Asset Allocation Strategies During Retirement

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People accumulate money during their working years for retirement, usually in a portfolio of investments. We call these “Accumulation” portfolios.

After retirement, if periodic income is required from these savings, we call these portfolios “Distribution” portfolios. Academics, advisors and investors are continuously searching for techniques and strategies that stretch the portfolio longevity and increase the chances of collecting a lifelong income from the portfolio.

There are two different areas to focus on to improve portfolio longevity:

- Assets: These involve different asset allocation techniques
- Cash Flow. These involve reductions or limitations of withdrawals during periods of adverse portfolio performance

In this article, we will look at the different asset allocation strategies. In the near future, we will look at cash flow techniques.

Popular asset allocation strategies are: Strategic Asset Allocation, Age Based Asset Allocation, Tactical Asset Allocation and the Trend Following Asset Allocation.

Strategic Asset Allocation: Strategic asset allocation is the most popular investment strategy in the financial industry. Followers of this strategy decide on a suitable asset mix of different asset classes (typically equity, bonds, real return bonds and cash) and maintain this asset mix over time. As asset values fluctuate over time, we sell some of the appreciated assets and buy more of the less-appreciated asset class. This is called “rebalancing”. My earlier article of February 2004 was about the optimum asset mix. My April 2004 showed how often the portfolio should be rebalanced based on market history since 1900. You may want to revisit them for further details.

In **Age Based Asset Allocation**, the amount allocated to equities is based on the client’s age. The premise of using this model is “as the retiree gets older, his portfolio should be more conservative”. For example, one might say: “In my portfolio, 100 minus my age is the percentage of equities”. If you are 85 then 15% of your portfolio is allocated to equities (100 minus 85). The problem with this strategy is, as you get older more of the assets are placed into fixed income. Thus, the portfolio’s ability to participate in a secular bull trend diminishes when it is most needed, in later years. In the long term, it does not provide a significant improvement over strategic asset allocation.

Tactical Asset Allocation is based on the premise that growth rate of equities eventually reverts to its historic mean. It assumes that markets move at random, piggy-backed onto the average historic growth rate. The portfolio starts with a base asset allocation such as 60% fixed income and 40% equity. At the end of the year the portfolio is reviewed: if equity markets did well in the preceding year, then fixed income is increased to, say, 75% to make the portfolio more defensive in the current year. If the equities lost money in the preceding year, the equity allocation is increased from 40% to, say 60% to make it more aggressive this year. The problem with this strategy is that it ignores the existence of secular trends. In a secular bull trend, which may last as long as 20 years, you may be sitting in a defensive position and miss all that growth. This is definitely not good for client retention.

Trend Following Asset Allocation is the exact opposite of tactical asset allocation. Its proponents believe that, once a trend is set in motion, it will continue until it changes its direction. If markets are trending up then an aggressive posture is taken, such as 70% equity and 30% fixed income. If the trend is down then a defensive posture is taken, such as 40% equity and 60% fixed income. The motto is “the trend is your friend”. It sounds fine in theory but there is a problem: Annual review of your clients’ portfolios is not good enough. Trend analysis works only if you watch markets constantly (e.g. weekly) and with great discipline. With reviews only annually, this strategy produces the worst results. In secular sideways trends, you lose money most of the time.

Example: Sam is 65 and retiring now. He needs $20,000 annually from his portfolio each year, indexed to inflation. His total retirement savings are $360,000. Which asset allocation strategy works best?

Figure 1 shows Sam's portfolio value if you plug these figures into a standard retirement calculator, with an assumed average annual growth rate of 7% and inflation of 3.5%. It projects that Sam's portfolio will not deplete until he is 95 (Year 30), as shown with the orange line.

Figure 1: Projection of Sam's retirement assets using a standard retirement calculator

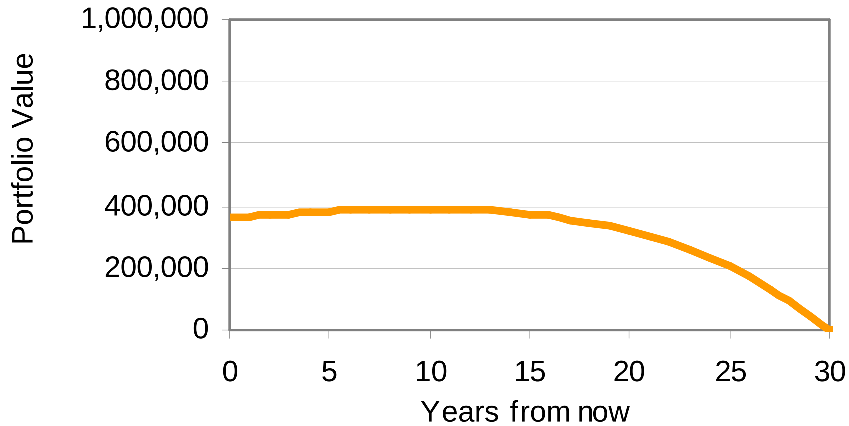


Figure 2 shows the reality based on market history for the Strategic Asset Allocation. History shows that most portfolios would have run out of money before the 24th year. The probability of running out of money was 19% by year 20 and 69% by year 30.

Figure 2: Projection of Sam's retirement assets using Strategic Asset Allocation and market history

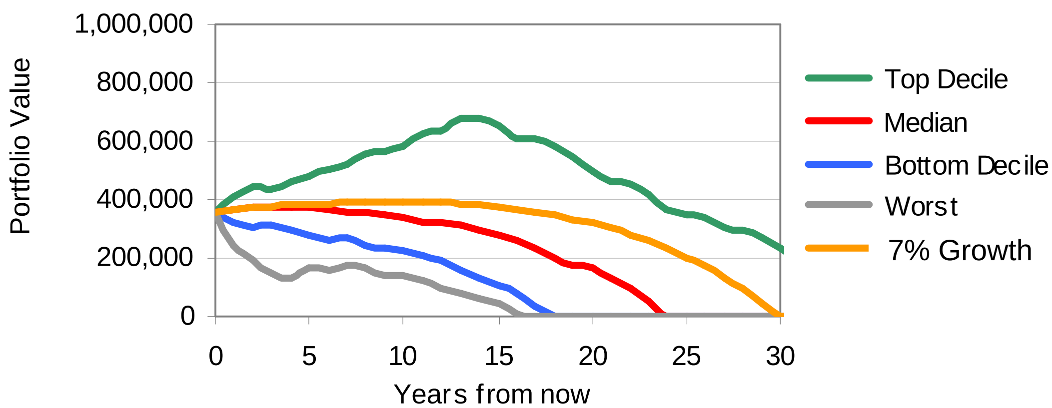


Figure 3 shows the reality based on market history for the Age Based Asset Allocation. In this case, 100 minus Sam's age was used as the percentage of equities in the portfolio. History shows that most portfolios would have run out of money before the 24th year. The probability of running out of money was 15% by year 20 and 75% by year 30.

Figure 3: Projection of Sam's retirement assets using Age Based Asset Allocation and market history

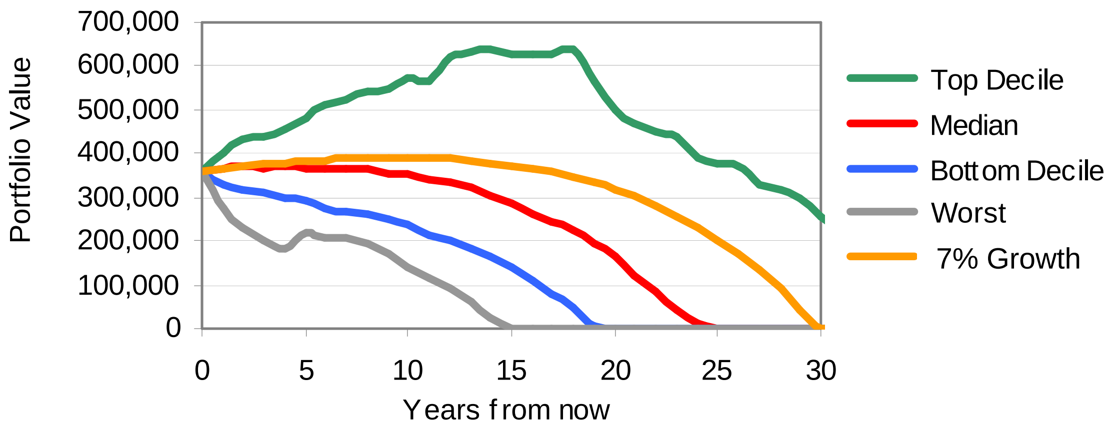


Figure 4 shows the reality based on market history for the Tactical Asset Allocation. History shows that most portfolios would have run out of money before the 26th year. The probability of running out of money was 7% by year 20 and 64% by year 30, a slight improvement over the Strategic Asset Allocation

Figure 4: Projection of Sam's retirement assets using Tactical Asset Allocation and market history

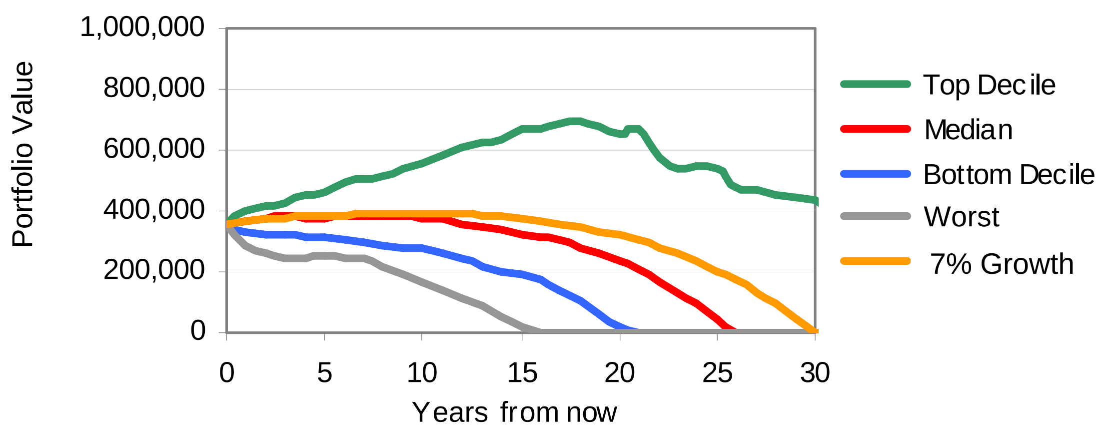
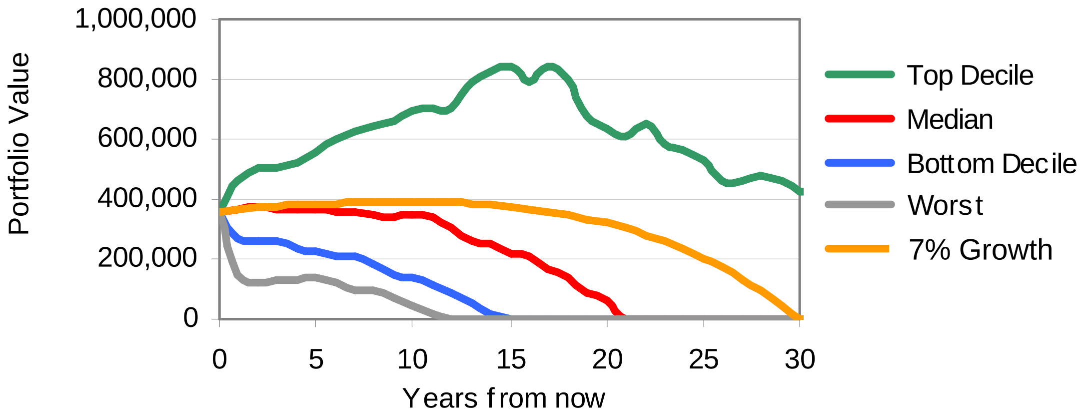


Figure 5 shows the reality based on market history for the Trend Following Asset Allocation. History shows that most portfolios would have run out of money before the 21st year. The probability of running out of money was 40% by year 20 and 68% by year 30.

Figure 5: Projection of Sam's retirement assets using Trend Following Asset Allocation and market history



Every so often, I come across a study that describes a novel strategy that claims; "Only if you do this and that, then your portfolio should last a lifetime". These claims generally involve one or more of the asset allocation and/or cash flow strategies. Some of them use market data covering only a short time period. Some use faulty assumptions. Some are too complicated to apply to client portfolios under current regulatory rules. As intriguing as they may sound, they cannot solve portfolio longevity problems without severe reduction and/or interruption of withdrawals during retirement.

My observation is that the strategic asset allocation, combined with optimum rebalancing and effective asset selection, is the most effective technique among these four. It is easy to explain to clients and it is easy to follow up. As simple as it is, it beats all other techniques. Next time your client challenges you with one of these asset allocation techniques, you will know how to respond with history on your side.

Jim C. Otar, CFP, CMT, BASc, MEng, is a certified financial planner, financial writer, market technician and a professional engineer. He is the author of "High Expectations & False Dreams – One Hundred Years of Stock Market History Applied to Retirement Planning". His articles are published in various magazines in Canada, U.S. and Australia. He won the prestigious CFP-Board Award for 2001 and in 2002 for his articles, the first Canadian to win such a prestigious award.