

Do Not Retire Your Stocks

by James K. Glassman



Tuesday, June 26, 2007 provided by

Reading a report on retirement by Bernstein Global Wealth Management the other day, I was pleased to learn that our prospects for staying alive on this beautiful earth are growing brighter. A male who reaches age 65 has a one-in-two chance of living beyond age 85 and a one-in-four chance of living beyond 92. Women can expect to live two to three years longer than men. And get this: For a couple reaching 65, either husband or wife has a one-in-two chance of living beyond 92 and a one-in-four chance of living beyond 97.

These figures, from the Society of Actuaries, were compiled in 2000. Because longevity keeps increasing, it's a good bet that if you're 35 today, you will have an excellent shot at becoming a centenarian. But because we're living longer, the bad news is that we need a good deal more money to support ourselves in lengthier retirements.

The retirement ratio

Alex Pollock, my colleague at the American Enterprise Institute and the former president of the Federal Home Loan Bank of Chicago, illustrates the problem with what he calls the work-to-retirement, or W/R, ratio. In the early 1960s, life expectancy for males at birth was just 69. Assume that a man then started work at age 20, retired at 65, and died at 70. He had five years of retirement, so his W/R ratio would be 45 to 5, or 9.

Today, we start work later, retire earlier and live longer.

So, writes Pollock, "A person who began work at 22, retires at 62 and lives to 82 would have 40 years of work and 20 of retirement. With a W/R ratio of 2, the required savings rate to finance retirement is too high -- about 14% of pretax income saved throughout the working life."

What's the solution? Working longer will boost the W/R ratio. Saving more before retirement will help your nest egg last. But another answer is to reconfigure your investments so that they perform better. Although reaching for higher returns means accepting higher risk, the volatility of your assets isn't the only danger. After all, what could possibly be riskier for a retiree than running out of money?

That is why Bernstein, a firm with a reputation for circumspection, emphasizes stocks in its report: "The problem with overdependence on fixed-income investments is that a retirement portfolio should be designed to ensure a client's financial well-being for decades -- not years -- and therefore needs to generate *growth*, not just income."

There are three problems with bonds. First, although they produce a reliable stream of income, they don't adequately protect you against inflation. Stocks beat inflation during each and every overlapping 20-year period between 1950 and 2005, but bonds beat inflation only 70% of the time. Second, bonds return far less than stocks -- on average, just 2.3% a year after inflation between 1987 and 2006, compared with 7.4% for stocks. Even in bad times, stocks tend to beat bonds. Between 1967 and 1986, bonds actually lost an annualized 0.5% after inflation; stocks gained 2.1%. The tax treatment of bond income (except for municipals, which have very low yields) is unfavorable compared with that of capital gains and dividends on stocks. For tax-

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deferred accounts, this deficiency can be overlooked, but most of us also have taxable savings for retirement.

Somerset Maugham once wrote a short story, titled "The Lotus Eater," about a man who went to work as a bank clerk at 17, retired at 35, used his savings to buy a 25-year annuity and, assuming he would live to age 60 (a W/R ratio of just 6 to 5), retired to Capri, the idyllic island off Naples. Unfortunately, he outlived his income and struggled in misery as an aged beggar. The object of a retirement portfolio, Maugham reminds us, is to keep us comfortable until we die -- whenever that may be.

Making money last

Bernstein's researchers decided to find out how long a retirement portfolio of \$5 million would last a 65-year-old couple under different assumptions. In each case, the couple drew down 5% of the portfolio each year, paying taxes on their investment income and taxable gains. Also in each case, 75% of the portfolio's investments were taxable and 25% were tax-deferred. Stocks were globally diversified, and bonds were a mix of municipal and intermediate-duration taxable securities. Three portfolios were tested. The first was 20% stocks and 80% bonds (20-80), the second was 40% stocks and 60% bonds (40-60), and the third was 60% stocks and 40% bonds (60-40).

All three portfolios had roughly the same chance of lasting until the couple turn 85. But remember that we're all living longer. If the couple (or just one spouse) live to age 90, the benefits of investing in stocks become clear. The 20-80 portfolio -- the one with the most in bonds -- has only a 55% chance of lasting to that age, while the 60-40 portfolio has a 70% chance. The 20-80 account has only a 23% chance of lasting until the couple are 95, while the 60-40 account makes it that far more than half the time (53%).

Smoother ride

Why not go 100% into stocks? Bear markets can last a long time; nevertheless, two spouses retiring at 65 and spending 5% of their portfolio each year will have a two-thirds chance of their money lasting until they die (assuming the actuarial average ages of death) if they put all their cash into stocks, but their money has only a one-half chance of lasting if it is distributed 20-80.

Here, however, is the catch: A 60-40 stock-bond portfolio does almost precisely as well as an all-stock portfolio, and the ride is a good deal less thrilling. Bernstein's research finds that an ideal combination for retirees is a 60-40 portfolio with a drawdown of 4% a year. That gives the couple an 85% chance of having their money last till death.

If the couple retire at age 55, then spending should be around 3.4% of assets. Retirement at 70 means a couple could be comfortable spending at a 4.5% rate; at 85, the rate could go to 7%.

"The spending rate," says the Bernstein report, "is the critical driver of a successful retirement." With a 60-40 portfolio and a 3% spending rate, you can have 90% confidence that your money will last more than 50 years. But at a 4% spending rate, the number of years falls by about half, and at a 6% spending rate, it drops to just 16 years.

Could you live decently if you drew down only 4% of your investment portfolio annually? For a \$1-million account, that's \$40,000 a year. Social Security, if it survives that long, would give you another \$20,000 or so, and you might have a defined-benefit plan from your employer as well.

For most Americans, accumulating a nest egg of \$1 million or more seems daunting, but it's probably going to be a necessity, especially if the inflation rate rises. And don't count on your own parsimony to get you through. A recent survey for the Employee Benefit Research Institute found that although 88% of prospective retirees expected to reduce their spending in retirement, only 45% actually did.

Of course, you should save as much as you can during your working years. But, as in retirement, the key is increasing your returns, and the answer is more stocks than you probably think you need -- or can tolerate.

Bernstein emphasizes that individual clients' needs differ. Certainly, but based on this report and other research, I have decided to raise my suggested quick-and-dirty stock allocations for retirement accounts this way: If you're under 40, there's no reason not to own a 100%-stock portfolio. Between ages 40 and 60, you can move to an 80-20 stock- bond ratio. Between age 60 and retirement, shift to keep at least 60%, and in most cases closer to 70%, in stocks.

Building a life-cycle portfolio

How does this seemingly aggressive stance compare with the allocations of popular new mutual funds that are geared to specific retirement dates and change their ratios of stocks and bonds as time passes? Generally, the funds have a lower proportion of stocks. For example, Fidelity Freedom 2025 (for a person age 47 today who wants to retire at 65) currently carries roughly a 70-30 stock-bond ratio. By 2025, the fund will shift to 50-50.

My recommendation is to construct your own life-cycle account, using bond and stock funds, and to reallocate every year or two to stick to your targets. Own a broad U.S. stock mutual fund or exchange-traded fund, a REIT fund, an international fund and a natural-resource fund, then invest in one or two Treasury-bond funds of different maturities. Once you have the strategy, the pieces fall into place. Just tilt those pieces stock-wise.

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