Strategies for Pursuing Your Retirement Paycheck

AAII Los Angeles

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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 3-month CD rates in 1970: 8.2%

Average 3-month CD rates in 1980: 12.6%

Average 3-month CD rates in 1990: 8.5%

Average 3-month CD rates in 2000: 7.1%

Average 3-month CD rates in 2011: **0.2%**

This trend is clearly not a retiree's friend…

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: 2.1%

Yield* for Intermediate-Term Treasury Bonds**: 0.9%

Yield* for Intermediate Municipal Bonds***: 2.0%

Yield* for Barclays Aggregate Long-Term Bond Index: 3.78%

*30-day SEC yield (past month's yield, annualized)

**Vanguard Intermediate-Term Treasury used as proxy

***Vanguard Intermediate-Term Tax-Exempt used as proxy

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: ~7.8%

2008 Return: -24%

Preferred Stock

Current Yield: 6.7%

2008 Return: -26%

Real Estate/REITs (U.S.)

Current Yield: 4.1%

2008 Return: -40%

Multisector Bond Fund

Current Yield: 3.5%

2008 Return: -15%

So what are the key ingredients for retiree portfolios today?

- 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 additional 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

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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, tax-loss sales, required minimum distributions, rebalancing

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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)

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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, with "ceiling" and "floor" built in.

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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:

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

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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
- Floating-rate/bank-loan funds

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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

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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
- Individual investments that deliver a lot of diversification in a single shot

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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)

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The Bucket Approach Helps Bring It All Together

- Allows you to build a portfolio that's well-diversified across asset classes; you don't have to focus on income at the expense of total return
- Enables you to cope amid a very low yield environment
- Helps you back into an appropriate asset allocation based on your income needs and time horizon
- Lets you ride out the volatility of your long-term (stock) assets, knowing that your near-term cash needs are covered by safe investments
- Includes components to deliver current income, income with inflation protection, and longevity protection/long-term growth

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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, Growth

Bucket 3

Years 10+
Holds: Stocks, Higher-Risk Bonds, "Other"
Goal: Long-Term Growth

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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.

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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 (with ceiling and floor to reduce the potential for dramatically different payouts)

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Step 3: Create Bucket 1: Income Reserves

- Bucket 1 will hold enough income to cover 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) or PIMCO Enhanced Short Maturity Strategy (MINT).

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Step 4: Create Bucket 2: Intermediate Assets

- Bucket 2 will consist of living expenses for ~years 3-15 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 Inflation-Protected Securities (VIPSX)

iShares Barclays TIPS Bond (TIP)

Vanguard Wellesley Income (VWINX)

Dodge & Cox Balanced (DODBX)

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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.
- Some favorite investments for Bucket 3 include:

  Vanguard Total Stock Market Index (VTSMX or VXUS)

  Vanguard Dividend Growth (VDIGX) or Appreciation (VIG)

  Vanguard Total International Stock Market (VGTSX)

  Dodge & Cox Stock (DODGX)

  T. Rowe Price Equity-Income (PRFDX)

  Oakmark International (OAKIX)

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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.
- “Mad money” bucket: 50th anniversary cruise, special gift for spouse, etc.
- Legacy bucket.

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Income Meets the Buckets: Why Can't We All Just Get Along?

- 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.
    - Capital gains distributions from 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.

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Income-Producing Securities Can and Should Be Part of Your Mix

Some favorite income-producing stocks include:

- Chevron Corporation CVX
- France Telecom FTE
- Novartis NVS
- Rio Tinto RIO

Some favorite income-producing funds and ETFs include:

- Vanguard Dividend Growth VIG
- Vanguard Equity-Income VEIPX
- WisdomTree Emerging Markets Small Cap Dividend DGS

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Step 6: Plan "Bucket Maintenance"

- In addition to periodically filling up Bucket 1, you also need to find a time for "bucket maintenance."
- Deplete one year's worth of living expenses from Bucket 1→
- Move one year's worth of living expenses from Buckets 2 or 3 to 1 →
- Move one year's worth of living expenses from Bucket 3 to 2.
- Ideally, "bucket maintenance" is annual or even quarterly, depending on your income distributions.

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Mind Tax Management for Buckets

- If you're 70-1/2 and taking required minimum distributions (RMDs) from your IRAs or 401(k)s, some or all of your near-term paycheck should come from those accounts.
- If you're not yet 70-1/2 or your RMDs won't cover your cash needs, turn to your taxable accounts.
- If your RMDs and taxable accounts won't cover near-term living expenses, turn to IRAs or company retirement plans to fund living expenses.
- Save Roth IRAs for last. (Tax benefits are the greatest.)
- This sequence of withdrawals will affect what types of assets you hold where.

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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

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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 3-11: $480,000

$130,0000 in T. Rowe Price Short-Term Bond PRWBX

$150,000 in Harbor Bond HABDX

$100,000 in Harbor Real Return HARRX

$100,000 in Vanguard Wellesley Income VWELX

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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: $200,000

$100,000 in Vanguard Total Stock Market Index VTSMX

$125,000 in Loomis Sayles Bond LSBDX

$75,000 in Harbor Commodity Real Return HACMX

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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 iShares Barclays TIPS Bond TIP

$80,000 in Vanguard Dividend Appreciation VIG

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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

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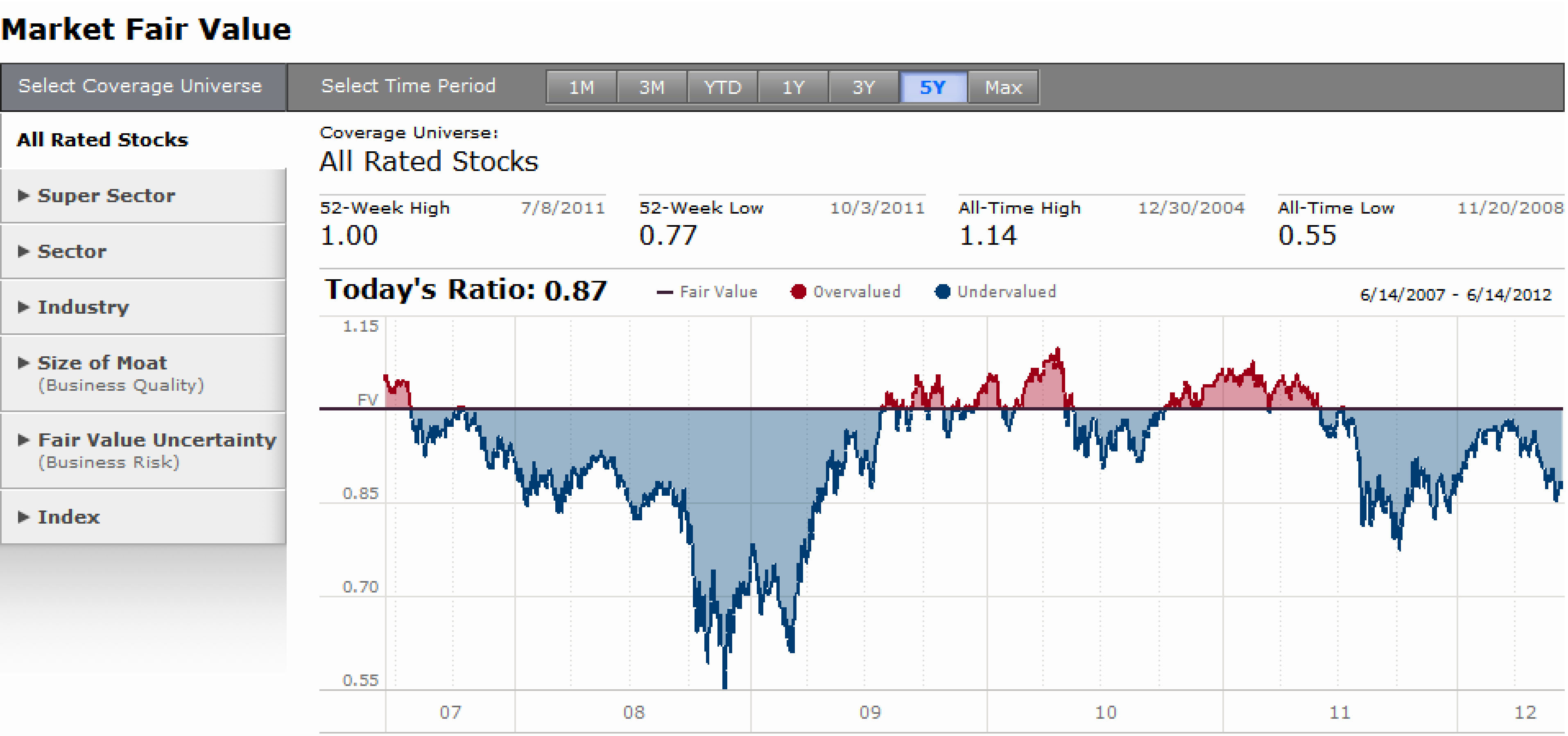
Revisiting Best Ideas: Broad Market = Undervalued Currently



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Wide Moats Undervalued, but Trade at a Premium to Our Total Coverage Universe; “Quality Play” Overdone?

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Communications, Energy Look Cheap; REITs, Utes: Meh

Economically Sensitive (0.96)

Communications Svc. P/FV: 0.78

Energy P/FV: 0.80

Industrials: 0.89

Technology: 0.85

Cyclical (0.94)

Basic Materials: 0.81

Consumer Cyclical P/FV: 0.92

Financial Services P/FV: 0.84

Real Estate 1.06

Defensive (0.99)

Consumer Defensive P/FV: 0.99

Utilities P/FV: 1.00

Health P/FV: 0.90

Sector Valuation graph available on Stocks cover page.

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Best ideas for equity investors: Individual stocks with 5 stars (low market valuations relative to our estimates of fair value), wide moats, low "uncertainty" ratings

Applied Materials AMAT

Chevron Corp CVX

Cisco Systems CSCO

Novartis AG NVS

Vulcan Materials VMC

Western Union WU

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Questions?
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