ASSET ALLOCATION AND RETIREMENT: DO YOU NEED TO MAKE A CHANGE?

By Iris Mack Dayoub

The asset allocation decision should not be based on your age or your stage in life, but rather on your time horizon, your risk tolerance, and your return needs.

My friend just retired. Until yesterday she went to work every day and invested 10% of her pretax paycheck in a portfolio of stocks and bonds with an asset allocation designed especially for her. Tomorrow she will not get a paycheck. But she still has a portfolio of stocks and bonds. Should her asset allocation be changed because she is no longer collecting a paycheck?

Many investors who are approaching retirement are asking this question. The information available from the popular press and many advisors is to generally guide retirees to change their allocation to one that is more conservative. This is usually interpreted to mean that the investor should lighten up on stocks and put more of their investments into bonds.

But retirement doesn't necessarily mean an individual should change their asset allocation. To see why, let's first look at the asset allocation process.

PICKING AN ALLOCATION

Every portfolio has an asset allocation that can be described by the percentage of assets in each asset class or subcategory. Diversifying among a broad range of asset classes is an important part of the asset allocation process.

The theory behind this is that by diversifying among different asset classes, an investment portfolio can be constructed that has less risk than the weighted average of its component parts. In other words, different asset classes move up and down at different times. The up and down movements are a risk for each asset class, but when combined with other asset classes the ups and downs of the total portfolio tend to be smoothed, with less subsequent risk.

Effective diversification depends not only on the number of assets in a portfolio but also on the ways and degrees in which their responses to economic events tend to reinforce, cancel, or neutralize one another.

One of the most common asset allocation techniques considers only three asset categories: stocks, bonds, and cash (or cash equivalents such as money markets and CDs). More sophisticated models use subcategories such as: large-capitalization stocks, foreign stocks, Treasury bills, corporate bonds, etc. Other categories might include various styles such as growth and value.

There are many ways to choose an asset allocation for your portfolio. Let's look at some of the advice currently proposed to the investing public:

- Investor questionnaires on risk tolerance are readily available from brokerage firms, mutual fund and insurance companies, and various Web sites. Asset allocations are then recommended based on the answers.
- Life cycle investing is an increasingly popular method—using the investor's stage of life to determine the portfolio allocation. Many of the life cycle concepts assume that age is the paramount criterion.
- Rule-of-thumb formulas are also sometimes suggested. One of the most popular formulas designed to provide a stage of life allocation—the Age

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Method—is to subtract your age from 100 to determine your stock percentage, put 10% in cash, and the remainder in bonds.

However, there is a way to determine an appropriate asset allocation for a portfolio that has nothing to do with age or multiple-choice questions, neither of which will provide you with the answers you need. I call this the Resource/Goal method for determining an appropriate asset allocation, and it is a three-step process:

- The first decision is to establish a time horizon. The longer the time horizon, the more you can afford to allocate to equities. Money that is needed in the next few years should not be invested in stocks.
- The second decision is to choose the asset classes that you want to include. Your attitude toward risk will help you choose the assets for your portfolio. Ask, "How much money am I willing to lose in a given year?" Then compare the losses that have occurred in a specific class during various market conditions. Consider also the size of your portfolio. High transaction costs may deter you from some classes, such as foreign bonds. Another consideration is your knowledge or experience—do not invest in an asset class that you do not understand.
- The last decision is to determine how much of the portfolio to invest in each asset class so that the targeted return can be achieved. Your target return, taking into consideration your risk tolerance, will help determine the percentage in stocks, bonds, and cash; then, within each specific asset class, different strategies or styles can be used. The main objective here is to choose an allocation whose expected returns and risk accomplish the goals you have set for your portfolio.

Tables 1 and 2 provide historical information that can help you make these decisions. Table 1 includes long-term returns for several major asset classes; note that the returns for many of these groups have been particularly high in recent years. However, for planning purposes you should use very long-term figures (for instance, the last 40 or 50 years) that cover many different market environments. Table 2 includes the worst returns for the three major asset categories for various holding periods; these can provide useful guidelines for the amount of risk you are undertaking with each category.

Table 3 may also be a useful guideline, providing target rates of return required to meet retirement living goals. The table indicates how long your retirement savings will last for various rates of return if you were to withdraw a given percentage during the first year and then increase your first-year payout by 4% each year for inflation. Conversely, if you know how much you will need to spend each year and how long it will need to last (based on your life expectancy), you can determine the return your portfolio would need to earn to meet those needs. Keep in mind that required returns must always be viewed in the context of risk; the higher the return required, the greater the risk the portfolio will have to take on. In addition, required portfolio returns above 10% are unrealistic, given the long-term returns from the various categories and the need for diversification among all categories.

TABLE 1. AVERAGE ANNUAL RETURNS (1949-1998)

No. of Yrs.	S&P 500 (%)	Small Stocks (%)	LT Corp Bonds (%)	LT Govt Bonds (%)	T-Bills (%)	CPI (%)
Last 10	19.2	13.2	10.9	11.7	5.3	3.1
Last 20	17.7	16.0	10.9	11.1	7.2	4.5
Last 30	12.7	12.1	9.1	9.1	6.8	5.2
Last 40	12.0	14.2	7.4	7.2	5.9	4.4
Last 50	13.6	14.8	6.2	5.9	5.1	3.9

TABLE 2. WORST RETURNS FOR VARIOUS HOLDING PERIODS (1946-1998)

Holding Periods	Stocks (%)	Bonds (%)	Cash (%)
1 Year	–26.5	–5.1	0.4
5 Years	–2.4	1.0	0.8
10 Years	1.2	1.3	1.1
20 Years	6.5	2.2	2.0

PLANNING RESOURCES

There are several other places where you can find historical data to help you make the final asset allocation decision. One of the best I have found is on the Web site www.callan.com. Callan Associates routinely collects performance on thousands of institutional investment and mutual fund products; the information is aggregated in the form of various indexes based on investment style and asset class. A similar database available to the general public is maintained by Wilshire Associates at www.wilshire.com.

In addition, there are several free Web sites that will help you determine an appropriate target return based on your current and future savings, other resources such as Social Security and pension plans, as well as your expected living expenses in retirement. These sites allow you to change many different variables, including expected inflation rates and tax rates, so you can do "what if" scenarios. These Web sites are listed at the bottom of page 13.

TABLE 3. NUMBER OF YEARS YOUR RETIREMENT SAVINGS WILL LAST*

First-Year Payout Rate (%)	Investment Return 4%	5%	6%	7%	8%	9%	10%
2	50.0	67.6	—	—	—	—	—
3	33.3	39.9	52.0	—	—	—	—
4	25.0	28.4	33.5	42.4	69.0	—	—
5	20.0	22.1	24.9	28.9	35.8	53.1	—
6	16.7	18.1	19.8	22.1	25.4	30.8	42.8
7	14.3	15.3	16.5	18.0	20.0	22.7	26.9
8	12.5	13.2	14.1	15.2	16.5	18.1	20.4
9	11.1	11.7	12.4	13.1	14.0	15.2	16.6
10	10.0	10.5	11.0	11.6	12.3	13.1	14.1

**Assumes payouts increase by 4% annually*

REACHING RETIREMENT

If you use this Resource/Goal method for determining an appropriate asset allocation, the decision as to whether or not you need to change your allocation when you retire will be dictated by changes in your risk tolerance, your time horizon, and your return needs, not by your age or life cycle stage.

Let's look at an example to show how this works. Bob is retiring tomorrow. He has saved $250,000 for his retirement. He would like to have $12,500 the first year and have that amount increase at a 4% rate each year. That means his first-year withdrawal rate is 5% ($12,500 is 5% of $250,000). Bob is 62 and wants to have his money last at least 35 years. Table 3 shows that he must earn 8% on his investment in order for his savings to last for his investment period. Tables 1 and 2 can then be used to determine an asset allocation that would have an expected rate of return of at least 8% annually, but with modest amounts of downside risk. There are, of course, many different mixes that would give an expected return of 8%, but keep in mind that one important goal is to keep the portfolio diversified to minimize the risk. Bob's reassessment of his situation may result in an allocation that is quite similar to the one he had before retirement, particularly if he was accurate in his assessment of his savings needs when he made his original allocation decision.

What changes are appropriate when a person reaches that time in their life when they decide to stop working and live on their resources?

Using an age-based asset allocation does not make sense if it is unable to produce a return that will match your needs. Your tolerance for risk will not change overnight just because you don't have to get up and go to work the next morning.

There is a strong tendency for retirees to focus heavily on fixed-income investments for income. Age-based and life cycle methods for determining asset allocation can also lead investors to focus too heavily on fixed income. For example, the Age Method would dictate a 40% commitment to equities for anyone age 60 and that amount would decline over the years. However, most retirees' goals would require a long-term portfolio return that is greater than could be achieved from only a 40% commitment to equities.

Of course, there are a few factors that will change when you retire. For instance, your very short-term needs may increase. To meet those needs, you may need to invest a higher percentage of your assets in very short-term fixed-income investments, such as money market funds or short-term CDs. However, you do not necessarily need to decrease your commitment to equities to accomplish this; you could, instead, simply use shorter-term instruments from the fixed-income portion of your portfolio.

In addition, some individuals may be more uncomfortable with fluctuations in their portfolio value when they are withdrawing assets. This may lead you to want to decrease your commitment to equities. But a portfolio that is too conservative may not produce the total return that is needed to meet your income needs over your time horizon. In that situation, you may be forced to curb your spending appetite, and you run the significant risk that you will outlive your resources.

With recent changes in the tax code that makes capital gains more attractive than income, retirees will benefit by continuing to have a large part of their investments in equities. The liquidity and marketability of equities make it possible to sell off portions for living expenses. And the potential for greater growth from equity investments makes them an important component of most retirees' portfolios—a portion that may be greater than if one of the other methods had been used to determine asset allocation.

Your age really has very little to do with being able to achieve your goal, whether it be to die with few resources leftover or to leave a legacy. ✦

Top-Rated Web Sites Offering Free Retirement Planning Features*

Financial Engines	**SmartMoney Interactive**
www. financialengines.com	www.smartmoney.com
Quicken.com	**Vanguard**
www.quicken.com	www.vanguard.com

**Source: AAII's Individual Investor's Guide to Investment Web Sites, September 1999 AAII Journal*