# Briefly Noted

## Retiree Portfolios and Warren Buffett's Allocation Instructions

Warren Buffett's instructions for allocating the cash bequeathed to his wife are 10% in short-term government bonds and 90% in a S&P 500 index fund. This simple allocation, though aggressive, has historically worked well for retirees who were willing to cope with higher levels of volatility.

Business school professor Javier Estrada tested Buffett's suggested allocation globally using rolling 30-year retirement periods between 1900 and 2014. Because Buffett did not list any specific guidelines for how to implement and follow the suggested allocation, Estrada made a few assumptions. He used a 4% withdrawal rate, with the initial withdrawal rate adjusted upward for inflation. Withdrawals were made proportionately to the target allocation. The portfolios were rebalanced back to the 90/10 allocation after the withdrawals were made.

Failure—defined as outliving one's savings—occurred during 28.1% of all 30-year periods across the 21 countries studied. In the United States, a retiree would have outlived savings during 2.3% of all 30-year rolling periods. (The failure rate was 0.0% for a 60/40 allocation.)

The variance of returns—as measured by standard deviation—increased as the proportion allocated to stocks rose, and fell as the allocation to stocks fell. This implies that a retiree takes on greater wealth uncertainty with a higher allocation to stocks. Nonetheless, wealth at the end of the 30-year periods ("terminal wealth") was highest with the most aggressive allocations to stocks, a finding that held true for both the best and worst 30-year cycles. Though retirees bore greater uncertainty in terms of return with higher allocations to stocks, they were rewarded with higher levels of terminal wealth.

Estrada also tested a modified version of the 90/10 allocation strategy. Withdrawals were made either from stocks or from bonds depending on the five-year annualized return of stocks. If the five-year return of stocks was above the annualized return of stocks from the start of retirement to the current year, withdrawals were made from stocks and the portfolio was rebalanced. If not, withdrawals were made from bonds and the portfolio was not rebalanced. This tweak resulted in volatility and downside risk nearly identical overall to the aforementioned approach, while providing higher terminal wealth during good periods.

*"Global Asset Allocation in Retirement: Buffett's Advice and a Simple Twist," Javier Estrada, SSRN, July 2016.*

## Guidance for Analyzing an Early Retirement Offer

An early retirement offer may be extended to you by an employer seeking to reduce staff. Though the offer may seem tempting, there several factors to keep in mind before deciding whether or not to take it.

The most obvious consideration is the severance package itself. Find out how much additional compensation will be paid. Consider whether or not the amount will be large enough to get you to your planned retirement date or at least large enough to cover expenses until a new job is found. Then look at the payment options. A lump sum provides the most flexibility, while deferred payments reduce the tax impact on a given year.

At the same time, review your current financial picture. Project retirement expenses (adjusting for inflation and taxes) and compare the number against your expected income and projected savings withdrawals. Social Security benefits can help, but claiming early (e.g., at age 62) will result in reduced income for the remainder of your life. If it is not financially feasible to retire early, it may make sense to turn down the early retirement offer. Before doing so, think about the likelihood of maintaining employment at your current employer if the offer is not taken.

If you have not qualified for your full pension benefits, see if the offer includes some type of an adjustment. An employer might add years to your age or length of service to help you qualify for a larger benefit. There might otherwise be a temporary boost to last until Social Security benefits are paid.

Inquire about health insurance. Will your employer continue to offer health insurance? How long will the coverage last and what will be the premiums? If employer coverage is not an option, then COBRA, individual policies and/or coverage through a spouse's plan should be looked into. The lack of good options for medical insurance can be a reason to turn down the early retirement offer, especially for a person who is not old enough to qualify for Medicare.

Then ask about other benefits. Some employers may offer life insurance, financial planning assistance, career counseling, educational programs or even extend the period during which stock options can be exercised.

*Source: "Evaluating an Early Retirement Offer," Captrust Financial Advisers, July 22, 2016.*

## 10 Attributes Great Investors Share

Michael Mauboussin, head of global financial strategies at Credit Suisse, compiled a list of the top 10 attributes he believes the great fundamental investors share. Those attributes are:

**1. Be numerate (and understand accounting):** Great investors are adept at analyzing financial statements to understand how a business has performed and to gain insight into how it may perform in the future.

**2. Understand value:** Great investors focus on both the magnitude and sustainability of free cash flow, including what it says about the current level of valuation.

**3. Properly assess strategy:** Great investors only invest in companies whose business models they can clearly explain and that have competitive advantages that are sustainable.

**4. Compare effectively (expectations versus fundamentals):** The ability to compare fundamentals against expectations and differentiate the two distinguishes average investors from great investors, according to Mauboussin.

**5. Think probabilistically (there are few sure things):** Outcomes largely affected by probability require a focus on how decisions are made rather than just the outcome alone. Realizing how profitable a correct decision is matters more than how many decisions are correct.

**6. Update your views effectively:** Great investors seek information on views different from their own and update their beliefs when the evidence says they should, whereas most people prefer to keep the beliefs constant over time.

**7. Beware of behavioral biases:** Great investors not only understand the impact of heuristics (mental shortcuts) and biases, but take steps to manage or mitigate their impact on investment decisions.

**8. Know the difference between information and influence:** Prices provide indications about expectations for future performance, but they can also be a source of influence—prompting investors to buy out of fear of missing out. Great investors separate expectations and fundamentals.

**9. Position sizing:** Success in investing comes from finding an edge and taking full advantage of it by allocating the proper amount of money to it (position sizing). Most investors do a poor job of position sizing, whereas great investors are more effective at it.

**10. Read (and keep an open mind):** Great investors generally allocate time to reading, read material across a wide spectrum of disciplines and read material they do not necessarily agree with.

*Source: "Thirty Years: Reflections on the Ten Attributes of Great Investors," Michael J. Mauboussin, Dan Callahan and Darius Majd, Credit Suisse, August 4, 2016.*

## Older Adults Place Less Value on Saving

Age impacts how willing a person is to save for the future. Each year a person ages, his or her discount rate—the implied internal rate of return (IRR) required for postponing having the money today—increases by approximately two percentage points.

The high rate of return is based on a module included in the 2014 Health and Retirement Study (HRS). Among the questions asked of randomly selected participants over the age of 70 was how much they would require 12 months from now to postpone receiving $100 today. The average amount required was $154, implying a discount rate of 54%. To put this number into perspective, a 2015 study intended to be representative of U.S. adults found an average discount rate of 29%. Representative studies of Danish and German adults found average discount rates ranging between 28% and 30%.

The higher the required IRR is, the more a person discounts the value of waiting to receive the sum of money until a future date. Put another way, higher discount rates imply a person places less value on forgoing consumption today to have greater wealth tomorrow. Lower discount rates imply a person sees greater benefit from postponing consumption.

David Huffman et al. found common characteristics among older adults who are more willing to postpone future consumption today for greater wealth in the future. One year of additional education reduces IRR by two percentage points. A cancer or heart condition diagnosis raises IRRs by 11 to 15 percentage points. A mental condition diagnosis (dementia or Alzheimer's disease) resulted in IRRs that were 35% higher than average. Wealth plays a role, with those whose IRRs were unusually high (more than one standard deviation above average) having 29% less wealth. Those with higher IRRs were also less likely to engage in healthy behaviors.

Not surprisingly, patience is tied to wealth, with those who were found to be more impatient having less wealth. Those who were classified as being impatient were also less likely to have long-term care insurance, assign a power of attorney, have a living will, or have discussed end-of-life medical plans with others.

*Source: "Time Discounting and Economic Decision-Making Among the Elderly," David Huffman, Raimond Maurer and Olivia S. Mitchell, National Bureau of Economic Research, July 2016.*