



How Much Should Retirees Allocate to Stocks?

By Elaine Floyd, CFP®

In determining the best ways to diversify your retirement portfolio, you need to change the inputs, look at the income streams, and decide what trade-off to make between inflation and market risk. There are no easy answers.

Conventional wisdom states that investment habits should change in retirement. Once you shift from the “accumulation phase” to the “distribution phase,” you presumably have everything you’re ever going to have, so the goal now is to make those assets last as long as you live, while generating an income along the way.

Let’s start with the assumption that stocks carry market risk and bonds carry purchasing-power (or inflation) risk. Here we’ll discuss some major technical points to touch on in conversation with your advisor. The central question you’ll need to address is: What is your ideal asset allocation between stocks and bonds?

IT’S NOT YOUR FATHER’S ASSET ALLOCATION

It wasn’t so long ago that the standard practice for advisors was+ to subtract their client’s age from 100 and put that amount in stocks. So the recommendation for a 60-year-old was to put 40% in stocks and 60% in bonds; for a 70-year-old, 30% stocks and 70% bonds. During the bull market of the late 1990s, that advice even seemed a little too conservative—the market risk we normally associate with equities was so imperceptible at the time that it seemed nonexistent.



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Then the market turned, portfolios started to lose value, and retirees became extremely nervous. With no income outside of that generated by their portfolio, they had no way to make up for those losses. Many got out of stocks entirely. These defectors didn't care about inflation risk—they just didn't want to lose any more money.

So then the question arose: was the entire approach flawed? Should the asset allocation be viewed differently depending on whether the investor is still working (accumulating) or in retirement (withdrawing)?

John Rekenenthaler, an investment manager and Morningstar Inc. research director at the time, published an excellent article on this subject, "Meeting the Needs of Retirees: A Different Twist on Asset Allocation," in the January 2000 issue of the *Journal of Financial Planning*. Among his points:

A longer time horizon usually reduces risk because it means there is more time to make up losses caused by volatility. But for retirees, time is an enemy, not a friend. The longer the time horizon, the greater the probability that they will suffer the ultimate failure: the loss of all their assets. This would suggest that a person who retires at 55 needs to be even more conservative than an 80-year-old who has less time for the various risks to chip away at the value of his portfolio.

To an accumulator, it doesn't matter if returns are clustered at the beginning of the period or the end; the accumulator cares only about the final results, not the ride along the way.

But to a living, breathing retiree, the timing of returns can be of greater importance than their absolute level. According to one study, a hypothetical client who retired in 1968 with \$250,000 and withdrew 8.5% per year would see his assets last 30 years if returns were averaged smoothly over the years. But an actual client who lived through that market period would have run out of money by 1981. This is because the poor returns for that particular period came up front, depleting the asset base too soon.

Rekenenthaler points out that computing power now can process hordes of simulations that help shed light on asset allocation and withdrawal rates for retirees. Let's look at some common-sense considerations.

CHANGING THE INPUTS

During your earning phase, the goal is the lump sum that will be needed at retirement. But that's really only the first phase of the overarching goal of being able to withdraw the needed income during retirement and ensure that those assets last

a lifetime (and beyond, if you wish to leave a legacy to heirs or to charity). Before retirement, the primary asset allocation considerations are:

- The amount being saved
- The rate of return
- The length of time between now and retirement
- The number of years in retirement
- Your own psychological tolerance to risk (how much volatility will cause you to lose sleep at night)

After retirement, the considerations become:

- The amount of annual income needed
- The size of the asset base
- The rate of return on invested assets
- Life expectancy

Risk tolerance is also important, but in retirement it is not measured by your personal level of risk-aversion. At that point the real risk lies in the likelihood that you will run out of money. When stated this way, every retiree's risk tolerance is zero.

ISSUES TO PONDER

What makes asset allocation in retirement such an individual matter is that the ultimate risk—that of running out of money—is different for everyone. That's why it is so essential to get qualified, personalized financial planning advice rather than turning to some one-size-fits-all model portfolio that does not consider other income sources you may possess. Typical prescribed models for current retirees allocate 20% to 40% to stocks. This could be too much or too little when other variable assets are taken into consideration.

Here are some issues to ponder when figuring out an asset allocation strategy with your advisor:

Find and value all the assets. A mistake the financial community tends to make is basing allocation planning on the pool of financial assets available for investment. But Social Security, pension income, annuity income, and income from work should also be considered part of the mix—we can call that the "expanded portfolio."

If your income is certain to continue for life (Social Security, pension, annuity), the income stream itself could be considered an asset, similar to a bond. The value of this

“bond” is the present value of the future income stream. For example, a monthly pension of \$3,000 per month (\$36,000 per year) has a present value of \$622,513, assuming a 4% discount rate and 30-year time horizon. The present value of Social Security benefits for a high-income person who was born in 1950 is \$572,000 for men and \$683,000 for women.

If the income is less certain (income from work), you should probably not count it at all. In fact, it might be safer to assume it will stop at some point and will need to be made up from other sources.

Identify the trade-offs. In addition to valuing the income as an “asset,” it is also advisable to consider whether it includes an inflation adjustment. If not, you will need to make larger withdrawals from your investment account in the future, and this will influence the decision of where you will ultimately place your assets. The main purpose of investing money in stocks is to grow the portfolio for when higher withdrawals become necessary. Advisors typically recommend taking on market risk to soften inflation risk.

But what if you have more than enough assets to cover the inflation risk? If you have no need to assume market risk, it could be argued that the allocation to stocks could be as low as zero.

On the other hand, it could also be argued that extra assets beyond the amount needed to ensure the inflation-adjusted income stream (plus any legacy goals) could be allocated to virtually any category because they won’t ever be needed. So if you do have enough assets to ensure a lifetime of inflation-adjusted income, it almost doesn’t matter how much you allocate to stocks.

In this scenario, you might establish additional goals with your advisor, such as contributions to charity, and base your asset allocation decision on them.

Having less wealth presents a real conundrum. Inflation risk, if ignored, can virtually assure the depletion of your asset base. In other words, if you can only eke out enough income to meet today’s living expenses, there’s sure to be trouble 10 or 20 years from now. A high allocation to bonds can therefore be a very risky strategy. But any amount allocated to stocks in an attempt to mitigate inflation risk is subject to market risk. This strategy could also deplete your assets, although the risk is not as certain.

NO EASY SOLUTION

This conundrum should be dealt with as an evaluation of whether you’ll have enough assets (including Social Security and pension) to ensure adequate inflation-adjusted income to age 95.

Because of these uncertainties, there is no clear answer as to how much you should invest in stocks. It may simply come down to preference—to what degree would you rather face inflation risk and have to lower your standard of living versus assuming market risk and possibly depleting your portfolio too soon?

Not a very pleasant choice, but it’s a scenario you need to consider in investing your assets over your retirement. Hopefully, you will never have to make that kind of decision, but it’s always good to explore all the possible outcomes and position your assets to achieve your long-term retirement goals.

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