What's Your Retirement Asset Allocation Strategy?

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Clients approaching retirement often ask us if they should adopt a more conservative investment strategy.

Traditionally, that means increasing exposure to fixed income (bonds) which have lower expected returns, but bring with them more stability than equities (stocks). While there's no single strategy suitable for everyone, the reality is how you approach this decision can profoundly influence how your financial goals are met over time.

The dilemma becomes: How should you think about your asset allocation, particularly your equity exposure throughout retirement? Some of our findings may surprise you.

Imagine you are at the onset of retirement and the reality that it's time to start relying more on your *financial* capital than your *human* capital is setting in.

Conventional wisdom suggests you should start reducing your equity exposure now and continue doing so every year. Perhaps this strategy sees you starting with 70 percent equities in your portfolio. Twenty years later, your equity exposure is at 30 percent. This doesn't sound like a bad idea, right? After all, with every passing year your investment time horizon shortens (in theory). Shouldn't you lessen the risk in your portfolio to match? Surprisingly, some recent research does not support this strategy.

One notable study[1] showed that declining equity exposure throughout retirement actually *reduces* the amount you can sustainably withdraw from your portfolio each year. In fact, you would generally fare better with what is called a static allocation. That means if your current allocation is 70/30, you would simply rebalance the portfolio annually to the same 70/30 target after withdrawing living expenses. In most scenarios, this approach is more efficient and will generally give you a higher probability of reaching your goals.

So why don't we see evidence that an "age in bonds" investment approach works in retirement? One reason is that it is much more advantageous for a retiree to obtain real, inflation-adjusted returns in the *first* half of retirement compared to the second half of retirement. Put another way, a sequence of poor returns in the early years of retirement could become the main risk to manage in the future. In such an environment, a strategy that decreases equity exposure over time is systematically selling more stocks during the times they are becoming more attractive investments to own. When the market does recover, there might not be enough equity left in the portfolio to generate enough returns to make up for the bad start.

But we can take this a step further. Research published in the Journal of Financial Planning this year[2] suggests there is viability in *increasing* equity exposure during retirement. We wouldn't blame you if this seems counterintuitive. In fairness, the research advocates starting with relatively lower equity levels at retirement before gliding upwards. Yet increasing equity in retirement is not a new concept to us. When equity markets have gone through an extended downturn in the past, we have advocated strategies where, most if not all, living

expenses were funded from the fixed income portion of the portfolios. This gave our clients a chance to allow markets to recover. But a natural consequence of this strategy is that we've increased equity weightings in the process, if only temporary.

Ultimately one of the keys to making good investment decisions in retirement is to minimize the need to sell under-performing assets at inopportune times. The more you're in position to sell on your own terms, the better. If this means you divert from a classic, formula-based asset allocation, then so be it. After all, what you're really doing is letting your goals and valuations drive your financial decisions -- not emotions.

It's not uncommon these days for retirement to last 30 or more years. Thus, it becomes important to adopt the mentality of investing *through* retirement and not simply until you retire. This philosophy shapes how we think about constructing and maintaining a portfolio. Regardless of age, it will be important to generate enough investment growth to maintain the purchasing power of your assets during retirement. At the same time, it's crucial to manage risk and have a distribution strategy that can help you navigate through market downturns even if that means debunking conventional wisdom.

Sources

1. Blanchett, David M. 2007 "Dynamic Allocation Strategies for Distribution Portfolios"
2. Pfau, Wade D. and Kitces, Michael E. 2014 "Reducing Retirement Risk with a Rising Equity Glide Path"