PORTFOLIO STRATEGIES WORKSHOP

Asset Allocation Strategies for Retirees Who Don't Need Income

By Maria Crawford Scott

Most investors focus their attention on asset allocation strategies to meet a particular goal. But sometimes it is appropriate to step back and rethink one's goals: What—or who—are you investing for?

Retirees With Sufficient Means

Gail and Matthew Lipinski are an older couple who are enjoying their years in retirement.

Matthew is 74 and spends a considerable amount of his time managing their investment portfolio. Gail, 69, is an avid gardener, and not at all interested in investing. They have three grown children, with whom they are very close, and four grandchildren.

While the Lipinskis are not rich, they are well-off. Both Matthew and Gail receive inflation-indexed pensions, and when combined with their Social Security benefits, they have enough income to meet all of their annual needs.

They do, however, have a fairly sizable savings portfolio (see Table 1). Almost half of the portfolio is invested in individual stock holdings of all sizes—small-cap, mid-cap and large-cap. They also have some assets in mutual funds to invest internationally, an area in which it would be difficult to enter using individual stocks. About 30% of their savings is invested in a tax-exempt municipal bond fund. Matthew also uses a tax-exempt money market fund for their cash portion, which provides liquidity should they need to raise funds at an inopportune time.

With about 60% of the total portfolio invested in the stock market, their portfolio is relatively typical for a conservative retired couple.

But Matthew has been reconsidering their current asset allocation strategy. First of all, he has started to worry about the large percentage of their portfolio that he invests in individual stocks. While Matthew has done well investing on his own, he knows that Gail would not be able to manage the stocks if something were to happen to him, and none of their children know much about investing in individual stocks.

For that reason, he has decided to gradually reduce the size of his individual stock holdings, and to concentrate his efforts primarily on the small-cap area where he feels his skill can most easily find value.

Secondly, Matthew has been rethinking their commitment to fixed income. When they first agreed upon their asset allocation commitment, they were newly retired and uncertain of their retirement income needs. They knew their pensions and Social Security would provide the bulk of their income, but they did not know how much of their savings they would need to draw upon for supplemental income, so tempering the volatility of their savings portfolio was a large concern.

But the Lipinskis have been in retirement for some time, and are much more certain of their income needs. Their expenses have actually gone down in recent years as they stopped traveling and simply spent more time at home and visiting their children. In addition, their house is fully paid, with no mortgage; the pensions are joint and survivor, so if one of them were to die, the other would still have sufficient income; and aside from Medicare, they have health insurance from Matthew's last employer.

The asset allocation decision is primarily a function of return needs (income or growth), time horizon, and risk tolerance. With no real income needs and a very long-term time horizon, their asset allocation primarily comes down to a question of risk tolerance. And Matthew is not bothered by short-term fluctuations in the portfolio's value.

At the same time, Matthew has taken a step back and re-examined their goals. With most of their short-term and long-term needs fulfilled, who are they really investing for?

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One thing is for sure—they aren't investing for the government, and the Lipinskis have already put their financial house in order to protect their assets against estate taxes; their wills are updated regularly.

But as far as investing the assets are concerned, Gail and Matthew agree that they are now primarily investing for their children, to whom they plan to leave their estate, and in some ways for their grandchildren.

With that in mind, Matthew began to consider what, perhaps, may be the needs of his children. Are there any investments he could make on their behalf now? Of course, when the children do inherit the assets they will receive a stepped-up basis, and at that time they can either keep the securities or sell at little tax cost. But the Lipinskis' children may also benefit now by being able to incorporate their probable inheritance into their own asset allocation strategies.

Matthew only has a rough idea of his children's savings portfolios, and he doesn't want to pry too much into their finances. Their oldest daughter is 39, with two children of her own who are nearing college age. Her family has savings, including assets in retirement accounts, but some of that will be drawn down as the kids enter college.

Their middle daughter is 34 years old, with two younger children, ages 8 and 9. Right now, savings are relatively low, and most of it is going toward building up an educational fund for the kids when they get older.

Their youngest son has been more unsettled, but eventually went to business school and has just started work this year. He is still paying off loans for his schooling, but he would also like to take advantage of his company's 401(k) plan, which unfortunately has only one stock investment option, in company stock.

Matthew decides that the best allocation for all of the children in general would be one that is more heavily invested in a diversified portfolio of stocks, including both aggressive growth stocks and conservative large-cap stocks. And he feels that mutual funds would be the best route, given his concerns about the ability of his survivors to manage a portfolio of individual stocks.

Although these assets aren't actually in his children's portfolios, they can be taken into consideration in their own asset allocation strategies. The two daughters would then be assured of equity participation at a time when they may be investing their own funds in short-term fixed-income in preparation for tuition payments.

Table 1.
The Lipinskis' Investment Portfolio and Asset Allocation

Holding		Current Value		Value After Changes**
Index Fund	Large-cap	$ —	Add from other sales & reinvestments	$ 325,000
Aggressive Growth Fund	Small-cap	—	Add from other sales	70,000
Individual stock holdings	Large, mid & small*	405,000	Sell over time, retain small- & mid-caps	175,000
International Fund	International	60,000	No change	60,000
Emerging Market Int'l Fund	International	25,000	No change	25,000
Municipal Bond Fund	Bond	245,000	Sell over time; reinvest income in index fund	80,000
Tax-Exempt Money Market Fund	Cash	80,000	No change	80,000
	Total	**$ 815,000**	**Total**	**$ 815,000**

* *60% large-cap before change; primarily small & mid-cap only after change*
** *Assumes no growth over time for illustration purposes*

Asset Allocation

Asset Class	Current Allocation (%)	Allocation After Changes (%)
Large-Cap Stocks	30	40
Small- & Mid-Cap Stocks	20	30
International Stocks	10	10
Stocks (Total)	60	80
Bonds	30	10
Cash	10	10
	100	100

And their son would be provided with stock diversification, reducing the risk of his single-stock 401(k) plan.

Gail agrees with the change in strategy, which they then discuss in general terms with their children.

With the new strategy decided upon, Matthew will gradually change the portfolio over time. Income from their tax-exempt bond fund will be reinvested in a large-cap stock index fund and shares in the tax-exempt fund will be gradually sold. In addition, he will gradually reduce the size of his individual stock holdings. Currently, he holds 20 different stocks and typically replaces about four or five stocks each year as they either reach their potential or become disappointments that he no longer wishes to own. Now, however, instead of replacing the large-cap stocks he sells, Matthew will reinvest the proceeds in the large-cap index fund and an aggressive growth fund.

Table 1 depicts the new asset allocation; the target value dollar amounts only illustrate the change in strategy and do not reflect any growth in the portfolio over time. Their new strategy reduces their bond holdings to 10% and raises their stock holdings to 80%, with the remainder in cash. This allocation is more typical of younger investors, reflecting the Lipinski's new goal of investing primarily for their children.

What's Your Goal?

How do you invest your assets if you are retired and have no real short-term or long-term income needs?

Here are some thoughts to keep in mind:

- Estate planning, of course, is a major concern for those with large amounts of accumulated assets. But assuming you have a properly drafted and uncomplicated estate plan, your concern may simply boil down to a question of asset allocation strategy. And to determine an appropriate asset allocation strategy, you need to ask yourself: Who are you investing for?
- Your goal may be simply to leave as much as possible in your estate, whether it be left to children, other relatives, a charity, or whatever. If that is the goal, then the appropriate asset allocation would be determined primarily by your tolerance for risk—how much do you mind seeing your portfolio fluctuate in value?
- Another approach would be to incorporate some of your heirs' needs into your current allocation strategy. While the actual assets remain in your control, your heirs can take the inheritance into consideration in their own asset allocation strategies, providing them with more diversification and flexibility. The extent to which you do this, of course, will be based on highly personal family decisions. Some families would prefer less input and discussion from heirs, while others may prefer to share the approach in greater detail.
- If the strategy results in a need to change your allocation, remember to follow the rules when any change occurs: Make the changes gradually over time, and make the changes in such a way as to keep taxes and transaction costs to a minimum.
- Give some thought to the types of assets your heirs and survivors would be able to manage on their own. Mutual funds, for example, are easier to manage than a portfolio of individual stocks, which demands more investment knowledge, time, and interest. Although inherited assets receive a step-up in basis and could be sold with little or no tax consequences, individuals with inadequate investment knowledge are often reluctant to do so without seeking help from a third party, who may or may not provide good advice.