7 Keys to Successful Retirement Portfolio Planning

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Presentation Overview

Part I: Key challenges facing retirees today

Part II: 7 keys to successful retirement portfolio planning

Part III: My model "bucket" portfolios for Morningstar.com

Challenge 1: Three-Legged Stool Is Now Two-Legged for Many

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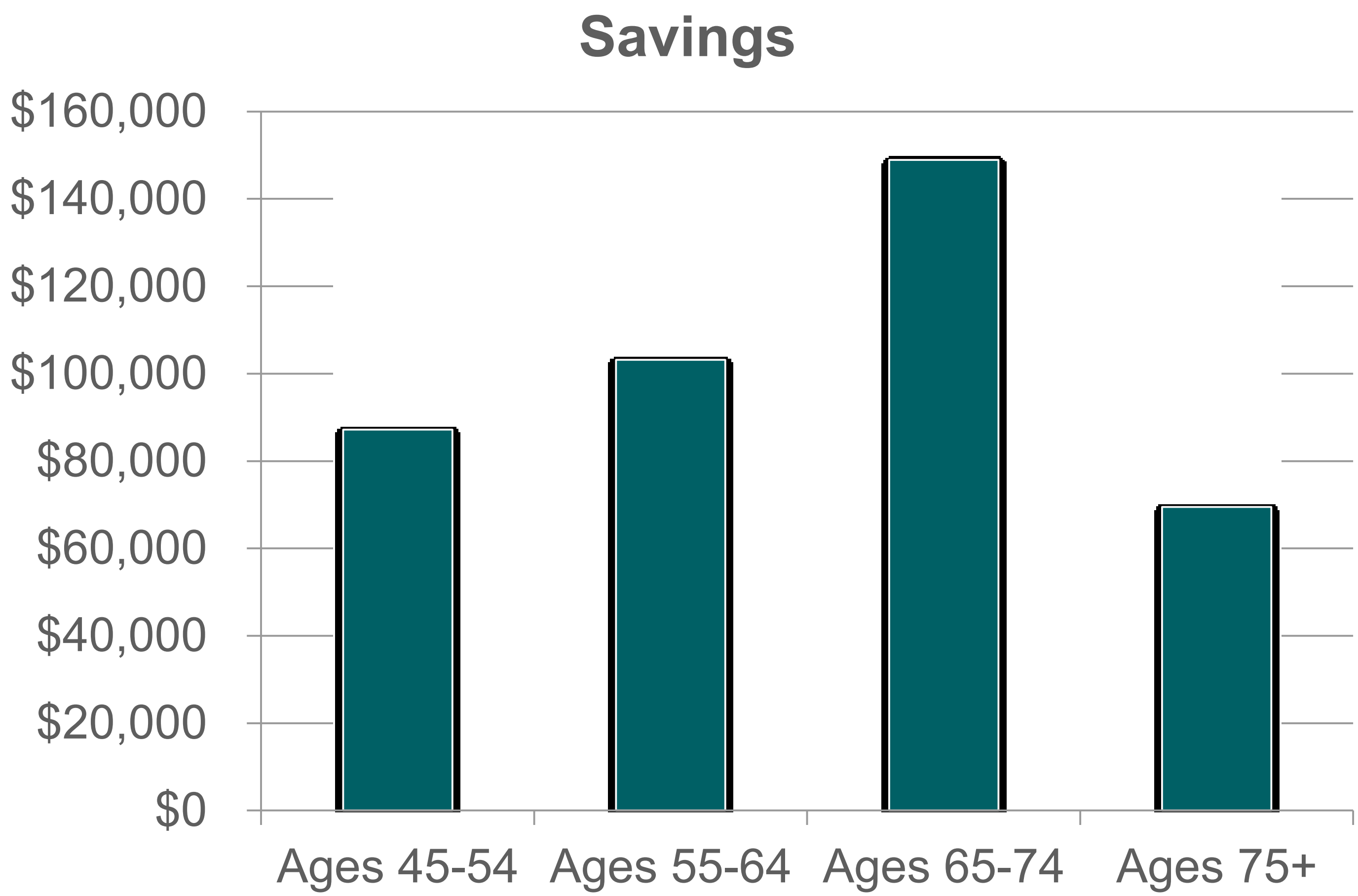
- In the past, many retirees were able to live on a combination of pensions plus whatever income their portfolios delivered.
- But that's changing…
- For starters, pensions are slowly ebbing away; most employers are switching to defined contribution plans like 401(k)s and 403(b)s.
  - 40% of workers were covered by pensions in 1980
  - By 2011, that number had dropped by more than half, according to the Bureau of Labor Statistics
  - Defined-contribution plans have become the retirement vehicle of choice for most companies

Challenge 2: Retirees' Savings Haven't Stepped Up to Meet the Challenge



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The Math Is Painful for In-Retirement Withdrawals

- $145,000 = Average balance for 401(k) participants age 65-75
- 4% of initial balance is often considered a “safe” withdrawal rate
- Safe = the amount that you could safely withdraw in year 1 of retirement and the years thereafter without risk of prematurely depleting your capital; assumes retiree receives annual inflation adjustment
- 4% of $145,000 = $5,800 ☹

The Retirement Crisis Is in Many Respects a Savings Crisis

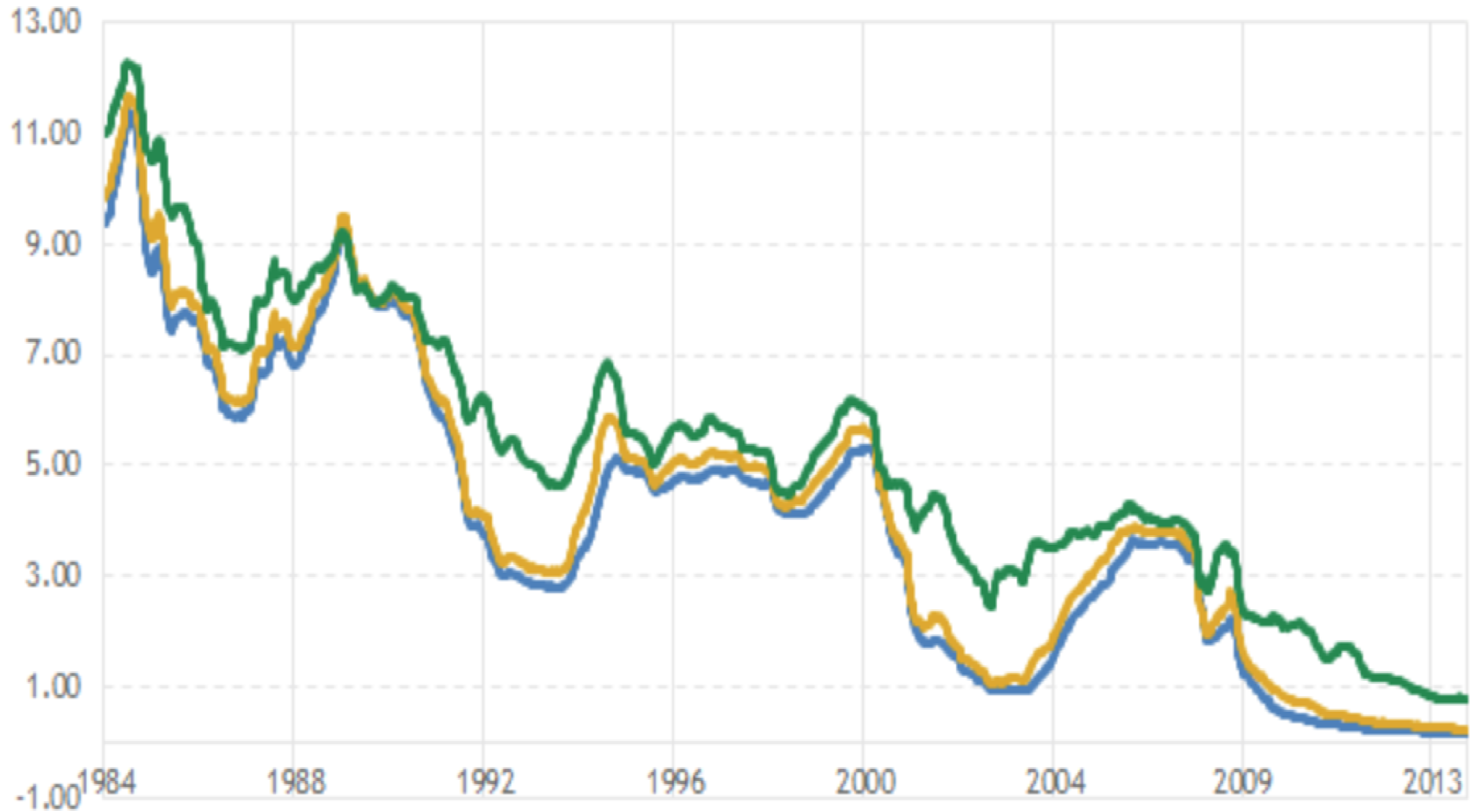
Savings rates by country

- Sweden: 10%
- Germany: 10.5%
- France: 12%
- U.S.: 5.5%

Other facts

- $15,270: Average credit card debt, U.S. households, 2014
- 50%: Percentage of households that have a budget
- $1.33 spent per every dollar earned
- 33%: Percentage of Americans who say they spend two or more hours EACH DAY worrying about their finances

Challenge 3: The Income Gods Have Not Delivered



6-month, 1-year, 5-year CD rates from 1984-2013.
Source: Bankrate.com.

Nor Are Yields Especially Encouraging for Investors Willing to Take More Interest-Rate Risk

- Yield for Barclays Aggregate Bond Index: ~2%
- Yield for Intermediate-Term Treasury Bonds: ~1.4%
- Yield for Intermediate Municipal Bonds: ~1.5%
- Yield for Barclays 20+ Year Long-Term Treasury Index: ~2.45%

Venturing Out on the Duration Spectrum Carries Its Own Risks

- Yield for Barclays 20+ Year Long-Term Treasury Index: 2.5%
- Current duration: 17 years
- Duration stress test: Duration minus current yield = anticipated loss in one-percentage-point interest rate hike over one-year period
- 17 years minus 2.5% yield = ~15% loss

Credit Quality Risk = Ballast Goes Bye-Bye

High-Yield Bonds
Current Yield: ~5.5%-7%
2008 Return: -24%

Emerging Markets Bond
Current Yield: ~6%-7%
2008 Return: -26%

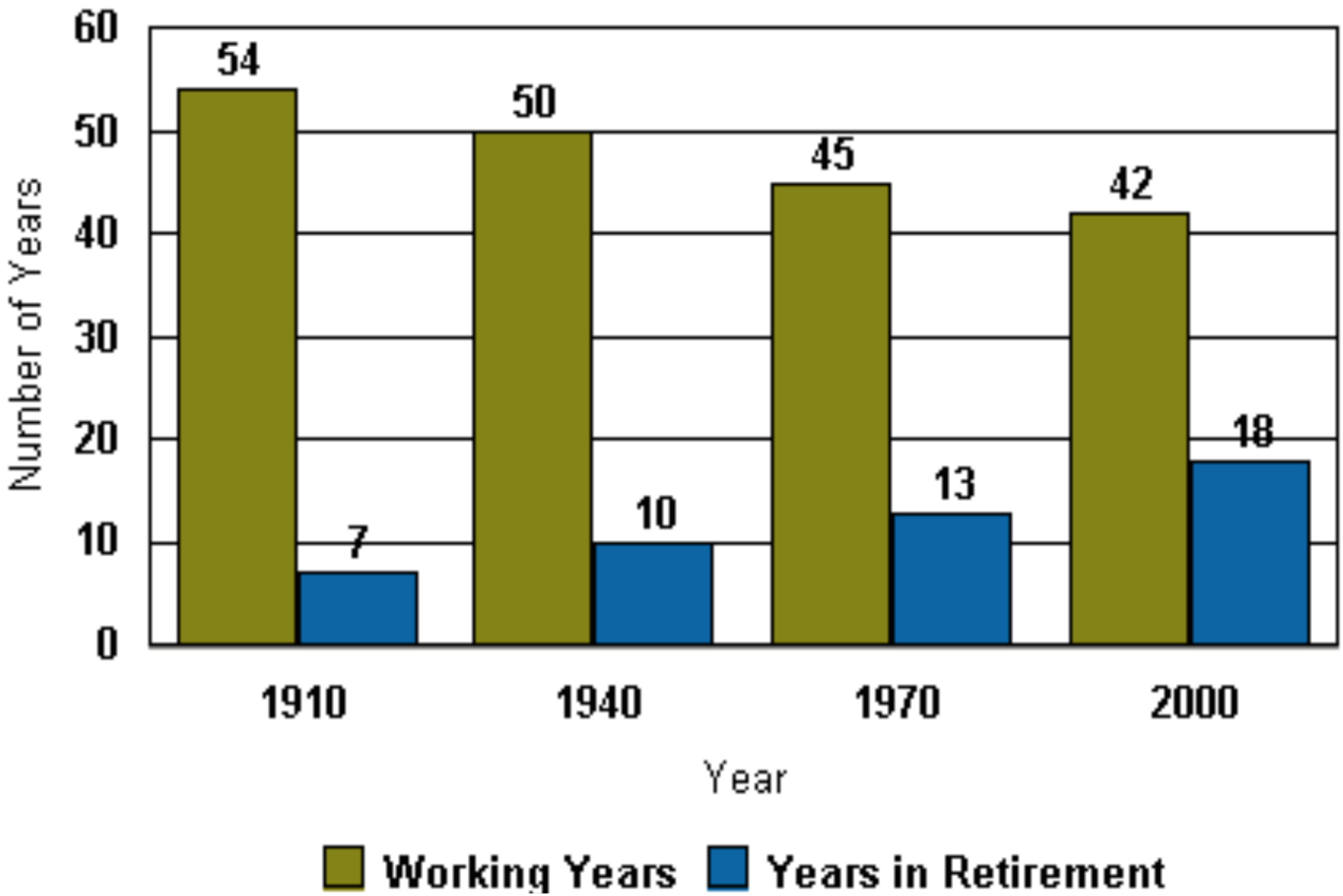
Bank Loan
Current Yield: ~4%-5%
2008 Return: -17%

Multisector Bond Fund
Current Yield: ~4%
2008 Return: -15%

7 Keys to Successful Retirement Portfolio Planning

- Key 1: Ample longevity protection
- Key 2: Adequate liquidity (cue the buckets)
- Key 3: Inflation protection
- Key 4: A sustainable withdrawal rate
- Key 5: Maximization of non-portfolio income sources
- Key 6: Tax efficiency
- Key 7: A“succession plan”

Key 1: Longevity protection: Why you need it



Key 1: Longevity protection: Why you need it

- 19 years: Average life expectancy, 65-year-old male
- 21 years: Average life expectancy, 65-year-old female
- 31%: Odds that one member of a 65 year-old-couple will live to age 95
- Higher incomes correlated with longer life expectancies (better access to health care, access to better health care)

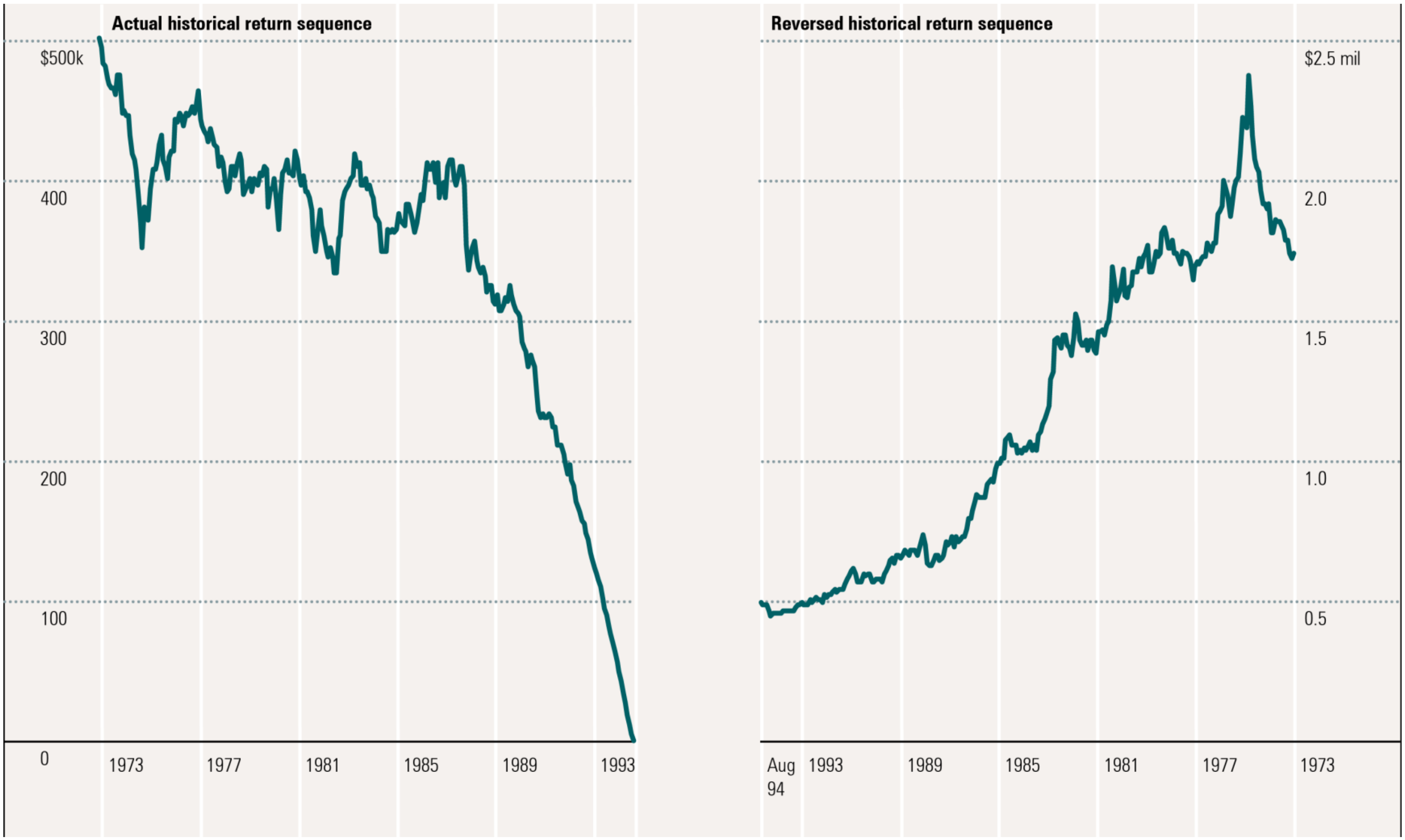
Key 1: Longevity protection: How to get it

- Maximize Social Security
  - 8% increase in delayed credits for each year past full retirement age up to age 70
  - Couples have even more options (even though file and suspend is ending)
- Opt for annuity option with pension
- Consider annuities for part of retirement cash flows
  - SPIA: Guaranteed lifetime income but payouts low
  - Deferred income annuities (aka longevity insurance)
- Maintain conservative withdrawal rate
- Hold healthy allocation (at least 50%) in stocks, diversified by style, size, geography

Key 2: Adequate liquidity: Why you need it

Even a 60/40 portfolio would have dropped 35% from 2007-2009

Key 2: Adequate liquidity: Why you need it



Encountering a bum market early in retirement can be deadly

Key 2: Adequate liquidity: Why you need it

- Holding a few years' worth of living expenses in cash can help protect you against a range of scenarios
    - Bad stock-market environment, especially in the early years of retirement
    - Reduced dividends on common stocks (e.g., bank dividends in 2008)
    - Rising interest rates, which crimp bond prices
- Cash cushion also provides a valuable intangible: peace of mind

Key 2: Adequate liquidity: How to get it

- Money market account or fund, laddered CDs
- Bank checking account or savings account
- One to two years' worth is plenty, plus a little extra to meet unanticipated expenses
- Bucket 1 is *not* for
  - Bonds
  - Bank loan investments
  - Dividend-paying stocks
  - MLPs etc.
- Refill bucket 1 quarterly, monthly, or annually using income distributions, rebalancing proceeds from long-term holdings

Key 3: Inflation protection: Why you need it

	Sept 14- Sept 15 Δ	Weights CPI-W	CPI-E	CPI-U
Food and beverages	1.45%	15.7%	12.8%	15.0%
Apparel	-1.46%	3.6%	2.4%	3.5%
Recreation	0.86%	5.5%	5.3%	5.9%
Education and communication	-0.34%	6.7%	3.8%	6.7%
Other goods and services	1.74%	5.1%	5.4%	5.3%
Weighted Average		**-0.12%**	**0.43%**	**0.09%**

Source: Bureau of Labor Statistics

Inflation is currently benign. Or is it?

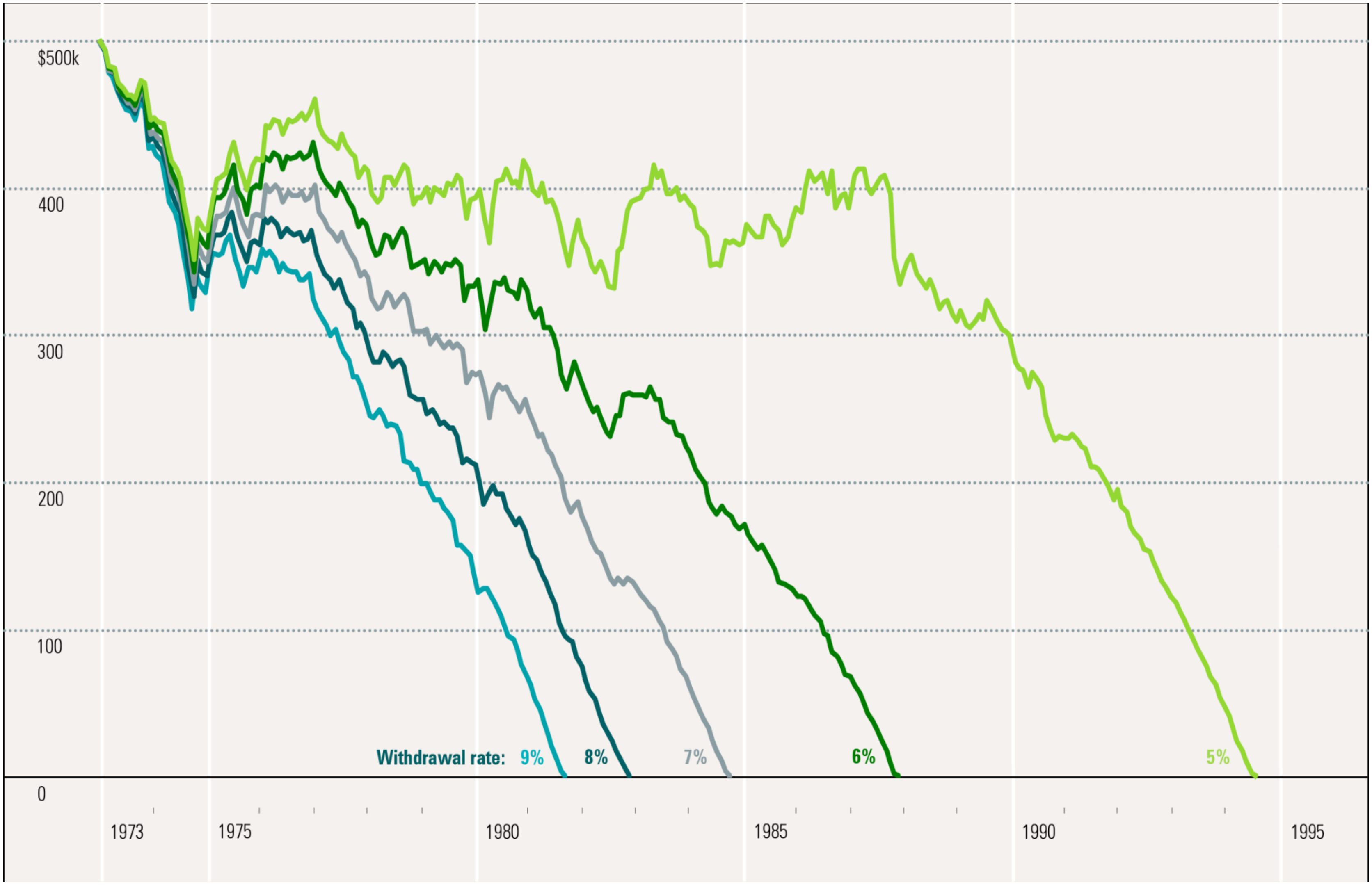
Key 3: Inflation protection: Why you need it

- Your personal inflation rate may be higher in retirement than it was when you were working
- In retirement, you won’t automatically receive cost-of-living increases to keep pace with inflation
- You’ll need to inflation-adjust your portfolio “paycheck,” especially if you have a large weighting in nominal bonds
- Inflation = natural enemy of anything with a fixed rate

Key 3: Inflation protection: How to get it

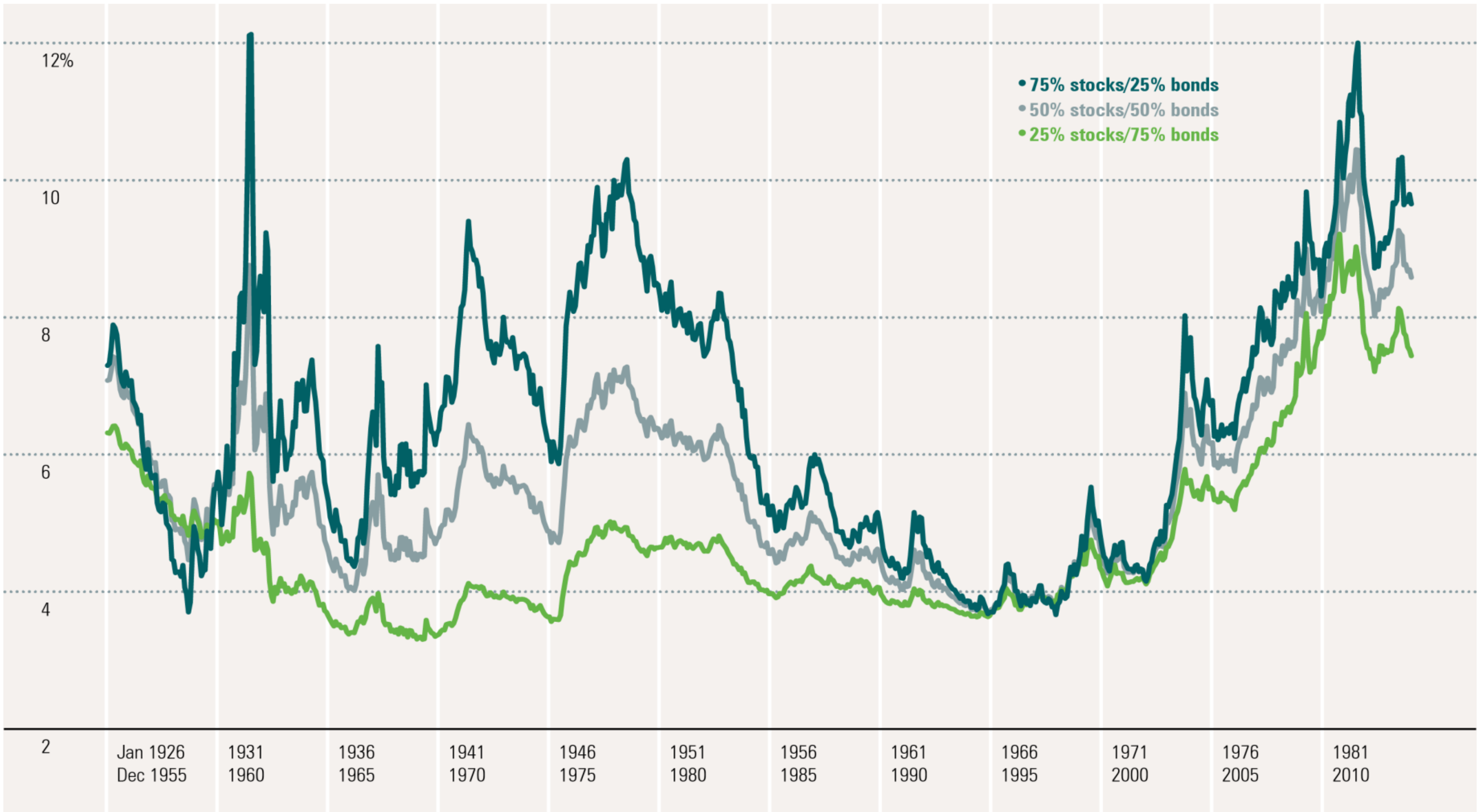
- For your portfolio:
  - Treasury Inflation-Protected Securities, I-Bonds (favorite fund: Vanguard Short-Term Inflation-Protected Securities VTIP or VTIPX)
  - Stocks: Best long-run shot at beating inflation
  - Bank-loans (favorite funds: Fidelity Floating Rate High Income FFRHX or Ridgeworth SEIX Floating Rate High Income SAMBX)
  - Commodities in small doses (favorite fund: Harbor Commodity Real Return HACMX)
- Also consider:
  - Delaying Social Security: Enhanced return is also inflation-adjusted
  - Adding inflation protection if purchasing long-term care insurance, annuities

Key 4: A sustainable withdrawal rate: Why you need it



A too-high withdrawal rate is risky in periods of meager returns

Key 4: A sustainable withdrawal rate: Why you need it



Sustainable withdrawal rates vary over time

Key 4: A sustainable withdrawal rate: How to get it

Best practices for withdrawal rates include:

- An element of market sensitivity
  - Take less in weak markets
  - Take more in strong ones
- Flexibility in case of unanticipated expenses
- Attention to time horizon
  - Take less if time horizon is very long
  - Take more if it's shorter (RMD tables)
- Attention to asset allocation
  - More stocks support a higher withdrawal rate (unless stocks are very expensive)
  - More bonds/cash necessitate a lower withdrawal rate

Key 4: A sustainable withdrawal rate: How to get it

"The 4% rule"

- Originally developed by financial planner Bill Bengen, refined by "Trinity study"
- 4% initial withdrawal; that dollar amount is inflation-adjusted annually (delivers most stable standard of living)
- Considered a reasonable starting point for withdrawals
- Assumptions:
  - Retiree takes 4% of initial balance, then inflation-adjusts that amount
  - Example: 4% of $800,000 starting balance = $32,000 in year 1; $32,960 in year 2
  - Portfolio is at least 50% equities
  - Time horizon is 30 years

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Key 4: A sustainable withdrawal rate: How to get it

Fixed percentage method

- Ensures portfolio sustainability by tethering withdrawals to market/portfolio performance
- But leads to substantial fluctuations in retirees' cash flows
    - 4% withdrawal on $1 million portfolio in 2007: $40,000
    - 4% withdrawal on $650,000 portfolio in 2009: $26,000
- Refinements of this method put "guardrails" on withdrawals, ensuring that withdrawals never go above or below a given level (see Jonathan Guyton's research)

Key 4: A sustainable withdrawal rate: How to get it

Income-only method

- Retiree subsists exclusively on bond income and dividend distributions, leaving principal intact
- Extremely sensitive to interest-rate environment
- Retirees may need to venture into riskier investments to deliver needed income (see: 2008-2015)
- Income distributions count as a withdrawal (a retiree taking 4% annual income from his/her portfolio has a 4% withdrawal rate)

Key 5: Maximization of non-portfolio income sources: Why you need it

- Non-portfolio income sources include:
  - Social security
  - Pension
  - Annuity income
  - Rental income
- Can serve as a paycheck to cover basic needs
- Lifetime income streams like Social Security, pensions, not subject to market fluctuations, help mitigate concerns about longevity
- Careful decision-making can help improve income you receive from these sources

Key 5: Maximization of non-portfolio income sources: How to get it

- Social security maximization
  - Waiting longer not always the right answer, but can help enhance lifetime, survivors’ benefits
  - Social Security calculators can help couples with dual earnings histories, ages, maximize their benefits
- Pension maximization
  - Annuity option often the better bet for retirees concerned about longevity
  - Payouts will be hard to beat in private annuity market
- Annuities: To annuitize or not?
  - Can be complex, costly, often sold, not bought
  - Income annuities, immediate and deferred, tend to be less complicated, less expensive

Key 6: Tax efficiency: Why you need it

- For tax-deferred accounts:
  - Withdrawals from Traditional IRAs and 401(k)s taxed at your ordinary income tax rate
  - Once RMDs commence, amount of taxable income outside your control
- For taxable accounts:
  - Income distributions (bond income, nonqualified dividends) taxed at your ordinary income tax rate
  - Short-term capital gains also taxed as ordinary income
  - Dividends, long-term cap gains taxed at lower rate

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Key 6: Tax efficiency: How to get it

- Tax diversification: Enter retirement with assets in the three major account types: tax-deferred, Roth, taxable
- Asset location
    - Tax-sheltered account: Hold tax-inefficient investments like bonds, REITs
    - Taxable account: Limit trading; hold tax-efficient investments like index funds, ETFs, muni bonds
- Proper withdrawal sequencing
    - RMDs
    - Taxable
    - Tax-deferred
    - Roth
- Synchronizing withdrawals, deductions on a two-year basis to stay in the lowest possible tax bracket

Key 7: A succession plan: Why you need it

- You may decide you want to pursue other activities rather than being very hands-on with your portfolio
- You may become disabled, die, or otherwise unable to manage your own finances.
- Who would take over? And would they know what to do?
- Could your portfolio run itself for a time if need be?

Key 7: A succession plan: How to get it

- Reduce the moving parts in your portfolio
    - Index funds, exchange-traded funds, all-in-one funds
- Create a master directory
    - What you hold
    - Where you hold it
    - Account numbers, passwords and contact names
    - Keep it up to date and password-protected!
- Keep a trusted loved one up to speed on what you're doing: Can you fit your investment strategy on a notecard?
- If your spouse or other loved one would be unable to manage without you, identify an advisor who can help
    - Look for CFP, fiduciary, fee-only (napfa.org)
    - Make the introduction!

Key 7: A succession plan: How to get it

- Keep basic estate-planning documents up to date
  - Living will
  - Will
  - Beneficiary designations
  - Power of attorney for health care, financial
- Investigate long-term care insurance, use probabilities to help guide how much coverage you buy
- If self-funding long-term care expenses:
  - Segregate assets from spendable assets
  - Use probabilities to help guide the size of your long-term care fund

The bucket approach in action

Bucket 1

For: Years 1 and 2

Holds: Cash

Goal: Fund Living Expenses

Bucket 2

For: Years 3-10

Holds: Bonds, Balanced Funds

Goal: Income production, stability, inflation protection, modest growth

Bucket 3

For: Years 11 and beyond

Holds: Stock

Goal: Growth

Bucket Maintenance: General Principles

- Spend money from bucket 1 on an ongoing basis
- Refill bucket 1 with income distributions from bonds, dividend-paying stocks, etc.
- If additional proceeds are needed at year-end to re-fill bucket 1, rebalance portfolio; move cash into appreciated winners

Bucket Maintenance Example

- Retiree needs $40,000 in cash flow from $1 million portfolio to re-fill bucket 1 in 2014
- 60% S&P 500/40% bond portfolio yields $21,820
- Portfolio also has capital return of $82,280 in 2014
- Retiree's $40,000 cash flow distribution comes from:
    - $21,820 in income
    - $18,180 from capital return
- Retiree reinvests remaining $64,100 of capital return

Sample In-Retirement Bucket Portfolios

Assumptions

- 65-year-old couple with $1.5 million portfolio
- 4% withdrawal rate with annual 3% inflation adjustment ($60,000 first-year withdrawal)
- Anticipated time horizon: 25 years
- Fairly aggressive/high risk tolerance (total portfolio is ~ 50% stock/50% bonds and cash)

Sample In-Retirement Bucket Portfolio: Mutual Fund

Bucket 1: Liquidity Portfolio for Years 1 and 2: $120,000

$120,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $480,000

$130,0000 in Fidelity Short-Term Bond FSHBX

$150,000 in Harbor Bond HABDX

$100,000 in Vanguard Short-Term Inflation-Protected Securities VTIPX

$100,000 in Vanguard Wellesley Income VWINX

Sample In-Retirement Bucket Portfolio: Mutual Fund

Bucket 3: Growth Portfolio for Years 11 and Beyond: $900,000

$400,000 in Vanguard Dividend Growth VDIGX

$200,000 in Harbor International HAINX

$100,000 in Vanguard Total Stock Market Index VTSMX

$125,000 in Loomis Sayles Bond LSBRX

$75,000 in Harbor Commodity Real Return HACMX

Sample In-Retirement Bucket Portfolios: ETF

Bucket 1: Liquidity Portfolio for Years 1 and 2: $120,000

$120,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $480,000

$100,000 in Vanguard Short-Term Bond ETF BSV

$150,000 in Vanguard Total Bond Market ETF BND

$50,000 in iShares IBoxx Investment Grade Corporate Bond LQD

$100,000 in Vanguard Short-Term Inflation-Protected Securities VTIP

$80,000 in Vanguard Dividend Appreciation VIG

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Sample In-Retirement Bucket Portfolio: ETF

Bucket 3: Growth Portfolio for Years 11 and Beyond: $900,000

$350,000 in Vanguard Dividend Appreciation VIG

$200,000 in Vanguard Total Stock Market Index VTI

$200,000 in Vanguard Total International Stock Market Index VXUS

$75,000 in iShares Barclays Capital High Yield Bond JNK

$75,000 in Greenhaven Continuous Commodity GCC

Basic Bucket Stress Test: 2000-2015

Assumptions

- 4% withdrawal rate with 3% annual inflation adjustment
- Reinvest all dividends and capital gains from buckets 2 and 3
- Rebalance positions when they exceed 110% of original size; use rebalancing proceeds to meet living expenses but tap bucket 1 if more needed
- If rebalancing proceeds exceed living expenses, re-fill bucket 1
- If bucket 1 is full, redeploy into positions below starting values

Results

- Starting value (2000): $1,500,000
- Ending value (year-end 2015): $1,932,016
- Total withdrawals: $1,187,080

Questions? Comments? Want a copy of my slides?

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