PORTFOLIO STRATEGIES WORKSHOP

Approaching Retirement: The Transistion From One Mix to Another

By Maria Crawford Scott

Major changes in lifestyle often result in major changes in portfolio allocations to reflect shifts in income and liquidity needs, as well as altering views of risk. Of course, it isn't easy to quickly change one's lifestyle; similarly, major portfolio changes require a period of transition.

How does one plan the transition? A case study illustrates one method.

The Nesbitts Approach Retirement

Tom and Margaret Nesbitt are in their late 50s, and are assessing their financial situation. Since their last child graduated from college eight years ago, the Nesbitts have been able to focus almost exclusively on building a retirement portfolio. By adding prodigiously to the retirement savings plans offered by his firm, and through successful investing of their taxable assets, the Nesbitts have been able to accumulate a fairly sizable nest egg, enough so that Tom feels fairly confident that he can retire within two to three years.

However, once Tom reaches retirement, the Nesbitts feel that changes will have to be made in their allocation. Currently, their assets are 100% invested in stocks. When Tom is retired, though, they would like their allocation to be somewhat less aggressive.

When should the change be accomplished?

The Nesbitts recognize that it is risky to try to time the market, moving into or out of the market based on a "prediction" of the opportune moment. Their asset allocation strategy up until now has been, for the most part, a buy-and-hold approach designed to keep them invested across all market environments, a form of time diversification. They realize that they should use the same principle when making a major shift in their portfolio—it would be impossible for them to predict with accuracy when the best time would be to pull out of any of their investment categories, and attempting to do so could easily backfire.

Instead, they decide to shift their assets gradually, in roughly equal payments over a two- to three-year time period, to reduce the impact of the market environment at any one point in time. They decide to start planning ahead, so they can make the transition gradually.

The Current and Future Picture

Before they can plan the transition, the Nesbitts need a picture of where they are now and where they want to be in two to three years.

Currently, Tom has quite a bit of his retirement plan money invested in the stock of the company in which he works. Tom knew it was risky to invest such a large portion in his company stock. But the company offered generous incentives to invest in the stock, and he has been quite confident in the stability of his firm while working there. The company, though, is not a large company, but rather a smaller, growing firm; because of the undiversified nature of the investment and the nature of the company, Tom considers the stock to be an aggressive stock investment.

At the same time, Tom did not invest all of his retirement plan assets in company stock. In addition, he invested a considerable portion in a growth and income fund—the only other stock alternative offered through the retirement plan. Together, these two investments total $337,500 in retirement plan assets. When he retires, Tom can either roll these assets into an IRA, or keep them invested in the plan.

The Nesbitts' taxable investments currently total $112,500. Because Tom's retirement plan only offered company stock and a growth and income fund, the Nesbitts

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have invested their taxable assets in other fund categories that complement their retirement plan investments and serve to further diversify their investments. The Nesbitts have $67,500 invested in an aggressive growth stock fund because they wanted greater—and diversified—exposure to the aggressive growth area; in addition, the Nesbitts felt they needed some exposure to foreign markets, and have about $45,000 invested in an international fund.

The bottom line: The Nesbitts have their domestic stock investments almost evenly divided between aggressive growth (25% + 15% = 40%) and growth and income stocks (50%), with about 10% invested in international stocks.

Where do they want to be after Tom is retired?

First, the Nesbitts want to add some lower-volatility fixed-income holdings to their portfolio, for an overall mix that is 75% stocks and 25% fixed-income, the latter of which would include a money market fund that will hold roughly a year's spending needs. Periodic withdrawals from other funds will be deposited in the money market fund (the actual funds from which they will withdraw will depend partly on rebalancing needs to keep their overall portfolio asset allocation at their desired mix), with the money market fund serving as their "spending" account.

Second, the Nesbitts want to substantially decrease their single holding in Tom's company. Since Tom will no longer be working at the firm, the incentives to add to the investment will no longer exist and, furthermore, Tom might not be in a particularly good position to make a judgment of the firm's position in the marketplace. Lastly, such a large holding in a single stock is too illiquid and volatile for the Nesbitts to keep in a portfolio from which they are going to be making periodic withdrawals. Tom remains a firm believer in the long-term growth prospects of his firm and does not want to move out of the stock altogether, though, so the Nesbitts settle on a desired holding of 5% of company stock.

The money they will be moving out of Tom's company stock is retirement plan money, which the Nesbitts want to keep in Tom's retirement plan; the Nesbitts therefore need to invest the proceeds in one of the retirement plan alternatives. They decide on the fixed-income fund offered in the plan, since they are adding fixed-income to their asset mix, and they do not wish to change their commitment to growth and income stocks, their only other retirement plan investment currently. An additional benefit is that the retirement plan will shelter the income generated from the fixed-income investment.

The Nesbitts also want continued exposure to a diversified portfolio of aggressive growth stocks, but they would like to lessen their commitment to a 10% holding, which, when added to their desired 5% holding in Tom's company stock, will result in an overall commitment of 15% to aggressive growth stocks.

The Nesbitts' current allocation, and their desired retirement allocation, is presented in Table 1.

The Transition

How do they get from here to there?

Table 1.
The Nesbitts' Retirement Transition

Holding	Current Allocation ($)	Current Allocation (%)	Retirement Allocation ($)	Retirement Allocation (%)	Total Change ($)	Quarterly Changes (over 12) quarters ($)	Additional Quarterly Contributions ($)	Net Quarterly Change ($)
Retirement Plan Assets								
Company Stock	112,500	25	22,500	5	(90,000)	(7,500)	138	(7,363)
Growth & Income Stock Fund	225,000	50	225,000	50	—	—	1,375	1,375
Bond Fund	0	0	90,000	20	90,000	7,500	550	8,050
Total Retirement Plans Assets:	337,500		337,500					
Taxable Assets								
Aggressive Growth Stock Fund	67,500	15	45,000	10	(22,500)	(1,875)	275	(1,600)
International Stock Fund	45,000	10	45,000	10	—	—	275	275
Money Market Fund	0	0	22,500	5	22,500	1,875	138	2,013
Total Taxable Assets:	112,500		112,500					
Total Assets	**450,000**							

The Nesbitts decide that they will make quarterly changes that gradually shift the portfolio to their desired allocation over a three-year period. Markets can change dramatically over the course of a year, and for that reason they feel that yearly changes would be too infrequent. Monthly would be an alternative, but it would be cumbersome for their taxable portfolio.

Table 1 illustrates a quarterly transition over a three-year period. The total changes over that period are divided into 12 equal installments, which represent equal quarterly changes over the next three years.

This illustration makes the simplified assumption that there is no change in the value of the portfolio over this period. In reality, over time there will be differing changes in the value of the various funds due to market movements, but the static assumption offers a useful starting point for planning purposes.

The Nesbitts can, though, take into consideration future contributions to their investments that they are certain they will be making. Tom currently adds (through a combination of his own and his employer's contributions) about $8,250 each year to his retirement plan. In addition, the Nesbitts are able to add a little under $3,000 annually to their taxable investments; in total, they will be adding about $33,000 ($11,000 annually for three years) to their investment portfolio. These contributions would be allocated according to the Nesbitt's desired retirement allocation mix. Of course, in practical terms the Nesbitts would not add to a fund from which they were also withdrawing. Instead, their withdrawal amount would decrease, and their additions elsewhere would increase.

The overall effect of these quarterly contributions is shown in the last column in Table 1. For example, each quarter, Tom would transfer $7,363 out of his company stock; the proceeds from the company stock, plus part of his additional contributions to the retirement plan, would be invested in the retirement plan's bond fund, for a total quarterly investment of $8,050, and part of his quarterly contributions ($1,375) would be added to the growth and income fund.

Practical Aspects: Dealing With Reality

The transition illustrated in Table 1 provides a starting point, but there are practical considerations that may call for modifications.

The transition for the retirement plan assets is relatively easy to implement, since there are no tax consequences involved when selling shares.

However, for their taxable portfolio, the withdrawal from the aggressive growth fund could result in potentially costly tax liabilities.

For that reason, the Nesbitts will wait until after Tom's retirement to sell shares, when they are in a lower tax bracket and can use the proceeds to meet living expenses, allowing them to minimize taxable income. They will still, however, make the withdrawals quarterly over a several-year period. In addition, they will make sure that any distributions from the fund are reinvested in their taxable money market fund.

In addition, the Nesbitts' overall portfolio will be constantly changing, and (they hope) growing. The Nesbitts will most likely be making adjustments that reflect the various changes in value. If the funds that are being deemphasized are growing more quickly than the overall portfolio, the Nesbitts may want to increase their quarterly withdrawals somewhat (while taking taxes into consideration). For example, assume that over the course of a year the Nesbitts' total portfolio has grown to $483,000. A 5% commitment to Tom's company stock would then imply a $24,150 investment. But let's say the stock's return has been greater than the portfolio's return, and after four quarterly withdrawals the stock fund now totals $90,750. The Nesbitts would need to withdraw $66,600 ($90,750 – $24,150) over the remaining eight quarters, or $8,325 each quarter ($8,187 net of contributions).

All-in-all, though, the Nesbitts have decided not to worry about pinpoint accuracy. They are more concerned with minimizing transaction costs and taxes than with asset mix precision, and as long as they are within a reasonable range of their target, they plan to fully enjoy their retirement years.