Strategies for Pursuing Your Retirement Paycheck

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The Changing Landscape for Retirement Planning

- In the past, many retirees were able to live on a combination of pensions plus whatever income their portfolios delivered.
- But that's changing…
- For starters, pensions are slowly ebbing away; most employers are switching to defined contribution plans like 401(k)s and 403(b)s.
  - 40% of workers were covered by pensions in 1980
  - By 2008, that number had dropped to 21%
  - Defined-contribution plans have become the retirement vehicle of choice for most companies

The Changing Landscape for Retirement Planning

CD rates have also plummeted.

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…

Source: Forecastchart.com.

The Changing Landscape for Retirement Planning

Yields aren't particularly encouraging for those willing to buy longer-duration bonds.

Yield for Barclays Aggregate Bond Index: 2.04%

Yield for Intermediate-Term Treasury Bonds: 1.81%

Yield for Intermediate Municipal Bonds: 1.80%

Yield for Barclays Aggregate U.S. Long Government Bond Index: 2.97%

The Changing Landscape for Retirement Planning

Yields are somewhat better for those willing to venture further out on the risk spectrum, but the downside potential is much greater.

High-Yield Bonds

Current Yield: ~5%

2008 Return: -24%

Emerging Markets Bond

Current Yield: ~5-6%

2008 Return: -26%

Bank Loan

Current Yield: ~3.5%

2008 Return: -17%

Multisector Bond Fund

Current Yield: ~4%

2008 Return: -15%

The Changing Landscape for Retirement Planning

A plain-vanilla balanced portfolio doesn't come close to generating most retirees' desired living expenses—at least not based solely on its income distributions.

60% S&P 500/40% Barclays Aggregate Blend

Current Yield: ~1.84%

2008 Loss: -22%

The Changing Landscape for Retirement Planning

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: 3.7%

2008 Loss: -35%

Building a portfolio with these key ingredients helps meet the challenge.

- A focus on total return, not just income
- 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 your plan on cruise control
- Attention to tax efficiency

A Focus on Total Return, Not Just Income

Why you need it:

- In 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, required minimum distributions

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 (aka, single premium immediate annuity, or SPIA)

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 (1-2 Years' Worth)

Why you need it:

- To supplement your fixed sources of income without having to tap your longer-term, more volatile assets (i.e., stocks) during a market downturn

Where to get it:

- Money market account or fund
- Bank checking, savings account, online savings account
- A high-quality short-term bond fund used in concert with above instruments

A Measure of Inflation Protection

Why you need it:

- To keep rising prices from eroding the purchasing power of money drawn from your investment accounts
- To help make up for the fact that you no longer are eligible for cost-of-living adjustments after you've stopped working

Where to get it:

- Social Security
- Treasury Inflation-Protected Securities or I-Bonds
- Stocks
- Commodities, precious metals, or real estate
- Floating-rate/bank-loan funds

A Growth Component for Longevity

Why you need it:

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

Where to get it:

- Stocks, diversified by size, style, and sector
- Alternative 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

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
- Hold tax-efficient investments in your taxable accounts (index funds, ETFs, municipal-bond funds)

The Bucket Approach in Action

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,

Bucket 3

Years 10+

Holds: Stocks, Higher-Risk Bonds, “Other”

Goal: Long-Term Growth

Step 1: Determine the Paycheck You Need from Your Portfolio

- Total your income needs for living expenses, either on a monthly or annual basis.
- Subtract steady sources of income, such as Social Security, pension income, annuity payouts.
- What's left is the amount of income your portfolio will need to replace.

Step 2: Make Sure Your Withdrawal Rate Is Sustainable

- The traditional rule of thumb is that 4% with an annual inflation adjustment is a safe withdrawal rate for most.
- For someone with an $800,000 portfolio:
    - Year 1 Withdrawal: $32,000
    - Year 2 Withdrawal: $32,960 (assuming 3% inflation)
- If you're not comfortable with withdrawing a fixed dollar amount regardless of market performance, you could:
    - Reduce your withdrawals during weak market environments/forego inflation adjustments
    - Employ a fixed-percentage withdrawal rate (understanding that your standard of living could be affected during weak markets)

Step 3: Create Bucket 1: Income Reserves

- Bucket 1 will hold enough income to cover one to two years' worth of living expenses.
- Bucket 1 should hold ultra-safe investments—CDs, money market accounts, money market funds, checking, savings.
- Your returns will be minimal. But the goal for Bucket 1 is stability, not high returns.
- If you'd like Bucket 1 to be larger (for example, holding 3-5 years' worth of living expenses), you could build a two-parter consisting of:
    - Cash (CDs, money market funds, etc.)
    - A high-quality short-term bond fund like T. Rowe Price Short-Term Bond (PRWBX).

Step 4: Create Bucket 2: Intermediate Assets

- Bucket 2 will consist of living expenses for ~years 3-10 of retirement.
- Because you won't be tapping it imminently, it can consist of slightly higher-risk investments: intermediate-term bonds and even small percentages of equity holdings.
- Some favorite investments for bucket #2 include:

  Harbor Bond (HABDX)/PIMCO Total Return (PTTRX)

  Metropolitan West Total Return Bond (MWTRX)

  Vanguard Short-Term Inflation-Protected Bond Index (VTIPX)

  Vanguard Wellesley Income (VWINX)

  Dodge & Cox Balanced (DODBX)

Step 5: Create Bucket 3: Long-Term Assets

- Bucket 3 will consist of income for years 10 and beyond of your retirement, as well as assets for your heirs.
- This is the long-term, higher-risk/higher-reward portion of your portfolio.
- The longer your time horizon, the larger bucket 3 will be.
- Some favorite investments for Bucket 3 include:

    Vanguard Total Stock Market Index (VTSMX or VTI)

    Vanguard Dividend Growth (VDIGX) or Appreciation (VIG)

    Vanguard Total International Stock Market (VGTSX)

    Dodge & Cox Stock (DODGX)

    T. Rowe Price Equity-Income (PRFDX)

Additional Buckets to Consider

- A separate bucket for emergency expenses during retirement (leaky roofs, new cars, unforeseen medical expenses). (Holds short- and intermediate-term assets such as bonds.)
- A bucket to help cover long-term care costs.
- Legacy bucket.
- Combination “last stop” bucket: Long-term care, health care, longevity, legacy expenses.

Step 6: Get a Plan for Refilling Bucket 1

- Note that filling Bucket 1 doesn't necessarily involve selling assets.
- You can refill Bucket 1 from a variety of sources, including:
    - **Distributions from income-producing securities** such as bonds or dividend-paying stocks held in Buckets 2 and 3.
    - **Rebalancing proceeds** from Buckets 2 and 3.
    - Proceeds from tax-loss harvesting in Buckets 2 and 3.
    - Required minimum distributions from accounts held in Buckets 2 and 3.
    - Capital gains distributions from funds in Buckets 2 and 3.
    - A combination of the above

Sample In-Retirement Portfolio Using 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 Bucket Approach

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

$130,0000 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 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

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

Basic Bucket Stress Test: 2000-2013

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 if more needed
- If rebalancing proceeds exceed living expenses, re-fill bucket 1
- If bucket 1 is full, redeploy into positions below starting values

Results

- Starting value (2000): $1,500,000
- Ending value (year-end 2013): $2,128,783
- Total withdrawals: $1,010,858

No Buckets: 2000-2013

Assumptions

- 4% withdrawal rate with 3% annual inflation adjustment
- Spend all income distributions; reinvest all capital gains from buckets 2 and 3
- Rebalance positions when they exceed 110% of original size; use rebalancing proceeds to meet living expenses not covered by income distributions

Results

- Starting value (2000): $1,500,000
- Ending value (year-end 2013): $2,282,294
- Total withdrawals: $1,010,858

And finally, a bit of "red meat"

- Price/fair value for all stocks in our coverage universe: 0.95
- Lowest P/FVs by sector: Basic materials (0.90), energy (0.79)
- Highest P/FVs by sector: Utilities (1.06)
- Top ideas with four or more stars, wide moats, and low uncertainty ratings

Baxter Int'l	Philip Morris	
ExxonMobil	Procter & Gamble	
Magellan Midstream	Spectra Energy Partners	(5*)
Merck	Wal-Mart	
Pfizer		

Questions?

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