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Investing in Preparation for Retirement

As you approach or enter retirement, how should you allocate your investable assets? Some people are fortunate enough not to have to worry about depleting assets during retirement and can invest any way they wish. The majority, however, require countless hours of preparation and consideration of several difficult issues in order to optimally allocate assets. The task is probably more difficult than they realize.

Think about this: pension fund managers have the advantages of institutional money managers and using "average life expectancy" in their projections and still cannot precisely determine funding requirements. Yet we expect individuals with uncertain longevity to manage their own personal pension.

Before determining allocation percentages of stocks and bonds, there are some necessary planning considerations. You need to know your funding gap as a percentage of assets. The funding gap is your retirement spending needs less guaranteed sources of income such as social security, pensions, annuities, and other secure income. Another important consideration is longevity. The same funding gap has dramatically different implications for a 55-year vs. a 70-year old. Of course, there are many other planning considerations such as legacy and long-term care needs, but we will leave them for another day.

Once you know your planning parameters, it is important to understand goals and risks. The investment goals become less benchmark based and more lifestyle based. Your portfolio's performance relative to the S&P 500 is not important. Your portfolio's ability to sustain your lifestyle is crucial. The abbreviated list of risks includes inflation, market performance, longevity, and sequence of returns.

PROFESSIONAL OPINION

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Inflation is a silent killer in retirement. Your income as a pre-retiree typically increases with inflation giving you a natural hedge against rising prices. During retirement, your assets must provide increasing income to overcome rising inflation. Even worse, rising inflation is often associated with poor investment performance. Your best defense against inflation is stocks and in particular, stocks that can pass price increases along to customers.

Market performance is a risk everyone understands given the fluctuations since March 2000. Most online retirement tools rely on historical market performance as the annual appreciation rate. While this is perfectly legitimate it introduces a "what if" factor. What happens if the nation's debt, deficits, and aging population cause the economy (and corporate profits) to slow in the coming years? It is possible investors will not realize historical performance figures. Conversely, if technologies such as energy, 3-D printing and biotechnologies propel the economy, historical returns are possible. In any event, it is best to plan for 4% and hope for 7% than plan on 7% and only get 4%. A balance of stocks, bonds, real estate, and other assets helps mitigate some market risk.

Longevity risk is the risk you live longer than expected and deplete your assets. Social security, pensions, and annuities are income streams that protect against longevity risk. If you defer collecting social security payments from age 62 to a later age, you are effectively buying an inflation adjusted annuity with each monthly check. Longevity risk is emotional. We all know someone who passed far too early in his or her retirement and we all know someone who is 95 and healthy. Frontloading retirement spending during your healthy years makes sense with a stopgap plan to make sure you live well in later years.

Sequence of returns risk affects unlucky retirees who retire during long periods of poor market returns. It is easily shown that retirees in 1982 (the start of the greatest bull market of all-time) fared much better than 2000 (the start of the current market cycle). The risk is out of your control but defending against it is something most retirees do well. Keeping a 3-4 year buffer of your funding gap in cash or short-term quality bonds reduces the risk of selling assets for income when markets are in decline. You always want to allow assets time for recovery during periods of market stress.

A product addressing these risks, albeit, in an imperfect manner is an immediate annuity with a payout escalator. Although you introduce some credit risk, the annuity does protect against the four risk factors. Most retirees have practical and emotional objections to these products. Annuities are not good if you have legacy goals, but the strongest objection is loss of control of one's assets and the thought that the insurance company will "win" in the event of premature death. On the other hand, immediate annuities do provide a high monthly payout while addressing our most pressing retirement income risks.

Insurance companies are also researching new products such as annuities with long-term care riders. Investors would receive inflation adjusted lifetime income with long-term care payouts if necessary.

Until a significant number of retirees accept current or new products, the challenge is to optimize the percentage of assets in stocks, bonds, annuities, cash, and alternative investments within their portfolios. Optimizer tools can show retirees' allocations giving them the best chance of a successful retirement. If you are within five years of retirement or recently retired, you should start preparations to optimize your portfolio. ■

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