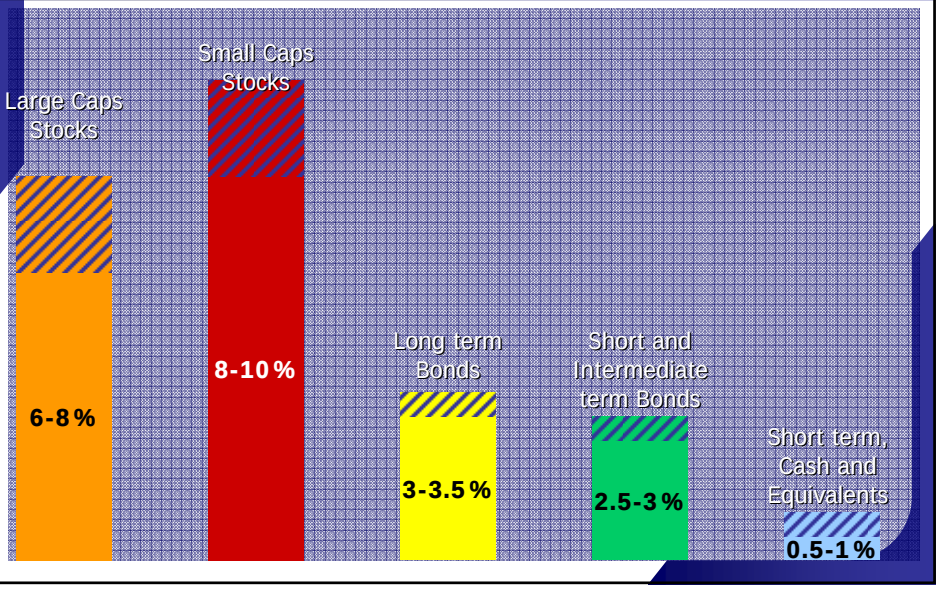
- Most investors may already have some sort of real estate investment (own house), so they should be careful and not to upset the asset allocation
- Real Estate protects against inflation
- However, this type of asset is very poor in terms of liquidity



Cash and Equivalents

- Cash and Equivalents provide liquidity and may be used to take advantage of investment opportunities
- The problem is that they provide lower expected rates of return

Historic Returns (Real Rates)



Investment Process

- Most experts charge by the hour, prepare for the interview!!!
- Analyze quality, experience and references of the experts you consult
- Consider accredited experts who do not charge commission but are for fee-only. They may be more expensive but conflicts of interest are avoided

Lawyers

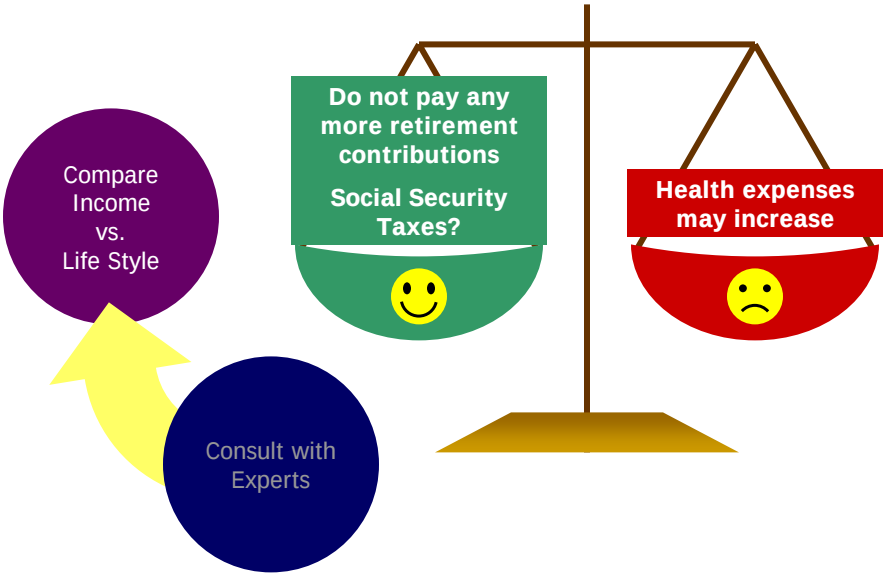
Accountants

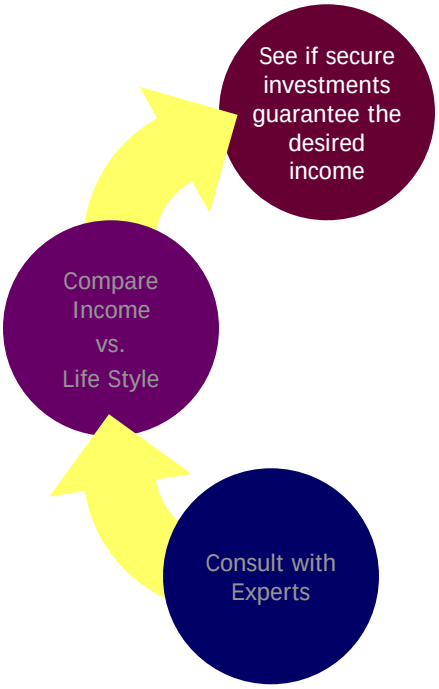
Financial Planners and Analysts

Banks and Investment Funds

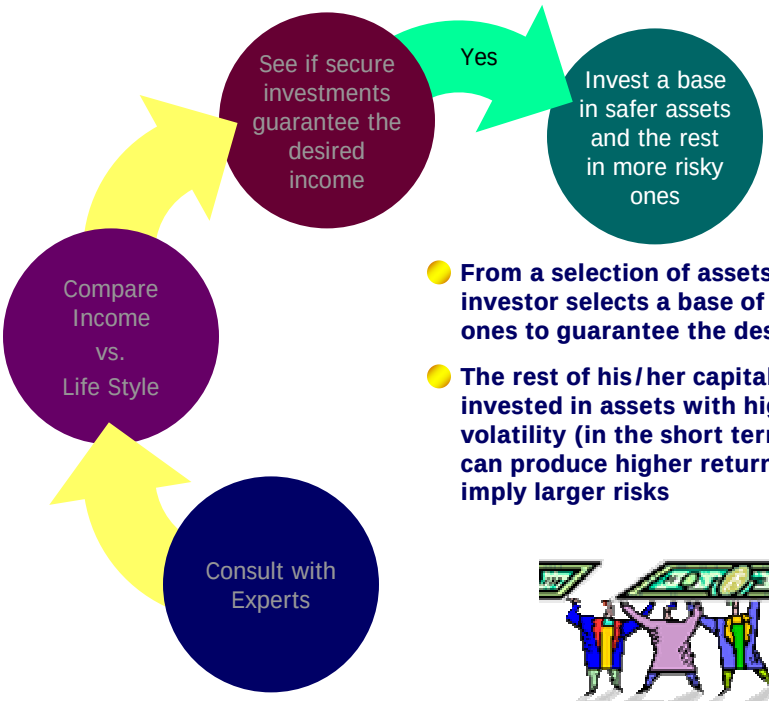
Consult with Experts

- Consider the possibility to buy long term care insurance

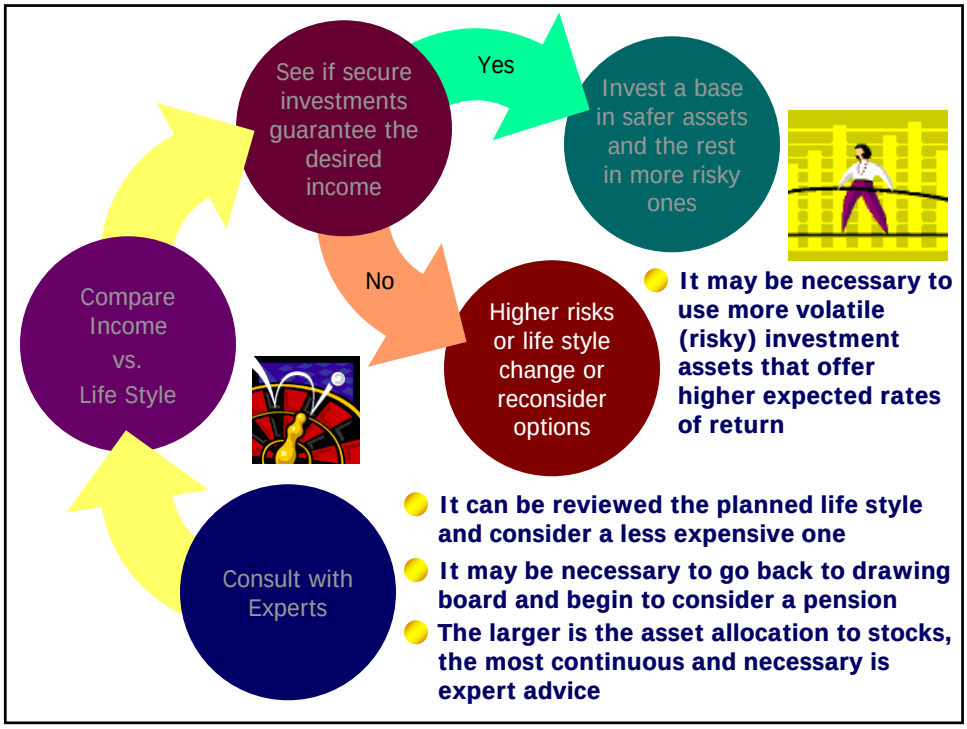


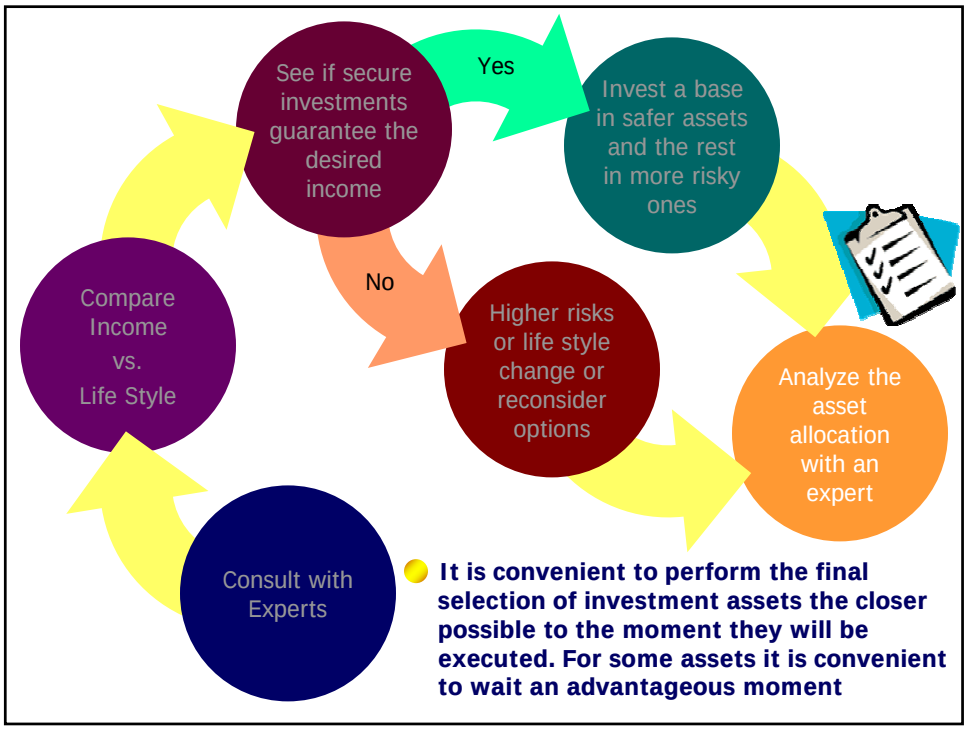


- **Every investment has risks, it is important to see if the future retiree will be able to achieve the desired income with the investments that have lower risk**

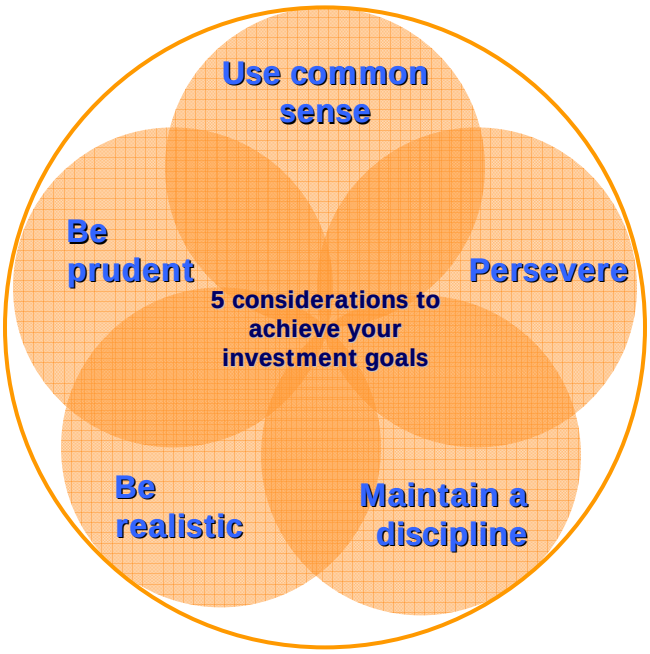


- **From a selection of assets, the investor selects a base of the safer ones to guarantee the desired income**
- **The rest of his/her capital can be invested in assets with higher volatility (in the short term) which can produce higher returns buy also imply larger risks**


See if secure investments guarantee the desired income
Yes
Invest a base in safer assets and the rest in more risky ones
No
Higher risks or life style change or reconsider options
Compare Income vs. Life Style
Consult with Experts
It may be necessary to use more volatile (risky) investment assets that offer higher expected rates of return
It can be reviewed the planned life style and consider a less expensive one
It may be necessary to go back to drawing board and begin to consider a pension
The larger is the asset allocation to stocks, the most continuous and necessary is expert advice


See if secure investments guarantee the desired income
Yes
Invest a base in safer assets and the rest in more risky ones
No
Higher risks or life style change or reconsider options
Analyze the asset allocation with an expert
Compare Income vs. Life Style
Consult with Experts
It is convenient to perform the final selection of investment assets the closer possible to the moment they will be executed. For some assets it is convenient to wait an advantageous moment

- **If necessary, review the process from the beginning**



Rules to Consider

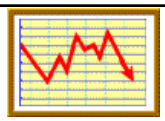
- **No.1:** Be comfortable with your decisions
- **No. 2:** Clear objectives and reasonable expectations
- **No. 3:** Do not become excessively ambitious
- **No. 4:** When in doubt, review rules No. 1, 2 and 3
- **No. 5:** Investing is the art of managing risk
- **No. 6:** Expected return larger than assumed risk
- **No. 7:** Diversify between non-correlated assets
- **No. 8:** Develop a long term strategy
- **No. 9:** Be patient and maintain discipline
- **No. 10:** Implement your strategy gradually
- **No. 11:** Re-balance periodically
- **No. 12:** Select wisely regarding taxes
- **No. 13:** Select managers with adequate record
- **No. 14:** Monitor your managers periodically
- **No. 15:** Do not ever ignore investment fees
- **No. 16:** Read the investments prospectus
- **No. 17:** Consult an specialized lawyer to leave your estate
- **No. 18:** Always remember the first three rules

Considerations about RISKS

Risks

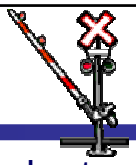
- In the investment world you cannot avoid risks
- The most an investor can aspire is to manage them
- When trying to protect himself/herself against a risk the investor normally will take others
- A compromise is created between the risks taken

Market Risk



- Comes with the lost of capital as a consequence of market volatility
- The larger the expected rate of return of an asset, the larger is the risk to lose capital, particularly in the short term
- One of the assets more associated with this type of risk is equity (stocks)
  - If a company that issued stocks is doing badly, the same happens to the investor who purchased its stocks
  - Large Caps vs. Small Caps

Market Risk: CONTROL

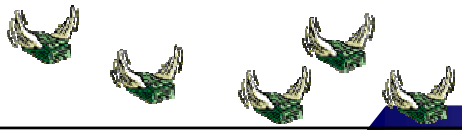


- Select investment assets were the expected rate of return is proportionally larger than the volatility (Rule No. 6)
- Develop a long term investment strategy (Rule No. 8)
  - There is evidence that the risk associated to a particular asset is decreased in the long term
- Diversify investments (Rule No. 7) and re-balance the portfolio periodically (Rule No. 11)
  - By diversifying if an asset is not giving good return, another investment can be providing them
  - Re-balancing ensures that the portfolio will never be excessively exposed to a particular type of risk

Inflation Risk

- When inflation is sustained, even if the capital is maintained, purchasing power decreases

- Inflation is not constant, varies through time
  - The investor has to be careful when assessing this parameter and monitor inflation periodically
- It is not convenient to over evaluate inflation, since there may be assets in the investor portfolio that are protecting him/her against inflation



Inflation Risk: CONTROL

- Stocks tend to protect against inflation (larger return) but they have larger market risk than other assets (compromise between two risks)
- Real estate investment tends to protect against inflation but generates another type of risk: low liquidity

- There are other types of investments that protect against inflation:
  - Step-up CDs
  - TIPS (Treasury Inflation Protected Securities)
  - But!!! The initial rates of return are lower!!!

Risk: Change of INTEREST Rates

- The investor should not care about nominal rates but for real rates, adjusted for inflation
- If inflation accelerates, depositors will claim higher interest rates to fight the lost of purchasing power
- Change of interest rates affect most assets but the effect is larger in bonds, when the interest rates increase the value of bonds decrease
- The larger the maturity of the bond, the larger the effect of the change in the interest rates on its value

Risk: Change of INTEREST Rates

1

30 year bond, value 100
Interest rate: 5.00%

2

Interest rates increase

- The longer the maturity, the larger the effect of the increase in interest rates

3

Government issues a NEW 30 year bond, value 100
Interest rate: 5.50%

4

The old 30 year bond decreases its value (i.e. value 90
Interest rate: 5.00%)
To compensate for the lower rate

Change of Interest Rates: CONTROL

- The same measures used to control inflation are used to control the change of interest rates
- When a bond matures, independently of its market value, the face value will be paid to the investor, so one protection would be to wait until maturity
- Build a bond ladder:
  - This can soften the effect of the change of interest rates
  - The investor waits for the bond to mature, and then buys other bonds of longer maturity and better interest rates

Risk: Credit Quality

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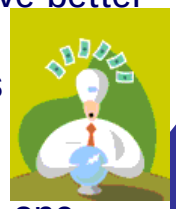


- Not all bonds have the same quality, even if they have the same maturity
- Healthier companies issue bonds that have better quality than more indebted companies
- With governments is the same, countries with bigger problems issue riskier bonds that promise to pay higher returns
- The relationship quality-risk is an inverse one
  - The higher the bond quality, the safer the investment. There is less risk but the promised return is also lower
  - Very indebted companies issue bonds with very low quality that promise to pay the highest returns (if the company does not go bankrupt!!)

Credit Quality: CONTROL

- If an investor is going to have low quality bonds in his/her portfolio the first thing he/she has to do is to be aware of this
- The investor has to achieve a healthy diversification and balance with higher quality securities (Rule No. 7)

- The investor should control his/her ambition (Rule No. 3), promises of higher return come hand to hand with higher risk, if the economic environment produces a downturn the companies in worse condition are the first to go bankrupt!!

Risk: Lack of Liquidity

- It is when the investor needs cash but did not take enough precautions to have it available
- This may force him/her to sell assets in the worst moment and realize a loss
- Unfortunately, The more liquid assets are the more affected by inflationary pressures and the ones that promise lower returns
  - Another typical compromise between different types of risks

Lack of Liquidity: CONTROL

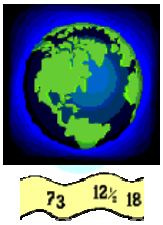
- Plan expenses carefully to determine cash needs with the highest possible precision
- In some cases the accumulation of cash reserves is good to take advantage of "investment opportunities" i.e. during low interest rate periods, forecasting an increase
- Have emergency reserves or access low interest loans to avoid "realizing" losses and be able to wait a more advantageous moment to sell other asset needed to cover cash needs

Risk: Currency Exchange

- The currency exchange risk is particularly important for investors that have overseas investments

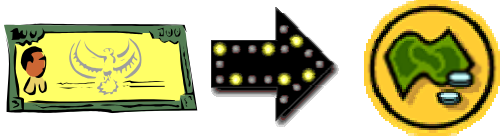
Currency Exchange: CONTROL

- One can “hedge” the portfolio (is like buying an insurance) to control this risk, but it may be too expensive for a small investor
- Perhaps more practical is to invest in mutual funds that have country and currency diversification so currency exchange risks cancel out (Rule No. 7)



Risk of Bond Recalls

- Some bonds are issued with a recall option, meaning that the company or country that issued it can repay the debt to the investor at any time; the risk is not for loss of capital (because the re-caller pays the face value of the bond) but to have to invest that capital in a moment that might not be opportune, i.e. if the interest rates are now lower than when the original bond was bought



Risk of Bond Recalls: CONTROL

- For the case of recallable bonds, the first thing for the investor is to be aware of that quality to plan accordingly; second, a good diversification will allow that even if one bond is recalled other bonds remain in the portfolio that will reduce the effect of recall (Rule No. 7)

Questions and Comments?