Motley Fool's *Rule Your Retirement* Newsletter

It's Time to Sell (Some) Stocks

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Hey, retirees — it's time to consider restuffing your cushion!

No, we're not talking about furniture; we're talking about your portfolio. Permit me to explain.

I joined The Motley Fool in 1999, leaving my job as a financial advisor with Prudential Securities to be an editor for the daily articles published on Fool.com. One of my first responsibilities was to edit the weekly Retiree Report, written by retired financial advisor David Braze (TMF Pixy).

One of Dave's articles was to become the foundation of asset allocation for tens of thousands of Fools. It was titled "Creating a Comfy 'Income Cushion,'" and it explained how he managed market risk.

It began:

"As a retiree, I maintain a five-year cushion of income that is not invested in the stock market. Like many Fools, I do so because I know I will spend that money within the next five years, and I don't wish to sell stocks during a down market when I need that cash. Accordingly, I keep that five-year income cushion in things like money market funds, Treasury bills, certificates of deposit, and short- to mid-term bonds where it can still earn interest yet avoid most of the volatility found in the stock market."

The method Dave laid out was Foolishly simple:

- Start with the amount of income you'll need this year.
- Subtract income you'll receive from non-portfolio sources (e.g., Social Security, a pension). That determines the shortfall that must come from investments.
- Project income needed and received for the subsequent four years, making adjustments for inflation, to determine the future shortfalls.
- Add up the total amount you'll need from your portfolio for the next five years, and invest that much in cash or bonds.

Here's an example, based on Dave's article. In this scenario, the retiree's costs and Social Security benefit grow 2% a year, but her pension is fixed.

	Year 1	Year 2	Year 3	Year 4	Year 5
Income Needed	$60,000	$61,200	$62,424	$63,672	$64,946
Less:					
Pension	$15,000	$15,000	$15,000	$15,000	$15,000
Social Security	$25,000	$25,500	$26,010	$26,530	$27,061
Shortfall	*$20,000*	*$20,700*	*$21,414*	*$22,142*	*$22,885*

Add up the five years' worth of shortfalls, and you get $107,141. That should be kept safe in cash, short-term bond funds, maybe even a bond or CD ladder. The rest of the portfolio could be invested in stocks.

One year later, go through the process again, replenishing the year's worth of the "income cushion" that was spent by recalculating the five-year shortfall, selling some stocks, and putting the proceeds in cash or bonds. However, according to Dave's methodology, the income cushion isn't replenished when the stock market is down; rather, the retiree keeps living off the cushion until the market recovers.

By the way, don't wait until retirement to begin creating your cushion. Those who are within five years of retirement should begin the process in order to reduce the chances that a downturn will delay their plans.

As we highlighted previously, research from Mark Hulbert found that since the mid-1920s, bear markets lasted on average 3.1 years from peak to trough and back to the peak (adjusted for inflation and dividends). Of course, that's the average; of the 28 bear markets included in the analysis, 10 took longer than 3.1 years to recover, and six took approximately five or more years. So a five-year income cushion is a prudent guideline for those near or in retirement.

Should You Be Restuffing?

As mentioned previously, you don't replenish your income cushion after years when the stock market declined. As we discussed in our annual review, 2018 was not a banner year for investors. Stocks of all types were down, and bonds were flat; just about the only asset class that made money was cash, and that was only if you took the time to seek out higher yields. All told, a typical well-diversified portfolio declined in the neighborhood of 5% to 15% in 2018, depending on the mix of cash, bonds, and stocks.

Thus, if we were to follow Dave's rules, the income cushion would not be replenished this year. However, as of this writing, the S&P 500 is up 6.5% so far in 2019. Mid-cap and small-cap stocks have performed even better, returning almost 10% year to date. And bonds have held their ground, earning around 0.5%. Therefore, whatever declines you experienced in 2018 may have already been erased by the returns of 2019... or at least nearly so.

Given that the stock market has been essentially flat over the last 13 months or so, should investors in or near retirement sell some stocks to replenish their income cushion? For most investors, I think the answer is yes. But the decision is up to you and your circumstances. Here are some factors that would tilt the scales toward playing it safer:

- You have a conservative to moderate tolerance for risk
- It's been two or more years since you've rebalanced your portfolio
- You are reliant on your portfolio for the majority of your income

- You don't have significant flexibility in your budget, and would be forced to sell stocks when they're down during a bear market

Despite the stock market's gyrations that began in September, the last decade has been good to investors, with the S&P 500 returning an annualized 14.7%. It's perfectly reasonable for those in or near retirement to protect a portion of what they've accumulated.