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The Appropriate Asset Allocation Strategy for Retirement (Part 2) - Revisited

Che H. Lee, *President*
Louisa Ho, *Senior Portfolio Analyst*

The Summer 2019 issue of *Observations* explained why conventional wisdom on asset allocation during retirement is mostly misguided and could actually put you at higher risk of outliving your money during a long retirement. We decided to revisit this topic, as we have clients who are approaching retirement. In that issue, we advised that stock price volatility cannot hurt you provided you avoid both emotional selling and selling depressed stocks to pay living expenses. We further presented how a diversified, carefully researched portfolio of stocks is likely to generate good growth over time, countering the eroding effects of withdrawals during retirement.

In this issue, we will explore what an appropriate asset allocation strategy for retirement looks like, including what the asset allocation should be at the initial phase of retirement, why you should increase your allocation to stocks during retirement once the so-called "sequence of returns" risk has been addressed, and the factors that dictate the timing and magnitude of an increasing stock allocation as retirement proceeds.

Appropriate asset allocation strategy during retirement

Start of Retirement

The appropriate asset allocation at the start of your retirement should address the following issues: sequence of returns; average duration of stock market declines; general stock market valuations; and your annual withdrawal rate as a percentage of your starting retirement assets. Since you will be withdrawing periodically from your retirement assets, your risk of outliving your money is based on the amount of your annual withdrawals, how long you live, the amount of your starting retirement assets, how much those assets grow over time, and the sequence of annual returns.

Sequence of Returns. While over the long run stocks are likely to grow much more than bonds and give the needed boost to your retirement assets,

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stocks will be much more volatile along the way. This means annual returns for your stocks will differ from year to year, with above-average returns and below-average returns hitting your stocks in an unpredictable, random sequence. ***Research has shown that the sequence of asset returns during the initial years of your retirement has an overwhelming impact on how much your assets will grow over time and the likelihood you will avoid outliving your money***.[1]

To address this "sequence of returns" risk, you need to develop an asset allocation strategy at the start of retirement which allows you to "win some" if good stock returns are front-end loaded, and "lose less" if poor returns hit during your initial retirement years. This can be accomplished by allocating more to short-term bonds and cash and less to stocks *initially*. If stock returns are generally good during the first phase of your retirement, the stock component of your retirement assets will benefit even if its allocation is relatively low. More importantly, if stock returns are generally poor during your initial retirement phase, you will have limited the overall hit to your retirement assets that are weighted in favor of conservative investments.

How much should you set aside in conservative investments at the start of your retirement? There are a couple of approaches to answering this question. The first approach is designed to avoid selling your stocks while they are depressed, so that the stock component can be left intact to recover when good returns arrive. This approach in turn requires some sense as to how long it takes for poor stock markets to rebound. The rebound period for the stock market depends on whether it is a correction or a more severe bear market.

Small corrections. Analyst Jeffrey Yale Rubin of Birinyi Associates (as cited in Zweig, 2014) calculated that between 1927 and October 2014, stock market declines of 4% or greater have happened every 2.5 months. The average loss during these periods was 8.9% and the drops lasted on average 27 days.[2]

Big corrections. Doug Ramsey, chief investment officer at the Leuthold Group (as cited in Zweig, 2014), points out that between 1928 and October 2014, the stock market has experienced intra-year declines of 16.7% on average; yet the market still ended with positive returns 62 out of the 86 calendar years (72% of the time).[3] A particularly noteworthy example, as Mr. Ramsey pointed out, was 1987 which ended up with positive returns even though the great market crash (down 33.5% from August 25, 1987 to December 4, 1987) occurred that year. So, the stock market recovers from big corrections relatively quickly.

Bear markets. According to an article by Nick Murray in September 2014, the average time from a major market top through the subsequent bear market and back to full recovery (with dividends reinvested and adjusted for inflation) since 1926 is about 40 months.[4] So it takes about 3.3 years on average to travel from a top, down to a bear market bottom and back to a new inflation-adjusted top. It takes even less time to get back to the prior pre-drop level if we do not adjust for inflation. A bear market is commonly defined as a price decline of at least 20% from the most recent peak.

Given the typical recovery time periods above for stocks after market declines, the amount of cushion invested in bonds/cash should be in the range of 3 to 4 years of your projected annual living expenses, which would allow sufficient time for depressed stocks to recover substantially in the vast majority of cases. Even in the unlikely event that stocks have not recovered fully within that time frame, some temporary adjustments to withdrawals/living expenses should adequately protect you in most situations. As you work down your initial allocation to cash and short-term bonds during periods of stock market weakness, in effect you would be wisely refusing to sell low and preserving your equity component of your retirement assets to benefit from the eventual arrival of good stock returns.

There is one other important factor to consider when establishing the cushion of conservative investments at the start of retirement. Over time, overvalued/undervalued stock markets do self-correct and tend to regress around the mean. If you start your retirement when the market seems overvalued, the likelihood of a period of poor returns during your initial retirement phase goes up. Under these circumstances, you might consider setting aside more in cash and short-term bonds. Conversely, you should consider allocating more to stocks at the start of retirement if the market appears to be undervalued.

Research from 2013 offers a second approach to address the sequence of returns problem, recommending a *starting* stock allocation of between 20 to 40%.[5] The authors of that research recommend allocating a higher percentage to stocks if you need more asset growth because of high withdrawal rates or an especially long retirement (e.g. because you retire younger than average or have a family history of longevity).[6]

During Retirement – Rising Equity Glide Path

The research above by Wade Pfau and Michael E. Kitces shows that the best way to deal with the return sequencing problem is to start retirement with a conservative asset allocation, but allocate more to stocks over time (this is known as “rising equity glide path”). This is counter-intuitive and will likely make you uncomfortable, but it is the correct strategy. The reason is that once you have mitigated the risk of significantly depleting your asset base from a series of poor annual stock returns during the initial phase of your retirement, you want increasing exposure to stocks over time to benefit from subsequent good stock market returns. In simple terms, you want a lower allocation to stocks during the initial period when poor stock returns would severely jeopardize your retirement, and high stock exposure when good stock returns arrive. The above research recommended a simple, mechanical step-increase in stock allocation of 1% per year with a goal of ending with a stock allocation somewhere in the 60-80% range. This approach is a form of dollar-cost averaging and was back-tested to show very good results.[7]

Another possible approach would be to increase your stock allocation over time, but with the timing and rate of increase based on then prevailing stock market valuations. Under this approach, you would increase your stock allocation more aggressively after poor market periods and slow down or suspend allocation increases during strong market periods. During the initial phase of your retirement when you have more money set aside in cash and short-term bonds, you should sell such conservative investments rather than depressed stocks to meet withdrawals if poor stock returns are front-end loaded. By doing so, you would in effect be preserving your equity component in your portfolio to benefit from the eventual arrival of strong stock market returns.[8]

Regardless of whether you follow a mechanical annual step-increase in stock allocation or a more flexible strategy of increasing stock allocation based on market valuation, the main point is that you should increase your allocation to stocks during retirement, once you have addressed the sequence of returns risk for the initial phase of your retirement. After you avoid serious capital depletion at the front end due to possible poor stock market returns, your capital base should increasingly be able to weather interim stock market fluctuations and ultimately benefit from the long-term growth of stocks, while reducing the risk that you will outlive your money.

There is a small group of retirees who don't need to follow the rising equity glide path if they are willing to accept the opportunity cost. This select group includes those whose annual withdrawal needs are minor relative to their retirement assets, either because most of their living expenses are covered by other sources of income, or because they have accumulated very substantial retirement assets. If you are not part of this group, you should be aware that following the conventional asset allocation rather than the rising equity glide path will put you at heightened risk of outliving your money. It is therefore important that you find ways to overcome any emotional and temperamental impediment to increasing your stock allocation over time and sticking to a rising equity glide path during retirement.

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2. Jason Zweig, "How Scared Should Investors Be?", *Total Return* (blog), *The Wall Street Journal*, Oct. 10, 2014, http://blogs.wsj.com/totalreturn/2014/10/10/how-scared-should-investors-be/.
3. Zweig
4. Nick Murray, "Ask Nick," *Nick Murray Interactive* 14, no. 9 (2014): 5.
5. Wade D. Pfau and Michael E. Kitces, "Reducing Retirement Risk with a Rising Equity Glide Path," *Journal of Financial Planning* 27, no. 1 (2014): 38-45.
6. Pfau and Kitces, "Reducing Retirement Risk with a Rising Equity Glide Path."
7. Pfau and Kitces, "Reducing Retirement Risk with a Rising Equity Glide Path."
8. Michael E. Kitces and Wade D. Pfau, "Retirement Risk, Rising Equity Glide Paths, and Valuation-Based Asset Allocation," *Journal of Financial Planning* 28, no. 3 (2015): 38-48.