

Craig Israelsen Answers Member Questions From His 10/7 Webinar Rebroadcast

On October 7, 2020, we rebroadcast the June 17, 2020, webinar presented by Craig Israelsen titled “Retirement Portfolio Analysis: A Multi-Decade Review,” which features an Excel-based spreadsheet he has developed to test key variables that impact retirement portfolio survival. Viewers submitted a number of questions that Israelsen took the time to respond to. Below are his answers.

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Do you assume dividends and capital gains are reinvested?

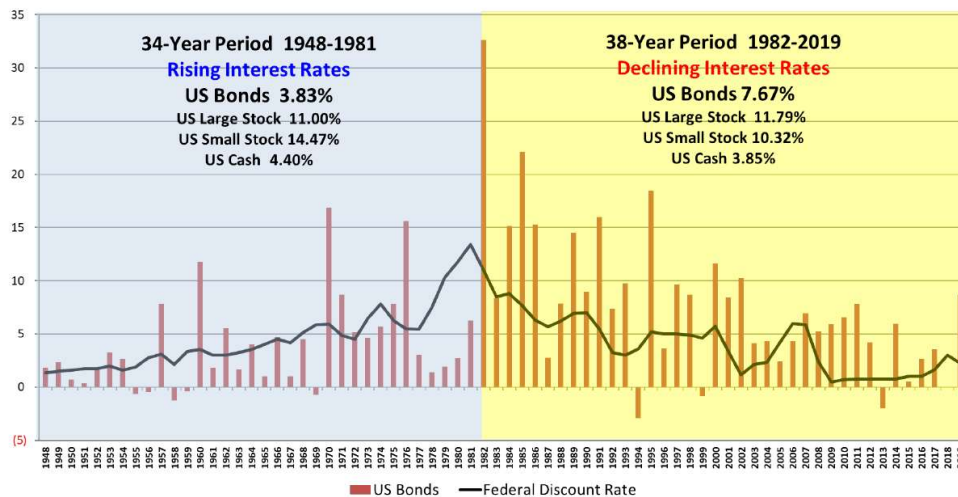
Yes, the index-based returns used in the model are “total” returns which assume the reinvestment of dividends and capital gains.

Please comment on the impaired role of bonds in portfolio construction.

The question implies that bonds will face a headwind in the years ahead when interest rates rise. That is correct. The question is: how bad? As we examine the period from 1948–1981 when interest rates were rising (see blue section of graph below), we observe that bonds produced an average annualized return of 3.83%. Not great, but certainly not a meltdown.

The more recent period from 1982–2019 has generally been a period of declining rates, and bond returns were better. The average annualized return of the aggregate bond index was 7.67%.

The point is that even if bonds only do half as well going forward our diversified portfolio will not be dramatically affected (unless you are 100% in bonds).



What is the return on the cash?

The historical annualized return for 90-day T-bills (cash) is just under 5% from 1970–2019. But the spreadsheet uses the annual return of T-bills as it happened—not the average return.

Does the current live example assume that the \$1 million is in a traditional IRA?

If the withdrawal method was based on the RMD (which is something the user can control), then the answer is yes.

Does the spreadsheet figure in the tax rate you would pay on withdrawals?

Yes, in the analysis engine in the third tab you can input a tax rate on withdrawals.

If you use the required minimum distribution (RMD), you may be taking more than you need to spend. I'm assuming this model assumes that everything is spent, not reinvested.

Correct. And if there is some of the RMD withdrawal that is not needed for retirement expenses, it can be saved or invested in a taxable account. The spreadsheet does not account for that, meaning that your portfolio results will be even better because the spreadsheet assumes none of the RMD withdrawal was reinvested.

If you assume age 62, not 72 or older, the RMD (cell B26) is not an option. Cell B30 must be used for withdraws, correct?

Yes, that is correct. But you actually have two options. You can enter a fixed dollar withdrawal amount in cell B30 OR you can enter a percentage rate withdrawal (such as 3% or 4%) in cell B26 (instead of entering "RMD").

Can I use a flexible withdrawal rate during retirement such as the Yale Endowment or 4% rule?

At present, there is not an option for a dynamic percentage withdrawal rate. However, if you choose a 4% withdrawal rate (instead of the RMD) the dollar amount of the annual withdrawal will be dynamic because the portfolio value is changing each year.

Are inflation changes considered for each of the serial sections? In other words, some periods experienced higher rates of inflation while others didn't? The problem is that you are looking at asset classes that are affected by inflation such as cash, bonds, etc. And I guess the concern is trying to optimize the asset class makeup of the portfolio returns.

In the third tab of the Excel-based spreadsheet you can specify a COLA (cost of living adjustment) that is based on the actual historical rate of inflation (using the consumer price index back to 1970).

A general comment about inflation: In the spreadsheet analysis tool ("35 Lifetimes") the key issue is the ability to observe 26 different 25-year periods between 1970 and 2019 and **the sequence of returns** that took place in each one and how a retirement portfolio held up under various withdrawal scenarios.

Understandably, those returns took place historically and inflation was a factor. However, we are using the spreadsheet tool as a way of examining our own retirement portfolio and all the variables that apply to our own situation (amount of money, withdrawal rate, asset allocation, age, etc.) starting NOW. The spreadsheet allows us to observe best-case scenario, worst-case scenario and average historical performance to give us a sense of how our portfolio might perform going forward.

Thus, historical inflation is not the key issue. Rather, the sequence of returns is the key issue.

And remember, inflation and the U.S. interest rate have about a 70% correlation. When inflation is high, the return of cash is high. When inflation is high, commodity returns are high. There is a relationship between the performance of several asset classes and inflation.

It seems that returns have been decreasing almost steadily in every period starting in 1976. What returns would you assume going forward?

The impact of the tech meltdown that began in the year 2000 shows up in the 25-year period of 1976–2000. Then, the impact of 2001 (another bad year) is incorporated into the next rolling 25-year return. Then 2002. Then 2008. Attempting to estimate returns going forward is not a skill I possess. However, the spreadsheet [showed in the webinar] allows you to lower the historical returns being used to cast a more pessimistic forecast into the analysis.

Have the markets really been that much worse in the last 25 years than before, and does that imply that markets will be more like that sad story in the coming years?

The more recent 25-year periods all incorporate the nasty impact of 2000, 2001, 2002, and 2008—all very rough years for U.S. and non-U.S. equity. Going forward, we can hope that the negative years in the U.S. equity market aren't as bad as in 2008. But that is precisely why we build diversified retirement portfolios that have a variety of asset classes. For example, in 2008 the aggregate bond index had a 5% return and cash had a return of 1.40%.

How do you see investment returns going forward (i.e., what would you use?), versus the historical returns embedded in your model?

That really depends on the asset allocation of your retirement portfolio. Assuming it is a well-diversified portfolio using a variety of asset classes (such as the 7Twelve Portfolio), I believe it's reasonable to assume an annualized return of 6% to 7% over rolling 25-year periods.

Most people will not live to age 97 and most also do *not* have \$1.5 million. Nobody is going to retire in 1975 again!

The starting balance can be adjusted. We will all face sequence of returns risk in our retirement portfolios. Whether our retirement “window” is from 1975 to 2000 OR 2020 to 2040 isn't what we should focus on. The fact is that our retirement portfolios will experience volatility for a variety of reasons. Modeling that volatility is the primary function of this spreadsheet tool.

Can we get a copy of the spreadsheet?

Yes, the spreadsheet is available for \$125 (a 50% discount for AAIL members). You can email me at craig@7TwelvePortfolio.com to place your order.

For the \$125, would the entire workbook with all of these scenarios be provided?

Yes, the spreadsheet has three tabs. Each tab is a separate analysis “engine.”

Can we get a copy of the presentation slides?

Yes, a PDF of the presentation slides is posted at www.aail.com/webinars and at the YouTube link: https://www.youtube.com/watch?v=T7_NrwHkLpw&feature=youtu.be