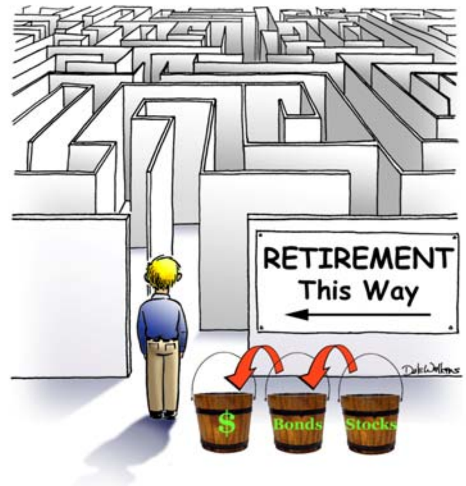
Reprinted from the
Lexington Minuteman

COROMANDEL WEALTH MANAGEMENT

November 2011

Market Making You Nervous? Use "Buckets"

Navigating the Retirement Maze



Retirement should be a time when you reap the fruits of a lifetime of hard work, disciplined saving, and wise investing. Anxiety about the daily fluctuations of the stock market can detract from this. However, volatility is a byproduct of investing in stocks and bonds, a necessity if you want your portfolio to keep pace with inflation. Thus, the challenge is to structure your investments to take advantage of market gains over time, while not losing any sleep.

One approach to retirement asset management that accomplishes this is referred to as the "bucket strategy." It can help reduce your market angst, while providing for long-term growth of your portfolio.

The Problem with Retirement Assets

Once your work career has ended and the retirement phase of your life has begun, you only have two or three sources to fund your living expenses: a pension (should you be fortunate enough to have one), Social Security, and your investment portfolio. The single biggest concern of retirees is: *"Will I outlive my assets?"*, which is why it's natural to be worried when your portfolio decreases in value.

Another problem is the need to sell stocks or mutual funds to pay for living expenses when the market is down. This forces you to liquidate assets when they are at a low valuation, sacrificing future gains when the market eventually recovers.

Bring on the Bucket Brigade

There are many approaches to managing retirement asset withdrawals. One that addresses the concerns outlined above is referred to as a "bucket strategy," also called "pooling." It separates longer term investment assets from more stable assets that can be tapped regularly for living expenses. While there are many different implementations of "bucketing" among investment advisors – one in four uses some version of this for their retired clients – here is one example of how a bucket strategy could be implemented:

- Bucket #1: 2 years' worth of living expenses held in low volatility "cash-like" assets (cash, money market, short-term bond funds) – around 8% of total investment assets.
- Bucket #2: 5 years' expenses held in medium volatility assets (CDs, intermediate term bond funds and individual bonds) – about 20% of assets.
- Bucket #3: Remaining assets in a diversified portfolio consisting mainly of stocks with some alternative assets (REITs, commodities, etc.) – 70-75% of assets.

The procedure for managing these "buckets" is as follows:

1. Make sure that the overall portfolio is adequately diversified among asset classes and has a long-term growth potential of at least 4-6% per year.
2. On a monthly basis, move one month's worth of living expenses from Bucket #1 into your checking account.
3. Once a year, sell assets equal to one year's worth of living expenses in Bucket #2, and transfer the proceeds to Bucket #1.
4. In Bucket #3, opportunistically sell specific assets when they have appreciated significantly (i.e., "sell high"), and hold the proceeds in medium volatility (i.e., Bucket #2-type) assets.
5. Every two years, move two years' worth of medium volatility assets from Bucket #3 to Bucket #2.

By using cash-equivalent assets for living expenses, there is no "selling low." The overall growth of your portfolio – all three buckets together – should return 4% to 6% per year on average, sufficient to keep pace with inflation. And because the more volatile longer-term assets do not need to be sold when the market is down, your portfolio can better weather the fluctuations inherent in stocks and alternative asset classes by taking advantage of the long-term growth of these asset classes. So even if the market has a down month or year, you can sleep peacefully with the knowledge that you won't have to sell at market bottoms.

Other Retirement Asset Issues

The bucket strategy is one alternative to handling allocation of retirement assets. What this strategy does not address, though, is the specific mix of assets that you need, nor the rate of withdrawal from your portfolio that ensures you don't run out of money before you run out of time. I'll be addressing these topics in future columns.

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