Ready Your Portfolio for Retirement

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The current yield environment remains a challenge

- Average 6-month CD rates in 1970: 9.1%
- Average 6-month CD rates in 1980: 13.4%
- Average 6-month CD rates in 1990: 8.2%
- Average 6-month CD rates in 2000: 6.2%
- Average 6-month CD rates in 2014: 0.7%

This trend is clearly not a retiree’s friend…
Yields aren’t particularly compelling for those willing to buy longer-duration bonds.

- Yield for Barclays Aggregate Bond Index: 2.15%
- Yield for intermediate-term Treasury bonds: 1.68%
- Yield for intermediate municipal bonds: ~2.20%
- Yield for Barclays Aggregate U.S. Long Government/Credit Float Adjusted Index: 4.47% (duration: 14 years currently)
What if you’re willing to take a bit more credit risk?

- Median yield, high-yield bond funds: 4.22%
- Median yield, multisector bond funds: 2.79%
- Median yield, bank-loan funds: 3.52%
- Median yield, emerging-markets bond funds: 4.38%
The trade-off is higher volatility and economic and equity sensitivity

- Median yield, high-yield bond funds: 4.22% (-24% 2008 loss)
- Median yield, multisector bond funds: 2.79% (-15% 2008 loss)
- Median yield, bank-loan funds: 3.52% (-17% 2008 loss)
- Median yield, emerging-markets bond funds: 4.38% (-26% 2008 loss)
The yield on a plain-vanilla balanced portfolio is underwhelming

60% S&P 500/40% Barclays Aggregate Blend
Current Yield: ~2.01%
2008 Loss: -22%
A higher-yielding mix looks better on the income front, but the risk is a lot higher, too

60% iShares High Dividend Yield Index/40% SPDR Barclays High Yield Bond
Current Yield: 4.49%
2008 Loss: -35%
Rather than gunning strictly for current income, successful retiree portfolios should include these ingredients

- A focus on total return, not just income production
- A component of guaranteed income
- A sustainable withdrawal rate
- A stable pool of assets from which to draw living expenses
- A measure of inflation protection
- A growth component for longevity
- The ability to put the plan on cruise control
- Attention to tax efficiency
A focus on total return, not just income production

Why you need it:

• In the current environment, it’s difficult to wring a livable income stream from a portfolio unless you have a LOT of assets or are willing to take a lot of risk
• A total-return approach helps ensure that you don’t forsake risk controls in the search for yield

Where to get it:

• A portfolio plan that enables you to draw income from a number of sources: dividend and interest income, REBALANCING, tax-loss sales, RMDs
A component of guaranteed income

Why you need it:
• To provide for basic living expenses regardless of how your investments perform

Where to get it:
• Social Security
• Pension, if you have one
• Fixed immediate annuity
A sustainable withdrawal rate

**Why you need it:**
- To ensure a livable spending rate without running the risk of prematurely depleting your assets.

**Where to get it:**
- Use “the 4% rule” as a starting point; tweak based on time horizon, asset allocation
  
  *or*

- Withdraw a fixed percentage of your portfolio on an annual basis
A stable pool of assets from which to draw living expenses (1 to 2 years’ worth)

Why you need it:
- To supplement your fixed sources of income without having to tap longer-term, more volatile assets (i.e., stocks) during a down market
- To give yourself time to regroup if one of your income sources is disrupted

Where to get it:
- CDs, money market account or fund
- Bank checking, savings account
- A high-quality, short-term bond fund in concert with above instruments
A measure of inflation protection

Why you need it:

• To keep rising prices from eroding the purchasing power of your investment assets
• To help make up for the fact that you no longer are eligible for cost-of-living adjustments through a paycheck

Where to get it:

• Social Security
• Treasury Inflation-Protected Securities or I-Bonds
• Stocks
• Commodities, precious metals, or real estate investments
• Floating-rate/bank-loan funds
A growth component for longevity

**Why you need it:**
- To help address the fact that you or your spouse may be retired for 25-30 years or more
- To help provide for other goals, including a legacy for children and grandchildren

**Where to get it:**
- Stocks, diversified by size, style, and sector
- Higher-risk, higher-reward bond types, including high-yield and foreign bonds
The ability to put your plan on cruise control

Why you need it:

• Most retirees would rather not devote a significant share of time to overseeing their investments
• Your spouse or other loved ones might not have the same investment savvy that you do

Where to get it:

• A portfolio that could “run itself” for a while if need be; your income needs will be met
• Individual investments that deliver a lot of diversification in a single shot
• Documentation of what you’re doing
Attention to tax efficiency

Why you need it:
- Taxes can extract a sizable percentage from your portfolio’s return
- Managing for tax efficiency is one of the easiest ways to exert control over your portfolio’s results

Where to get it:
- A tax-efficient plan for asset location and sequencing your withdrawals
- A portfolio that’s diversified across three categories (Traditional, Roth, taxable)
- Attention to tax efficiency in your taxable accounts (index funds, ETFs, municipal-bond funds)
The bucket approach helps bring it all together

**Bucket 1**
- **Years:** 1 and 2
- **Holds:** Cash
- **Goal:** Fund Living Expenses

**Bucket 2**
- **Years:** 3-10
- **Holds:** Bonds, Balanced Funds
- **Goal:** Stability with Income, Growth

**Bucket 3**
- **Years:** 11 and beyond
- **Holds:** Stocks, Aggressive Bond Types, Commodities, Real Estate, etc.
Sample in-retirement portfolio using the bucket approach

**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 portfolio using the bucket approach

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

- $120,000 in CDs, money market accounts/funds, other cash
Sample in-retirement portfolio using the bucket approach

**Bucket 2: Intermediate Portfolio for Years 3-10:**

$480,000

- $130,000 in T. Rowe Price Short-Term Bond (PRWBX)
- $150,000 in Harbor Bond (HABDX)
- $100,000 in Vanguard Short-Term Inflation-Protected Securities (VTIPX)
- $100,000 in Vanguard Wellesley Income (VWELX)
Sample in-retirement portfolio using the bucket approach

**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 portfolio: the ETF version

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

- $120,000 in CDs, money market accounts/funds, other cash
Sample in-retirement portfolio: the ETF version

**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)
Sample in-retirement portfolio: the ETF version

**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 PowerShares DB Commodity Index Tracking (DBC)
Sample in-retirement portfolio: the cruise control version

**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**
- $120,000 in T. Rowe Price Short-Term Bond (PRWBX)
- $360,000 in Vanguard Total Bond Market Index (VBMFX)

**Bucket 3: Growth Portfolio for Years 11 and Beyond: $900,000**
- $900,000 in Vanguard Total World Stock Market Index (VTWSX)
Bucket stress test: 2007-2012

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

Results
- Starting value: $1,500,000
- Ending value: $1,637,996
- Total withdrawals: $378,549
No bucket 1: 2007-2012

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 short-term bond fund if more needed
- If rebalancing proceeds exceed living expenses, redeploy into positions below starting values

Results
- Starting value: $1,500,000
- Ending value: $1,622,33
- Total withdrawals: $378,549
A longer stress test: 2000-2012

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 and then short-term bond fund if more needed
- If rebalancing proceeds exceed living expenses, refill bucket 1
- If bucket 1 is full, redeploy into positions below starting values

Results

- Starting value: $1,500,000
- Ending value: $2,029,138
- Total withdrawals: $925,313
What you need to know before trying this at home

• “Buckets” aren’t a call to reinvent the wheel. Many of your existing holdings will work in this framework
• If you have multiple account types, bucketing won’t be as simple as what’s shown here
• Buckets can be right-sized to suit retiree’s own goals and risk preferences
• Over time, bucket 1 (cash) may be a slight drag on the total portfolio relative to a no-bucket approach
• “Bucket maintenance” is mission-critical
Bucket maintenance

- Bucket 1 can be refilled using a retiree’s own preferences:
  - Income-centric: Move income and dividend distributions directly into bucket 1 (don’t reinvest)
  - Strict-constructionist total return: Reinvest dividends and capital gains; fill up bucket 1 with rebalancing proceeds only
  - Opportunistic: Use a combination of income distributions and rebalancing proceeds

- The idea isn’t to spend the buckets until only equities are left