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How to Think About Risk in Retirement

The Best Way to Guard Against Your Greatest Risk: Running Out of Money

By William J. Bernstein

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What should we take away from the turmoil this fall in stock markets? Two things: a clear understanding of risk, and the importance of "glide paths."

No, we aren't talking about skiing or aircraft, but rather adjusting a portfolio's stock/bond mix with age, particularly in retirement.

The most venerable method for doing so, the age-in-bonds formula, reduces your equity allocation by one percentage point a year. A 25-year-old, for example, holds 25% in bonds, and thus 75% in stocks, whereas an 80-year-old holds 80% bonds and 20% stocks.

The theory behind this rule is simple and intuitive: Stocks are less risky for young investors, who have years to overcome bear markets, than they are for retirees, who depend on their investments for much of their income.

But venerable, as we are learning, doesn't always mean prudent. There are other glide paths—in the opposite direction of the age-in-bonds path—that do a better job of protecting retirees against the greatest risk they face: running out of money.

An Eyebrow Raiser

Earlier this year, Wade Pfau, a professor of retirement income at American College in Bryn Mawr, Pa., and Michael Kitces, research director of Pinnacle Advisory Group in Columbia, Md., ruffled feathers with an influential study in the Journal of Financial Planning showing that *increasing* the equity allocation throughout retirement was a bit less risky than lowering it.

The results weren't all that dramatic; they found, for example, that at a 4% annual withdrawal rate, a portfolio that began retirement at 30% stocks and increased over the next 30 years to 80% succeeded (that is, lasted 30 years) 74% of the time. An approximate age-in-bonds portfolio that began at 40% equity and decreased to 10% over 30 years yielded a 73% success rate.

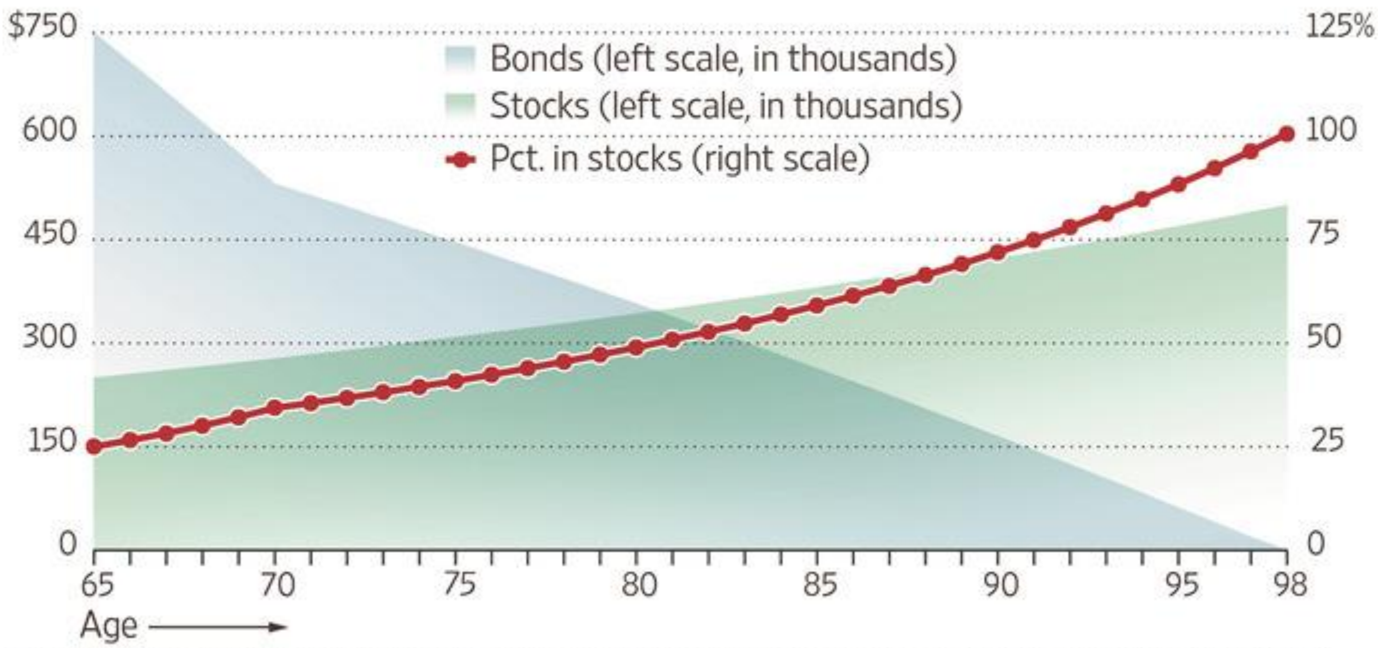
A difference without a distinction, you might say, but it surprised many that increasing equity exposure to a stratospheric 80% toward the end of life didn't add risk.

So, now what's an investor supposed to think? The answer isn't a simple stock/bond split that adjusts according to any formula. But it does result in stocks accounting for a growing portion of a portfolio.

As a starting point, the safest approach is for an investor to build a portfolio that throws off enough principal and income to cover the investor's expenses. One way to do that, for those who have enough assets, is to buy an inflation-adjusted annuity with payouts that match projected spending. A TIPS ladder—a collection of Treasury inflation-protected securities with varied maturities to provide a steady stream of principal and income over many years—also is a good way to match that spending.

A Mix of Stocks and Bonds

How an investor's asset allocation would change if he starts with a 25/75 stock/bond split in an IRA valued at $1 million, and spends down his bonds to meet living expenses:



Note: Assumes a real return of 1% on bonds and 2.12% on stocks starting at age 65, as well as an annual withdrawal of $50,000 through age 70 and $21,700 thereafter to meet expenses. The bonds are a mix of Treasury inflation-protected securities and high-quality corporate bonds; the stocks are a globally diversified portfolio.

Source: William J. Bernstein

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But neither approach is perfect. The payout rates of inflation-adjusted annuities are historically low, so the payout an investor needs—whatever it may be—costs more than ever before. Also, purchasers run the risk that the insurance company they buy the annuity from will default, a possibility highlighted by the recent financial crisis. True, most states "guarantee" annuities, but in the event of a severe systemic crisis, those promises might not be worth much.

On the other hand, a retiree might outlive even a 30-year TIPS ladder. Further, it's best, for tax-reporting reasons, to confine TIPS to tax-sheltered accounts, and many investors don't have a sheltered account big enough to hold the entire ladder.

A more prudent course of action might be to hold standard Treasury securities and high-quality municipal and corporate bonds of short maturity in lieu of purchasing either an annuity or TIPS. Why short maturities? Because interest rates are so low now. Short maturities don't lock investors into those low rates for the long term; they allow money to be reinvested at higher interest rates later should the opportunity arise.

The key point is that all three choices—an inflation-adjusted annuity, TIPS ladder or short-bond portfolio—or any combination of them would match the retiree's annual needs well, because they all provide a known stream of income and principal over the years. A portfolio starting at 60% bonds and 40% stocks with a subsequent glide path away from equities most certainly doesn't provide that assurance.

What does matching investments to spending look like in real life? Imagine a 65-year-old man named Fred who has $50,000 in annual living expenses and taxes, no pension, and $20,000 of annual Social Security income, and whose entire savings consist of a $1 million rollover IRA.

Fred needs an inflation-adjusted $30,000 a year to make up the difference between Social Security and his expenses. Currently, he can purchase an inflation-adjusted annuity that will accomplish this for $625,000. This is the amount that meets his basic living needs in retirement. In finance-speak, this is Fred's liability-matching portfolio, or LMP.

But Fred, like many retirees, doesn't like the idea of handing over such a large chunk of change to an insurance company. Delaying Social Security to age 70, he realizes, increases his annual payout to $28,300 a year—knocking down the amount he will need from his investments at that point to $21,700 a year. He'll "pay" for this extra benefit by meeting his $50,000 annual living expenses out of his nest egg for the next five years.

He reckons that a $750,000 portfolio of TIPS and high-quality corporate bonds yielding a real return of 1% a year, from which he will withdraw $50,000 annually before age 70 and $21,700 a year thereafter, will last him to age 98. He can put the remaining $250,000 into a globally diversified portfolio of stocks. Let's call this $250,000 of equities his risk portfolio, or RP.

Stocks on the Side

So, Fred begins retirement with a 25/75 stock/bond split. But as he taps his bonds, his stock allocation will rise; if he lives to 98, he'll have an all-stock portfolio. What happens if he makes it much past 98? He will need what retirement specialists call longevity insurance, and his risk portfolio, under all but the worst scenarios, should provide just that. After all, doubling the value of his stock portfolio to an inflation-adjusted $500,000 by age 98 requires only a 2.12% real annualized return.

The reverse-glide-path approach, then, works because it starts out with a large, ultrasafe liability-matching portfolio and a small risk portfolio. As the retiree ages, the LMP gets spent down and the RP gets larger.

There's nothing special or new about this; it's simply a variant of the long-established "two-bucket" approach that separates, with mental accounting, a safe portfolio dedicated to essential living expenses from a risky one aimed at one's heirs, charities and the odd business-class seat.

Reverse glide path or two-bucket LMP/RP strategy? You say tuh-may-toe, I say tuh-mah-toe. Either approach will do a superb job of minimizing your risk of dying poor.

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