

Using the Bucket Approach With Your Retirement Portfolio

By Christine Benz

Article Highlights

- The bucket approach combines long-term growth potential with cash to help retirees ride out periodic market downturns.
- An example of what a bucket portfolio with actual mutual funds might look like is presented.
- Bucket maintenance may be best achieved through rebalancing or by combining portfolio income with other investment proceeds.

Here's your assignment: Gather up all of your retirement accounts and shape them into a portfolio that will supply you with the income you'll need during your retirement years.

Oh, and one other tiny to-do: You'll also need to make sure you never run out of money, even though you don't know exactly how long you'll need it.

In the past, one simple and elegant solution to the above problem was to buy an immediate annuity that would pay you a stream of income for the rest of your life. But many investors don't like the loss of control that accompanies annuities. A more temporal problem is that today's ultra-low interest rates mean payouts from such annuities are lousy right now.

One other intuitively appealing idea is to sink your portfolio into income-producing investments, such as bonds and dividend-paying stocks, and live off whatever yield they generate. That way you might never have to tap your principal at all. The big drawback, however, is that you're buffeted around by whatever the interest-rate gods serve up. When yields are up, you're living high off the hog; when they're miserly, as they have been for the better part of a decade, you have the unappetizing choice of scaling your spending way back or venturing into riskier income-producing securities to get the yield you need.

Given that each of those approaches has become more challenging in the current low-interest-rate environment, it's no wonder that so many retirees and pre-retirees have been receptive to another strategy: "bucketing" their portfolio



for retirement. Originally conceived by financial-planning guru Harold Evensky, bucketing is a total-return approach in which you segment your portfolio based on when you expect to need your money. Money for near-term income needs is parked in cash and short-term bonds, while money needed for longer-range income needs remains in bonds and stocks.

The Beauty of Buckets

Why has bucketing become so popular? First, it bows to reality by acknowledging that all but very wealthy investors will need to tap their principal during retirement; second, it provides a sensible and easy-to-use framework for doing so. And given that many retirees will live for 25 or more years in retirement, the bucket approach provides a necessary dose of long-term growth potential, enabling a retiree to hold stocks as well as safer securities for nearer-term income needs.

Bucketing also helps address some of retirees' key psychological roadblocks. By carving out a cash position in their portfolios and automating withdrawals from that account, a retiree can receive a steady paycheck, month in and month out, just like they received when they were still working. Knowing that a predictable stream of income is coming in the door can provide great peace of mind.

Moreover, holding a cash component (Bucket 1) can help retirees ride out periodic downturns in their long-term portfolios without panicking. If they know their near-term income needs are covered in the cash bucket—and, in a worst-case scenario, in their bond bucket as the next-line

Table 1. The Funds in the Model Bucket Portfolio

Fund (Ticker)	Category	Avg Annual Return			Expense Ratio (%)	Notes
		1-Yr (%)	3-Yr (%)	5-Yr (%)		
PIMCO Enhanced Short Maturity ETF (MINT)	Ultrashort Bond	0.76	1.24	na	0.35	Historically offered a higher yield than cash, but investors should prepare for added volatility in a rising-yield environment.
T. Rowe Price Short-Term Bond (PRWBX)	Short-Term Bond	0.03	1.39	2.89	0.53	Features a long-tenured manager, reasonable costs, and a conservative strategy.
Harbor Bond Institutional Class (HABDX)	Intermed-Term Bond	(1.39)	2.84	6.63	0.55	No-load PIMCO-managed fund employs a go-anywhere strategy that should be an advantage in an uncertain bond-market environment.
Harbor Real Return Institutional Class (HARRX)	Inflat-Protected Securities	(7.48)	3.15	4.25	0.59	PIMCO-managed fund that provides dedicated inflation-protected bond exposure. Buckle up for volatility if interest rates trend up.
Vanguard Wellesley Income Investor Shares (VWINX)	Conservative Allocation	5.21	9.21	8.46	0.25	60%–65% in investment-grade bonds and the rest in dividend-paying stocks. Boasts experienced management team, but is vulnerable to interest-rate shock.
Vanguard Dividend Growth Investor Shares (VDIGX)	Large Blend	18.35	18.08	8.38	0.29	Manager Don Kilbride seeks reasonably priced stocks of firms that have historically grown their dividends.
Harbor International Institutional Class (HAINX)	Foreign Large Blend	15.99	10.82	3.46	0.77	Mgmt team of this longtime Morningstar favorite employs a value-leaning style & very long-term mindset.
Vanguard Total Stock Market Index Investor Shares (VTSMX)	Large Blend	20.08	18.80	7.71	0.17	Ultra-cheap, tax-efficient fund provides broad-based U.S. market exposure in a single shot.
Loomis Sayles Bond Institutional Class (LSBDX)	Multisector Bond	5.61	8.22	8.76	0.63	Aggressive, value-leaning fund that typically includes a mix of high-yield and foreign bonds, as well as dividend-paying stocks.
Harbor Commodity Real Return Strategy Institutional Class (HACMX)	Commodities Broad Basket	(14.96)	2.36	na	0.89	PIMCO-managed commodities fund that is volatile, so best used as a small portion (5%–10%) of a long-term portfolio.

na = not applicable.
Source: Christine Benz and Morningstar, Inc.. Data through August 30, 2013.

reserve—they're likely to be less rattled the next time stocks plunge.

Bucketing also helps retirees get away from the income-only mindset, which may not lead to an optimal outcome. Many retired investors make a strict distinction between their principal and the interest it kicks off. The former is sacrosanct, never to be touched and, ideally, left to heirs. The latter is what they must rely on to meet their living expenses. Yet never touching principal might lead a retiree to underspend,

forsaking quality-of-life considerations and leaving more to heirs than would be optimal. Perhaps even more significantly, as yields on safe securities have shrunk to lower than 2% to 3% during the past few years, income-only investors have found themselves with a stark choice: Either stick with cash and high-quality bonds and reduce their standard of living, or venture into securities that promise a higher payout with higher volatility to boot.

Instead of relying on dividends and

bond income to supply living expenses, a retiree using a bucket approach can be unrestrictive about how he replenishes the cash in Bucket 1 once it becomes depleted. Such a retiree could rely on bond and dividend income from his portfolio to fulfill some of his living expenses, but also use rebalancing proceeds, tax-loss harvesting proceeds, and so forth.

Finally, bucketing is compelling because it's flexible. A bucket portfolio can incorporate many of a retiree or

pre-retiree's existing holdings, and a bucket plan can be readily customized to suit a retiree's own specifications. For example, an older retiree with an expected 10-year time horizon might have just two buckets—one for very short-term needs and another bucket earmarked for the medium term. A younger retiree with a longer time horizon, meanwhile, might have similarly positioned short- and intermediate-term buckets as well as a sizable equity bucket for long-term growth.

A Model Bucket Portfolio

To help illustrate what an actual bucketed portfolio might look like, let's assume we're building a portfolio for a soon-to-retire couple with the following attributes:

- They have a \$1.5 million portfolio.
- Their time horizon is 25 years, and they have a very high risk capacity.
- They plan to withdraw 4% of their initial balance in year 1 of retirement (\$60,000), then inflation-adjust that amount every year.

Given those variables, here's a sample bucketed portfolio employing some of Morningstar analysts' favorite funds. (See Table 1 for details on these funds.) Note that because this portfolio is geared toward risk-tolerant investors with a very long time horizon, it's quite equity-heavy, with a roughly 50% stock/50% bond asset allocation. This profile will be too aggressive for many retirees.

Bucket 1: Years 1 and 2

- \$60,000: Cash (certificates of deposit, money market accounts, and so on)
- \$60,000: PIMCO Enhanced Short Maturity ETF (MINT)

This portion of the portfolio is designed to cover living expenses in years 1 and 2 of retirement. Its goal is stability of principal with modest income production. Risk-averse investors who want an explicit guarantee of principal stability will want to stick with FDIC-insured products for this sleeve of the portfolio. On the flip side, investors

comfortable with slight fluctuations in their principal values may steer less than a year's worth of living expenses to true cash instruments. Our model portfolio splits the difference, investing a year's worth of living expenses in true cash instruments and another year's worth of living expenses in an ultra short-term bond exchange-traded fund.

Bucket 2: Years 3 to 10

- \$130,000: T. Rowe Price Short-Term Bond (PRWBX)
- \$150,000: Harbor Bond Institutional Class (HABDX)
- \$100,000: Harbor Real Return Institutional Class (HARRX)
- \$100,000: Vanguard Wellesley Income Investor Shares (VWINX)

The goal for Bucket 2 is stability and inflation protection as well as income and a modest amount of capital growth. It's anchored by two sturdy, flexible core bond funds—one short-term and the other intermediate. [Harbor Bond is a no-load near-clone of PIMCO Total Return Institutional Class (PTTRX).] In addition, it includes exposure to inflation-protected securities (Harbor Real Return) and a hybrid stock/bond fund (Vanguard Wellesley Income) to provide income with a shot of equity exposure.

Bucket 3: Years 11 to 25

- \$400,000: Vanguard Dividend Growth Investor Shares (VDIGX)
- \$200,000: Harbor International Institutional Class (HAINX)
- \$100,000: Vanguard Total Stock Market Index Investor Shares (VTSMX)
- \$125,000: Loomis Sayles Bond Institutional Class (LSBDX)
- \$75,000: Harbor Commodity Real Return Strategy Institutional Class (HACMX)

Because this component of the portfolio will remain untouched for the next decade, save for rebalancing, the assets here are primarily invested in equities. This component of the portfolio also includes smaller stakes in high-risk bonds (Loomis Sayles Bond) and commodities for inflation protection. This is

the growth engine of the portfolio, but note that the core equity holding—Vanguard Dividend Growth—focuses on high-quality names and tends to offer better downside protection than many large-cap equity funds. This portion of the portfolio also includes a fairly high stake in foreign stocks, which have the potential to add to the portfolio's volatility level, in part because of currency fluctuations. Risk-conscious investors might therefore consider scaling back the foreign-stock portion of the portfolio.

Backtesting The Returns

I began creating sample bucket retirement portfolios—consisting of both traditional mutual funds and exchange-traded funds—in 2012, so they don't have a sufficiently long track record to observe. But at the risk of being accused of data mining, I took a look back at the aforementioned bucket portfolio to see how it would have performed if it had started in 2007, encountered the stress test of the 2008 financial crisis and also enjoyed the subsequent equity-market recovery. The portfolio's heavy equity weighting has been a big help recently as the equity markets have rallied, but the equity-heavy stance also left the portfolio with a big hole to claw its way out of in 2008.

The exercise yielded some encouraging results over this admittedly arbitrary time period. The headline is that from 2007 through the end of 2012, the value of the portfolio was ahead of the starting value, even though our fictitious retiree was also withdrawing 4% of the portfolio, adjusted for inflation, per year. To arrive at those results, we assumed that the retiree periodically peeled back on positions that had appreciated more than 10% from their starting value. We further assumed that the retiree used those rebalancing proceeds to fund living expenses; if additional funds for living expenses were needed (as was the case in 2008), the retiree would withdraw cash from Bucket 1. If proceeds from rebalancing exceeded desired living expenses, they could be used to top up the cash bucket and, if there was any

Six Steps for Successful Bucketing

Step 1. Determine the Paycheck You Need from Your Portfolio

- Total up annual income needs during retirement; subtract steady sources of income such as Social Security or pension payments.
- The amount left over is what you'll need your portfolio to replace.

Step 2. Check Your Withdrawal Rate for Sustainability

- Make sure your proposed withdrawal rate passes the 4% sniff test.
- For someone with an \$800,000 portfolio:
Year 1 Withdrawal: \$32,000;
Year 2 Withdrawal: \$32,960 (assuming 3% inflation).
- Plan to reduce withdrawals in weak market environments.

Step 3. Create Bucket 1: Income Reserves

- Bucket 1 covers one to two years' worth of living expenses.

- Holds ultra-safe investments (CDs, money market funds, etc.).

Step 4. Create Bucket 2: Intermediate-Term Assets

- Bucket 2 holds living expenses for years 3 to 10 of retirement.
- Holds core bonds, TIPS, possibly a conservative allocation fund such as Vanguard Wellesley Income.

Step 5. Create Bucket 3: Long-Term Assets

- Bucket 3 holds living expenses for years 10 and beyond.
- Holds primarily equities as well as higher-risk bond-fund types.

Step 6. Plan Bucket Maintenance

- Plan to re-fill Bucket 1 annually.
- May use a combination of rebalancing proceeds, dividend and income distributions, tax-loss sales, etc.

money left over, it could be plowed into underperforming stock and bond positions.

Of course, there's no guarantee that a bucket portfolio started today will fare as well, particularly given rock-bottom bond yields and the fact that equity-market valuations are nowhere near as attractive as they were following the market crash of 2008. But the results do indicate that holding a well-diversified portfolio, along with a cash cushion, can go a long way toward meeting income needs without forsaking long-term growth.

Bucket Maintenance

The result you achieve with a bucket portfolio will depend on the securities you employ, as well as your approach to bucket maintenance—where you go for cash to meet your living expenses, as well as how you rebalance.

Should you simply transfer money from Bucket 3 (stocks) to Bucket 2 (bonds) to Bucket 1 (cash) on a regular, preset basis? Or should you take a more

eclectic, opportunistic approach, refilling your cash bucket (Bucket 1) with income and dividends from bonds and stocks, rebalancing proceeds, tax-loss harvesting, and so forth? Alternatively, should you take a truly total-return or income-oriented approach to bucket maintenance?

Each of these strategies has its pros and cons, as outlined below. Ultimately, a few of these approaches run counter to the central premises of bucketing and are therefore less than optimal. What I call the “strict constructionist total-return” and “opportunistic” approaches will generally make the most sense for retirees wishing to employ a bucket strategy.

The Mechanical Approach

Under a strategy such as this, a retiree would move assets from Bucket 2 (bonds) to Bucket 1 (cash), and from Bucket 3 (stocks) to Bucket 2 on an annual basis (on some other time-period-based frequency). The entire portfolio would become progressively more conservative as the assets in Bucket 3

are depleted.

Pros: The strategy is simple to understand. And because the equity portion (Bucket 3) is apt to decline as a percentage of the portfolio over time, it reduces risk in the portfolio as the investor's time horizon grows shorter. That's something some—but not all—retirees may find desirable.

Cons: The big drawback to mechanically selling stocks and bonds on a calendar-year basis is that it doesn't take into account whether it's an opportune time to sell a given asset class. For example, someone adhering to a strictly mechanical approach to bucket maintenance would have been selling stocks and bonds throughout the 2007–2009 bear market and moving the proceeds into cash, thereby leaving fewer long-term securities in place to rebound in the subsequent bull market. In this respect, such a maintenance strategy undermines one of the central attractions of bucketing: The cash sleeve is there to keep the investor from selling long-term assets at the wrong time. For that reason, such a mechanical approach

to bucket maintenance isn't advisable.

The Income-Only Approach

Using this strategy, Bucket 1 is refilled with whatever income the cash, bond, and stock holdings kick off.

Pros: Because it doesn't involve tapping principal, this approach guarantees not only that a retiree won't outlive his or her assets, but also that there will be principal left over for heirs or for in-retirement splurges. In addition, an income-centric approach is the lowest-maintenance, as it's easy to automate the income distributions into Bucket 1.

Cons: One of the central attractions of the bucket approach is that it helps a retiree smooth his or her income stream by holding a static amount in Bucket 1, based on real-life living expenses. But by relying only on income distributions to refill Bucket 1, a retiree is apt to find that the income stream varies based on the prevailing yield environment. Moreover, the income-generating securities in a portfolio may not generate a livable yield at various points in time (like right now), leaving the retiree with no choice but to withdraw principal.

The Strict Constructionist Total-Return Approach

Under this strategy, a retiree reinvests all income, dividends, and capital gains back into his or her holdings. The retiree regularly rebalances, periodically scaling back on those holdings that have performed the best, whether they are stock or bonds, to bring the total portfolio's asset-class exposures back in line with targets. (Those targets may gradually grow more conservative over time,

depending on the asset-allocation glide path the retiree is using.) The retiree can use those rebalancing proceeds to meet living expenses, augmenting them with withdrawals from Bucket 1 (cash) on an as-needed basis. (This is the strategy we used in the backtest of our bucketed portfolio outlined above.)

Pros: The big advantage to the total-return approach, in contrast with the one outlined above, is that it's extremely plugged into market movements and valuation, forcing the investor to sell appreciated assets on a regular basis while leaving the underperforming assets in place or even adding to them. An investor using this strategy during the bear market, for example, would have been trimming high-quality bond holdings to meet living expenses and/or to refill Bucket 1, leaving potentially undervalued equity assets intact.

Cons: Rebalancing too often may prompt a retiree to prematurely scale back on an asset class, thus reducing the portfolio's total-return potential. That argues for holding at least two to three years' worth of living expenses in Bucket 1, thereby giving the retiree more discretion over when to sell assets for rebalancing.

The Opportunistic Approach

Under this strategy, a retiree takes a unrestrictive approach to refilling Bucket 1. Income distributions from cash holdings, bonds and dividend-paying stocks are automatically transferred to Bucket 1. If those distributions are insufficient to refill Bucket 1, the retiree can look to rebalancing proceeds, tax-loss harvesting and required minimum

distributions from Bucket 2 and Bucket 3 to top up depleted cash stakes.

Pros: By directing income and dividend distributions into Bucket 1, this approach provides a baseline of income for living expenses. Those income distributions may also trend up in periods of market distress, as yields often move in the inverse direction of prices. That extra income, in turn, could help the retiree avoid tapping principal during a market downturn.

Cons: Because income and dividend distributions aren't being reinvested, the long-term portfolio's total-return potential is apt to be less than is the case with the strict constructionist total-return approach.

Tailor the Strategy to Your Situation

The model bucket portfolio and the strategies presented in this article are less complicated than most retirees' situations, in that most people come into retirement with multiple accounts, both taxable and tax-sheltered. Plus, couples' planning adds even more wrinkles. This means real-life bucket setup and maintenance is going to be more complex than is the case for the single portfolio featured here, owing to asset-location and withdrawal-sequencing issues and the need to take required minimum distributions from tax-deferred accounts, among other considerations. These factors shouldn't deter you from employing buckets in your own retirement distribution plan, but they do mean you should consider your own financial situation when implementing such a system. ▲

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