Using Cash and Short-Term Bonds to Avoid Taking Losses in Retirement

An Interview With Jane Bryant Quinn

Article Highlights

- A cash bucket exists for safety. It allows a retiree to cover living expenses for the next two years.
- Cash and short-term bond buckets should be replenished when there are profits in the stock and intermediate-term bond buckets.
- Combining a diversified portfolio with a cash bucket allows a retiree to live off of the cash during periods when other investments are showing a loss.

Jane Bryant Quinn is a nationally known personal finance writer and commentator. Her latest book is "How to Make Your Money Last: The Indispensable Retirement Guide" (Simon & Schuster, 2016). In this first part of our conversation, we discussed why retirees should have the equivalent of up to five years of expenses allocated to cash and short-term bond funds.

—Charles Rotblut, CFA

***Charles Rotblut (CR):** In your book, you recommend that retirees consider holding two to three years' worth of expenses in cash. Can you give the rationale for the two- to three-year period?*

Jane Bryant Quinn (JBQ): That comes from financial planners, and it comes from people's feelings of how long they feel they must be safe. It includes income that you're withdrawing from your financial accounts.

You may feel comfortable holding less in cash, but two years seems to be the average amount that retirees feel comfortable with. If the stock market is a mess, the bond market is a mess and you want to feel that you don't have to sell anything to take care of your expenses, two years seems to be a time where you are able to say "I can draw on my cash for two years. I can sit it out, and I will feel comfortable with that."

***CR:** You also suggest holding an additional two years in bonds, correct?*

JBQ: That goes to the safety question. How safe do you feel you have to be? The answer will depend on how large your income is relative to your expenses, as always. The retirees who feel they need to be really super safe might hold three years' worth of short-term bond funds in their bond portfolio. If the stock market goes bad for two years and the bond market goes bad for two years and you still need to make withdrawals, you can take the money out of these short-term bond funds, which don't lose very much in a bad bond market because they are turned over so quickly. This gives you an additional safety source.

To come up with these periods of time, I asked a top investment manager to tell me how long it took for people to recover their money from a market decline. The average was 29 months. The shortest period was five months in 1998. The longest period was 2000 to 2006, a little over five years.

If you want to say "I am absolutely safe for five years; I won't have to sell any stocks or bonds; I'll be fine," then two years' cash and three years' short-term bond funds will cover you for five years and can help you afford to wait for the markets to be good again.

***CR:** In terms of calculating the five years, I'm presuming people should do an inflation-adjusted estimate of their expenses.*

JBQ: Yes. You should be doing that all along. It is how you are looking going forward. Of course, your Social Security benefits are automatically inflation-adjusted. If you are following any of the withdrawal rules of taking X% of your money in the first year you retire, I call it making your homemade paycheck out of your savings. You will also inflation-adjust those withdrawals. So you've got two automatic inflation adjustments working for you.

***CR:** Concerning the cash bucket, any suggestions on what people should use—such as money market funds and accounts or certificates of deposit (CDs)—or is it more just personal preference?*

JBQ: I think it's personal preference. Some people will stay with money markets. Right now, as we talk in March 2016, CDs are paying a little more. But none of them are paying very much. This is a question I get about cash buckets—people say since interest rates are so low, why should I do this? The answer is that the money you set aside for cash is not investment money.

It doesn't matter that you're earning zilch, which is what's going on today. I mean, it may matter in your head that you're not earning anything, but it really doesn't matter in terms of your personal finances. You have that cash bucket for safety. You know you can take care of all your expenses for the next two years. The interest rate is entirely beside the point.

Why do you have a cash bucket? You have it for safety. If safety is not primary in your mind, if something else is primary, then you don't have a cash bucket. You put that money into an investing account instead.

***CR:** Speaking of buckets, do you have a preference for how many buckets people should have?*

JBQ: Well, I think the most common way that people approach bucketing is this: One bucket is a cash bucket, one bucket is a bond bucket and one bucket is a stock bucket. That seems to be a pretty logical thing. A typical split is 60% stocks/40% bonds for the amount of money that is not in your cash bucket. But you do your cash bucket based on the dollar amount you need. I don't think there's a percentage there.

The cash bucket is how much actual money you will need in order to keep yourself safe for the next two years. With the additional money, you can have a certain percentage allocation between stocks and bonds. But whatever your allocation is between stock funds and bond funds, the money for those comes after you've taken the dollar amount out and put it in your cash bucket.

One thing that I keep trying to emphasize is the question of longevity. At 65 years old, you are going to live, both male and female, on average, into your late 80s. So you're looking at a 20- and perhaps 30-year retirement. That means that at age 65, you are a long-term investor. The idea that you should somehow really not hold a lot of stock funds at age 65, but rather have the major amount in bond funds and CDs—I just don't think that's looking at things right.

When you've got 15 or 20 years ahead, what's going to happen to the U.S. economy? It's going to grow. The global economy is going to grow. Stock prices are going to go up over that period of time. If you are trying to grow your money to help finance the second half of your retirement, you need to be substantially in equities and think like a long-term investor. You thought like a long-term investor when you were 40. Well, surprise, you're still a long-term investor when you're 60 and 65.

***CR:** How does someone go about replenishing their cash bucket, or even their short-term bond bucket? Is there a better or worse time to do it?*

JBQ: Well, you try to replenish them when the market is up. When you look at how the stock market grew after the 2007–2008 crash, going up from 2009, eventually you were making money. At that point, you have would started replenishing whatever bucket you had been reaching into. If you had been reaching into your cash bucket, that's when you would have replenished your cash bucket.

It's a little complicated. If you have a manager working for you and you say "that's how I want to approach it," they will do it automatically.

If you are doing it yourself, when you see you have profits, you take some profits out and you put them into your cash bucket first. Then your bond bucket can vary: Maybe the short-term bonds are two years' worth of expenses instead of three years of expenses. Things don't have to happen right away.

In any event, it depends on the tax position of how you're investing. If you're investing with an individual retirement account (IRA), you're perfectly free to move things around. If you're investing in a taxable account, you might not want to take your profits, pay taxes on them and replenish your cash bucket right away. You might want to wait until you have some losses to offset against those profits before you do it.

It's easier to make these moves inside an IRA than outside an IRA or 401(k) retirement plan. You have to pay more attention to what the tax consequences should be. And you can take your time; you don't have to do it overnight. You can let it go for a year and a half, two years, whatever. What I'm saying is that you can do it over time; you don't have to do it instantly.

Part of the cash bucket and bond bucket exists because we're assuming that you're drawing money out of savings. Well, if you are flexible in your spending and you don't have to draw money out of savings in a down year, you don't. So that would make it easier to keep your cash bucket intact.

***CR:** It sounds like you're talking about approaching it more strategically, taking a look at your situation first and then deciding whether now is the ideal time to replenish a bucket or if it would be better to hold off and wait for a more opportune time. If it's a bad period in terms of returns, maybe a retiree should wait six months and then revisit.*

JBQ: The point is that you need to have this plan in your mind. If you're doing it by the seat of your pants and you're trying to keep it all juggled in your head, it gets very confusing. So I'm a huge proponent of writing out a plan, a basic plan. It doesn't have to be very complicated: "This is what I am going to do. This is what my goals are. This is how I am going to arrange stocks, bonds, and cash. This is my philosophy on paying taxes and how I work it out."

If you have that in your desk drawer, then when markets change and you're wondering if you should make withdrawals or postpone doing so, you can refer to what your intention was and what percentages you meant to keep in stocks and what percentages in bonds. That will help you make these decisions. If you're just looking at the screen and saying "maybe I'll do this, maybe I'll do that" without reference to a basic written outline of what you intend, you're much more apt to go off track.

CR: *One of the things you wrote about is never taking a loss in terms of retirement withdrawals. Could you elaborate?*

JBQ: Well, this is a theoretical possibility depending on how the markets go. Let's say you are a bucketer and you have enough money in your cash bucket to cover you for two years. To cover you, by the way, means to fill the gap between your expenses and income from guaranteed sources. So, it's not all of your expenses that you need to cover. You've got Social Security, maybe you have a pension, maybe you have guaranteed income from another source, but there's a gap between that income and your expenses. So in your [cash] bucket is the amount that fills that gap.

You need two years' worth of cash to make sure that gap is filled for two years. So that's there. Then, let's say you have half of your money in stock funds and half in bond funds. You're on a plan where when you first retired or started drawing on your savings, you said "I'm going to take 4.5% in my first year. Each year thereafter, I'm going to take that same dollar amount plus an increase for inflation." That's your plan.

If stocks are doing particularly well, this year I take my money, my 4.5%, out of stocks. If my stocks aren't doing so well, but my bonds are doing fine, I will take my 4.5% out of bonds. If they both are doing very badly, I will take my 4.5% out of my cash reserve. So, in principle, you can get by for at least two years without ever having to sell anything at a loss.

If the bad time goes further than that and you still have your stocks at a loss and your bonds at a loss, at that point you start making your 4.5% withdrawals from your short-term bond fund.

But the idea of having this kind of diversification and having this sort of a plan with that cash reserve is to try to live on your cash during periods when your other investments are showing a loss, and only go back to your other investments once you can take out gains.

How Retirees Can Avoid Booking a Loss

In her book, "How to Make Your Money Last," Quinn presents a strategy that she says "comes straight from the desks of some very smart financial planners." The strategy assumes a retiree has a diversified mixture of assets in savings and retirement accounts, including those that can rise in value and those whose value does not change much in any given year. Such an allocation allows for cash withdrawals to be taken without having to sell securities at a loss.

The example she gives assumes the year end is approaching and a cash withdrawal equal to 4% of the portfolio's value will need to be taken. Four investments are held: a stock index fund, an intermediate-term Treasury bond fund, a short-term bond fund with a large enough allocation to cover two years of planned withdrawals and a cash reserve equal to two years of living expenses.

Here is how the strategy would work:

- **Stocks and bonds both rise in price:** Withdrawals come out of the stock and intermediate-term bond funds.
- **Stocks are up, but bonds are down:** Withdrawals come principally out of the stock fund. If the gain in the stock fund is not large enough to cover the entire withdrawal, the remaining amount is withdrawn from the short-term bond fund or the cash reserve.
- **Bonds are up, but stocks are down:** Withdraw from the intermediate-term bond fund.
- **Both stocks and bonds are down or flat:** Withdraw from the cash reserves; if not enough is in cash reserves, tap the short-term bond fund. Even if the short-term bond fund has a negative return, the loss probably will not be large enough to derail your plan.

CR: *You wrote that you and your husband settled on a 4.5% withdrawal rate. I have, and I'm sure you have too, seen suggested withdrawal rates of 3% and up to 5% and 5.5%. Is there a reason why you picked 4.5%?*

JBQ: I picked that just as a starter. I'm reasonably well diversified, but I think that's pretty conservative. I expect that we will probably go up from there. These 4%, 4.5% withdrawal rates were created to get you through the worst 30-year periods that our history has ever had: the depression of the 1930s; and the stagflation of the late 1960s, 1970s and early 1980s, which was the worst time ever for retirees.

You're withdrawing 4% if you're invested in an S&P 500 index fund or 4.5% if you're invested in both large and small stocks, through, say, total market index funds. But what are the odds going forward of living through another one of the worst 30-year periods that we have ever had? The fact is that we've only had really two awful periods where you had to have that minimum withdrawal rate. So I think my odds, and I think most people's odds, are very good that the 30-year period they are looking at is going to be better than the 30 years of the Great Depression or the 30 years that included the Great Stagflation.

I think 4% and 4.5% are pretty conservative. I started there because I wanted to start in a conservative way. But I think going forward, I might very well increase that. The 5.5% level is one

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education is not only a great investment, but also a great way to perpetuate your extended family's financial success.

- A matched savings program. As many companies do with 401(k) retirement plans, you can promote higher savings rates among your children and grandchildren by establishing a program to match all or part of what they save.
- Compensation for responsibilities as a member of your Family Inc. board of directors. Just as some companies pay for the services of an independent board of advisers, you might choose to compensate family members for actively engaging in family financial meetings and for specific financial management responsibilities such as assisting with tax preparation or managing rental property.
- Capital contributions to heirs based on enhancing desired performance metrics such as income or net worth. For example, one might make annual payments to family members based on a percentage of their earnings or net worth.

No technique is perfect. These, however, are all designed to have the same impact: promote skill development and responsible financial planning and behavior that allows your heirs to not only assume the responsibilities of being the family CFO, but thrive while doing it.

Picking Your Successor

The activities outlined in this article can have a profound impact on your next generation's ability to effectively manage and perpetuate the family resources. However, it also takes willing participants and some level of natural aptitude.

In some cases, family members may not possess that aptitude or interest to develop these skills. As the family CFO, you must be brutally objective about this aptitude and interest. Allocate capital and bequests based on equity and fairness. Allocate control of financial resources and decisions on the basis of capabilities and merit. These two concepts don't necessarily go together. You can allocate your financial resources equally among heirs, but give disproportionate decision rights to heirs or outside advisers with the aptitude and personality to effectively manage, expand and perpetuate your Family Inc.

Your heirs who are not financially astute may thank you in the long run for not simply awarding decision rights by default. And regardless of whether they thank you or not, they will be more financially secure. ➤

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of the favorites for people who are as flexible about spending as my husband and I are.

There are ways it can go higher. If you're older, you might choose to go higher than that. But just remember that this is your plan and the basis is that it gets you through the worst 30 years.

If you say "the odds are I won't have those worst 30 years," then you can go higher. But again, if you go higher, you need to understand why you are going higher and what choices you've made. If you hit a very bad period for five years, as we had overall from 2000 to 2006, then you can cut back on your spending and ride it out for a while—refrain from making withdrawals. And, by the way, I'm sure your members know this, but many people still get confused when you say a 4.5% withdrawal rate. I find that people think that's 4.5% a year; it is not.

If you take 4.5% a year, your income is going to go up and down. The objective of a withdrawal rate is to have a steady inflation-adjusted income that you can budget for. So the 4.5% applies only to the first year you start drawing on your money. After that, you simply increase the dollar amount you took that first year by inflation every year. So after that, the whole 4.5% concept goes away, and you are just increasing your withdrawals by inflation amount.

Now, 10 years down the road, you may say, "I'm living too conservatively. I have a lot more money than that." Then you reset. Or maybe you started a little higher and the market turns out to be a little worse than you had hoped; then you reset 10 years from your retirement date.

The idea is to have that plan that you start with and to, what I call, "right-size your life." This means getting your expenses to a level where you are living within that particular plan you have chosen. You know that you can afford your life, which is a major thing. And once that's done, you can make other choices with your savings and your spending. ➤

See part two of the conversation with Jane Bryant Quinn on investing in retirement in the June AAII Journal.

Jane Bryant Quinn is a nationally known personal finance writer and commentator. Her latest book is "How to Make Your Money Last: The Indispensable Retirement Guide" (Simon & Schuster, 2016). Find out more at www.aaii.com/authors/jane-bryant-quinn.
Charles Rotblut is a vice president at AAII and editor of the AAII Journal. Follow him on Twitter at twitter.com/CharlesRAAII.