WILL THEIR PORTFOLIO LAST? THE REST OF THE STORY

By Dennis Stearns

An analysis of "John and Mary's" retirement portfolio and its ability to meet their income needs and goals generated considerable interest and lots of inquiries. Dennis Stearns tackles your questions about portfolio sustainability, withdrawal rates, and asset allocation scenario analysis.

INVESTOR PROFILE & FINANCIAL SUMMARY

- Retired couple, both age 65.
- John has reasonable money skills; Mary has low money skills and interest.
- Both are in good health and expect to live to roughly to age 85.
- Long-term goal is a withdrawal rate of 8% from their portfolio to supplement Social Security and a pension.
- They consider their risk tolerance to be "moderate."
- Expected living expenses: $65,000 annually after taxes.
- Income: $28,000 annual pension; $27,000 annual Social Security.
- Net worth: $547,831.
- Current allocation: 55% stocks, 45% cash and fixed income.

In the April 2003 *AAII Journal*, I examined the financial plan of "John and Mary," a retired couple, both age 65, to see if their assets and asset allocation strategy could sustain their planned retirement spending needs and desires through the rest of their years.

The technique I used to analyze the plan was a combination of traditional financial planning techniques, as well as a newer method, Scenario Learning, in which plausible scenarios for the next one- and three-year periods are developed and coupled with simulation studies to see how an investor would fare in the majority of probable scenarios.

The conclusion I reached was that John and Mary were in reasonably good condition to achieve all their goals—even in some of the more difficult economic scenarios that were examined.

However, the article raised quite a few questions from AAII members around the country, seeking further discussion of the withdrawal sustainability of the portfolios and a deeper analysis of how portfolio asset allocation fits into the Scenario Learning analysis.

Here, as Paul Harvey would say, is "the rest of the story" that tackles those questions and discusses the portfolio ideas in more depth.

Question: "Safe" Withdrawal Rates

John and Mary indicated that they would like to withdraw from their savings at an 8% withdrawal rate. You said that was not achievable. What was their actual withdrawal rate and what determines a "safe" withdrawal rate?

Answer:

At my firm, we define the withdrawal rate as an aftertax number required to make ends meet. Using John and Mary's actual expenses year-by-year in

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my analysis, coupled with assumptions about the efficiency of their mutual funds and "special" expenses they said they were projecting (like a new car or contingency fund for home repairs), I determined that they would need to withdraw 2.3% annually from their investments, much less than they were expecting. Their pension and Social Security help keep their savings withdrawal number low—a luxury that will be available to less investors in the future as companies replace defined-benefit pensions with 401(k)s.

The "safe" withdrawal rate is a major hot potato today among planners and academics. Several studies in the bull market of the 1990s suggested that 5% was a safe withdrawal rate, and 6% to 7% could work if you had a high percentage invested in stocks. However, *most* credible studies found that lower rates, of 4% to 4.5%, were sustainable if you could accept a 10% to 20% chance of plan failure. On the other hand, most retirees that I know would prefer as close to 100% odds of success as possible. The 8% withdrawal rate suggested by John and Mary would not be viewed as safe under virtually any study.

In virtually all of the sustainability studies, if you take on more risk (i.e., investing in stocks), you can count on a higher withdrawal rate. A new study by Dr. Rory Terry published in the May 2003 Journal of Financial Planning comes to a radically different conclusion: Higher stock commitments *lower* your sustainable withdrawal rate. However, many of the experts I have talked to feel that some of the assumptions in this study are faulty and such a portfolio would be problematic given today's extremely low interest rates.

The problem facing retirees with portfolios invested in stocks is that the sustainability of the portfolio when you are withdrawing from it depends on the timing of stock market returns. If you retired in 1972, right before the terrible 1973–1974 bear market, your optimum withdrawal rate would have been extremely low. Retire just three years later after the worst is over, and it skyrockets. Unfortunately, you have no idea in advance which it will be. You could argue that today is more like 1975 than 1972, but there could be other unique crosswinds in the future that can change the dynamics and make an aggressive withdrawal rate backfire unless you have a well-disciplined approach on both your spending and investing strategies.

The best approach to portfolio withdrawals I have seen is to create a gradual increase or decrease in spending based on portfolio volatility and asset size compared to expenses. If you couple this with good portfolio discipline, you've got a great chance of accomplishing your long-term spending goals. If you can accomplish your goals at a 3% withdrawal rate, *great*. If 4% is needed, stay more disciplined on buy/sell targets and rebalancing, and look for special opportunities to occasionally boost returns. If 5% or more is needed, you should consider more radical strategies to enhance returns, but you must be willing to temporarily tighten your belt if your investment strategy does not go as planned.

Question: Life Expectancy Assumptions

What if I live longer than the IRS life expectancy tables?

Answer:

It is important to keep in mind that the IRS Life Expectancy tables are an *average*. That means that 50% of the population die *before* the stated life expectancy, and 50% die later. If you are in good health, come from a long-lived family, and take care of yourself, you definitely need to examine the "live longer" scenarios, and use longer life expectancies in your analyses. Several of our clients are working in biotechnology research and strongly believe that 10 years from now, the average American will not only live longer, but also stay as energetic and sharp as they are today. Just look at your typical 60- and 70-year-old today versus just 20 years ago. They are, on balance, living longer and staying more active.

Before you start breaking out the champagne, consider this. If you live 10 years longer and continue to be more active in your travels, hobbies or whatever you enjoy, will your target withdrawal rate still hold up?

Question: Including Pension Payments in Asset Allocation

John and Mary have a high pension and Social Security income. Does it make sense to convert that into a "bond equivalent" and have those payments calculated as part of the asset allocation analysis?

Answer:

This question has been debated for years with no clear answer being favored, other than the fact that most advisors ignore the issue for allocation purposes. If you do this in John and Mary's case, you end up deciding that their regular investment portfolio should be 100% stocks to arrive at the desired 50/50 mix when the pensions are included. But you lose specialty bond holdings that have performed well in the bear market and, we believe, will do very well in the future scenarios we envision.

My biggest concern with this approach is that many people would abandon the strategy before the theoretical benefits would pay off. For example, last fall, how many retirees could stand the volatility of an all-stock allocation of their regular investment portfolio and not abandon ship at just the wrong time? As important, how many *spouses* with, typically, a lower threshold for risk would stay the course as liquid assets move lower and lower? At least half our clients who are married have measurably different tolerances for risk among spouses: We know of many cases where the higher-risk spouse forced a more aggressive allocation in late 1999 or early

2000, and this has become a major marital issue.

Question: Allocation for a Possible Stock Market Rebound

Your Scenario Learning approach is very interesting. It sounds like the odds favor a stock market rebound in the next three to five years. Should John and Mary be more aggressive in their allocation?

Answer:

There are several issues involved in this question.

First, if you are using a Scenario Learning approach, you should avoid the temptation to bet it all on a *single* scenario, and you should avoid shifting your weightings dramatically in one direction. One example of this was in the mid-1990s when the warning signs of an overheated stock market were becoming evident in higher price-earnings ratios. At that point, some investors moved to the sidelines and stayed there, missing a major opportunity that, with disciplined rebalancing, would have put them years ahead of their goals. The moral is that some weight shift is fine, but too much market timing using Scenario Learning techniques can put you even further behind the eight ball.

Second is the issue of taking extra risk (by increasing your stock commitment) when your withdrawal rate is low and you don't need to. This is tempting to some people because, after all, you could use the extra money if you lived longer than planned, or your children or grandchildren might need it, or you could help out your favorite charity. But what happens if you're wrong? After the lessons of the technology-led stock bubble in the late 1990s, you would think this would be tattooed on the forehead (or some other appropriate spot) of every investor. Unfortunately, history lessons are often ignored with the mantra "It's different this time!"

In my opinion, John and Mary are not too far off from their ideal investment weighting, with a few caveats that

RECOMMENDED PORTFOLIO

	Allocation (%)	Type of Account	Comments
Cash–Money Market	**6**	Taxable	Over half in Harbor Ultra-Short Duration fund
Bonds			
Loomis Sayles Bond	8	IRA	Dan Fuss manages this excellent fund
Fremont Bond	14	IRA	Bill Gross manages; one of the best for bonds
Vanguard Inflation-Protected Securities	5	IRA	Do you really want to bet on deflation?
Vanguard High Yield	5	IRA	Good conservative risk/reward profile
Vanguard Short-Term Corporate Fund	5	IRA	Conservative short-term income fund
Subtotal Bonds	**37**		
U.S. Stocks			
Dodge & Cox Stock	10	Taxable	Strong managers with low expenses
Selected American	7	Taxable	Fallen angel with good prospects
Longleaf Partners	6	IRA	Talented mid-cap focus
Westport Select Cap.	5	Taxable	Talented small-/mid-cap focus
Jensen Portfolio	6	Taxable	15% ROE criteria should bode well for focused portfolio
IBM	3	Taxable	A sentimental favorite for John; trimmed by over half
Subtotal U.S. Stocks	**37**		
International/Global Stocks			
Oakmark International	6	Taxable	Good core portfolio choice
First Eagle Sogen Global	4	IRA	Good diversification, plus good gold manager
Subtotal International	**10**		
Real Estate Assets			
Morgan Stanley REIT	5	IRA	Good dividend yield; stay alert to valuation cycle
PIMCO All Asset	5	IRA	Not yet available for retail investors
Subtotal Real Estate	**10**		
Total	**100%**		

Note: Due to the multiple accounts held by John and Mary, some mutual funds will need to be held in both IRAs and taxable accounts.

are addressed in the next sections.

Question: Too Many Funds

John and Mary seem to have a lot of mutual fund holdings (over 45). Are they over-diversified?

Answer:

Yes, they have accumulated a lot of funds over the years, although John has tried to prune them down recently. It is not as bad as you might think at first glance, since there are so many different accounts (his and her IRAs, personal accounts, and annuities) that require the use of different funds.

The danger with too many funds on the stock side is that you can end up with a "closet" index fund—in other words, all of your holdings when combined acting like an index fund, yet you are paying active manager expenses. Another more pressing danger is that many funds buy similar stocks—you have the illusion of diversification but are actually too concentrated in certain areas.

Question: Allocation and Fund Recommendations

Is their current mutual fund allocation correct given John and Mary's risk level and situation?

Answer:

My original article focused on the withdrawal issue. However, an analysis of their portfolio suggests the following:

- Their current portfolio was a bit better than an index fund for returns over the last 10 years, with slightly less risk than the overall market. However, that is looking through the rear-view mirror. Looking out the front windshield, I would make quite a few changes. Since the withdrawal rate is low relative to the size of the portfolio, I would trim the cash holdings back quite a bit to 6% of the portfolio. If the withdrawal rate were significantly higher, I would likely reserve more cash in short-term bond funds so they would not have to liquidate stock funds at an inopportune time.
- My firm has four distinct classes of objectives and risk, which are then customized to the client's situation. I would use our Growth and Income with a Moderately Aggressive Risk category, which is currently at a 43% cash and fixed income/57% stock allocation, using creative mutual fund alternatives in both the stock and bond areas (see the Recommended Portfolio box for my recommendations) to keep volatility under control. Since John and Mary have a low withdrawal requirement, they are comfortable taking a bit more risk (hence the "aggressive bias"), but don't want to be heavily dependent in the future on the stock market. In our methodology, "aggressive bias" means willing to have fewer mutual funds in the portfolio, concentrating a bit more in attractive areas (but still within disciplined limits) and taking more marginal risk with the stock allocation.
- The new portfolio has lower volatility than the existing one, it has a better risk/reward profile, and it's done better over one-, three-, five- and 10-year periods. Most importantly, it is better aligned to where we think the best risk/reward trade-offs are in the future.
- Our bond holdings are much more condensed, focusing on Fremont Bond, Vanguard High Yield (conservative for its category, but a steady performer), Vanguard Inflation-Protected Securities (investing in TIPs, or Treasury Inflation-Protected securities) and Vanguard Short-Term Corporate fund, with Loomis Sayles Bond fund as a way to get into more creative bond areas that should do well in the volatile bond markets that we expect going forward.
- This new portfolio has only five U.S. stock mutual funds, focused on large-cap growth stocks (Jensen), large-cap value (Dodge & Cox), opportunistic large-cap value (Selected or Clipper), mid-cap stocks (Longleaf) and small-cap stocks (Westport). As we have seen better visibility on corporate earnings, my firm has shifted toward more growth in all sectors, but we are still comfortable with the growth-at-a-reasonable price approach taken by some of the existing managers—especially given the new tax law's lower rates on stock dividends.
- We also like the international area more now with the compelling price-earnings ratios (20% less than U.S. price-earnings figures) and dividend yields (almost double the S&P 500). Our model has 10% international versus 6.5% for the existing portfolio. In this category, we have stayed in less aggressive alternatives like First Eagle Sogen (assuming you get it at no commission cost through Schwab or a similar program) and Oakmark International.
- Finally, we have a REIT fund (where the dividend yield still looks good and it has been a great diversifier) and a quasi-hedge fund, PIMCO All Asset, designed to provide solid real returns in a variety of market environments. However, this PIMCO fund is currently available only as an institutional fund (a $5 million minimum, but much lower through Schwab Institutional).
- This revised portfolio is based on mutual funds that we would use in a portfolio for investors with the same characteristics and goals as John and Mary. If John and Mary were to switch to this portfolio, it would have tax consequences for taxable assets, which would need further analysis.
- One last investment observation: In a "core and explore" model, you would normally have low-cost index funds in efficient market areas (like large-cap stocks) serving as the "core" and active managers in other less-efficient areas or in specialty areas where indexing is not an option. We have an alternative

growth and income model that would have worked almost as well using exchange-traded index funds in certain areas. However, if you have higher withdrawal rates or less downside tolerance for risk, we would favor our active portfolio given the many potential pitfalls we see in the near future.

Question: The Effect of New Tax Laws

How does the new tax law affect John and Mary's situation?

Answer:

Some of the best and brightest are developing new models to test how portfolios should look going forward under the new tax law. With the reduced 15% tax on both capital gains and dividends, it is tempting to go with the seemingly simple answer to put all of your income stocks and growth stocks in taxable accounts and all of your bonds in tax-deferred accounts. That's not a bad rule of thumb, although a few exceptions should be contemplated.

Many stock strategists, including our firm, are taking a proactive approach to profit and loss management. Since the beginning of the year, we have had several stocks move up significantly from where we purchased them and hit our three- to five-year price targets in less than one year from purchase. Automatic sale, even at higher short-term gains rates? No, since some of these stocks have improving fundamentals that suggest a lot of bloom is still left on the rose. But some are almost finished blooming. For John and Mary's stated risk level, if we had individual stocks as part of the strategy, we would be trimming many of these stocks and rotating into more attractive areas.

More active and disciplined trimming suggest that some growth stocks might be better left in tax-deferred accounts. Why? If you have ever found yourself as a "deer in the headlights" when it comes to pruning high flyers—frozen because you don't want to pay tax on the gain—it is doubly important that you not ignore the benefits of having some of your growth stocks or less tax-efficient mutual fund favorites in your tax-deferred accounts.

Another interesting wrinkle is the mutual funds that have a negative capital gain exposure. This is the opposite of what we worried about in the go-go 1990s when imbedded capital gains in a mutual fund might mean getting a tax bill even if you just bought the fund. Many of our favorites that fit this situation are used in our growth accounts and are not suggested for John and Mary. However, one of our favorite lower-risk international funds, Tweedy Browne Global Value, has over a 20% imbedded loss, making it more tax efficient (at least for a while).

Below are just a few of our favorite funds of this type, with the caveat that bigger imbedded losses probably means they are spicier funds that may not fit your own objectives.

Fund	Potential Exposure
Harbor Capital App	–39%
Artisan International	–25%
Tweedy Browne Gl Val	–20%
AMRO Montag Growth	–20%

Source: Morningstar as of 6/9/03.

Go to Morningstar's Web site (www.morningstar.com) to get the latest estimate of a fund's tax position. ✦