Getting the right mix of assets can help sweeten your retirement

Among the many changes that retirement (or other major life transitions) generally brings is a shift in your investment strategy. In a general sense, you’re moving from the asset-accumulation phase that characterized your working years to a drawdown phase in which you begin to spend the money you’ve set aside to fund your retirement. More specifically, your investment objectives become less focused on growth – and the increased risk that goes with it – and more concerned with protecting your principal and generating reliable income to meet your ongoing expenses.

While retirement itself may be somewhat abrupt – one Friday you have a job and the following Monday you don’t – your investment strategy should shift more gradually and actually precede your retirement date. The primary change will be in your asset allocation – the respective percentage of your retirement assets that you have in stocks, bonds and cash – and that mix will be determined by a number of factors, not just a date. Your risk tolerance, overall financial situation and investment time horizon – in this case the number of years you need your money to last – are among the factors you should discuss with your financial advisor.
Let’s take a look at each of the primary asset classes and how they can contribute to your retirement:

**CASH** | Although low interest rates can make it seem unattractive to hold a significant amount of your retirement assets in cash, it’s important to remember that cash serves a number of purposes. As we’ve seen, stocks can be very volatile. Having a substantial cash reserve can make it easier to ride out the ups and downs of the stock market. For example, retirees who had a couple years’ worth of expenses set aside in cash may have been able to better withstand the market decline of 2008-2009 and hang in there for the subsequent rebound. Cash on hand means that your investment decisions can be made with deliberation rather than in haste.

**BONDS** | The prospect of rising interest rates has led some investors to avoid bonds, but it’s important to remember the many benefits – and types – of bonds. For example, municipal bonds can provide retirees with reliable income that’s free of federal taxes – and in some cases state taxes as well. That’s important if tax rates increase. Investors who hold bonds to maturity know exactly what they’re going to earn – the coupon rate plus the par value. If interest rates rise, investors who own short-term bonds can hold them to maturity and then reinvest their money at higher rates, building an income stream that grows over time. In addition, bonds tend to be less volatile than stocks and may provide important diversification benefits when equities do poorly.

**STOCKS** | While they have caused innumerable sleepless nights and heart-stopping moments along the way, stocks returned an average of more than 11% a year between 1928 and 2013 (as measured by the S&P 500 and not adjusting for inflation). In other words, if you want growth in your portfolio – and you do – stocks have a long history of providing it. The primary reason retirees need growth is to attempt to keep up with inflation. While it may not be attracting much attention right now, even a mild inflation rate can do a lot of damage over the course of today’s longer retirements. For example, if inflation runs 3% annually over a 25-year retirement, what cost you $100 when you first retired will cost more than $200 as you reach your later years.

Changing priorities
Your asset allocation should evolve as your life does*

Generally, retirement investment objectives should be less focused on growth and more on protecting your principal and generating reliable income to meet your ongoing expenses.

*Hypothetical example
Source: Blackrock
asset allocation as you enter retirement. Second, although you can and should plan thoroughly, you're going to have a much better idea of what your cash flow and overall budget really look like after you've been retired for a while. The choices you make about your investment strategy at that point will be better informed.

Building a versatile portfolio

Your retirement portfolio has to wear many hats – producing reliable income, protecting you against inflation and providing a buffer that can help you withstand the inevitable periods of market volatility without making panicky decisions. It isn’t something you can “set and forget,” especially in today’s ever-changing investment environment.

You should begin reviewing your asset allocation mix well before your retirement begins to determine if your portfolio can potentially generate the income and growth you anticipate needing. If it can’t, you need to increase the amount you are saving, reduce your retirement spending plans, or think about delaying your retirement until your portfolio has reached the level required to throw off a reliable income stream while also retaining the potential to appreciate. In all these considerations, your financial advisor can be of great assistance.

How much can I withdraw each year?

Determining a safe withdrawal rate is one of the toughest challenges facing retirees. According to a long-used rule of thumb, retirees generally can count on not outliving their money if they withdraw 4% from savings in the first year of retirement, increasing that amount by a certain percentage in following years to account for inflation. For example, withdrawing $40,000 (pretax) from a $1 million portfolio in the first year and increasing that initial amount by 3% each year ($41,200 in year two, $42,436 in year three, etc.) has a high probability of being sustainable for a 30-year period.

Sounds good in theory, and the 4% rule is based on the historical performance of a portfolio with the traditional retirement composition of 60% large-cap stocks and 40% intermediate-term bonds. However, a couple retiring at the beginning of 2008 would have had a much different experience. If the value of your portfolio drops significantly as you enter retirement, the 4% rule isn’t likely to work.

What to do? Well, the IRS is pretty good with numbers, and once you reach 70½ you’re going to become acquainted with their formula for determining required minimum distributions (RMDs) – the amount you must withdraw annually from 401(k)s and IRAs. Your annual RMDs are determined by dividing the amount in your retirement account at year-end by your life expectancy. Let’s say you have $1 million in your retirement portfolio when you retire at age 65. According to the IRS, you have a current life expectancy of 21 years. Dividing 21 into $1 million would mean you could withdraw $47,620. A year later, when your life expectancy would be 20.2 years, you divide that into the value of your portfolio to determine how much you could withdraw.

RMD = \frac{\text{Retirement account balance}}{\text{Life expectancy}}

*The remaining number of years an individual is expected to live, based on IRS issued life expectancy tables, after beginning to take distributions

This approach means that the amount you can withdraw will fluctuate from year to year, depending on the value of your portfolio. While that uncertainty may be unsettling for some, the associated advantage is that withdrawing less after your portfolio value has declined gives you a better chance at sustainable income.

Whatever method you choose, be sure to revisit it regularly to be certain you’re not depleting your portfolio. Your advisor can help with this.

1 While interest on municipal bonds is generally exempt from federal income tax, it may be subject to the federal alternative minimum tax, or state or local taxes. Profits and losses on federally tax-exempt bonds may be subject to capital gains tax treatment. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax.

2 Past performance does not guarantee future results. The S&P 500 is an unmanaged index of 500 widely held stocks and cannot be invested in directly. There is no assurance these trends will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs which would reduce an investor’s return. Dividends are not guaranteed and will fluctuate.

3 Asset allocation and diversification do not guarantee a profit nor protect against loss.