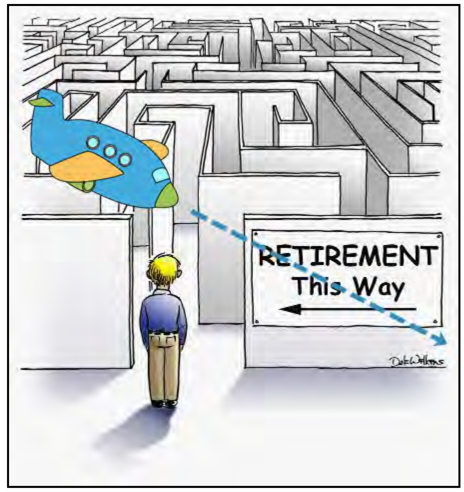
Reprinted from the
Lexington
Minuteman

CWM
COROMANDEL WEALTH MANAGEMENT

March 2014

How safe is your "glide path"?

Navigating the Retirement Maze



Target date funds (TDFs) have become increasingly popular in recent years. 41 percent of 401(k) plan participants owned TDFs at year-end 2012, compared to 19 percent in 2006, according to the Investment Company Institute. With the growth of TDFs, a new phrase has entered investing vocabulary: "glide path." Briefly, it is the rate at which a particular TDF or portfolio decreases equity exposure as the owner approaches retirement, thus "gliding down" to less equity and, therefore, lower risk.

The fund families that manage TDFs each have their own interpretation of what constitutes an ideal "glide path." Individuals who self-manage their retirement portfolios define their own. Recently, many investors have become emboldened by the upward trend of the stock market over the past several years, and increased their equity allocation to 80 percent or more in the hope of greater gains.

So why does your "glide path" matter? Most investors know that holding a higher percentage of equity will result in better returns over the long run. However, increased equity exposure creates an elevated risk of loss in any given year, and therein lies the dilemma. Balancing portfolio return versus risk is one of the basic tenets of retirement investing: You need those higher returns from equity, but with a tolerable level of downside risk. Your portfolio's "glide path" is a key determinant of both potential return and magnitude of loss.

Too much equity = a bumpy ride

The primary financial goal of retirement is simple: Ensure that your money lasts longer than you do. So during your working years you regularly stash away a significant percentage of your paycheck, and watch your nest egg grow. By your retirement date, you've amassed a $1 million portfolio.

Suddenly, you get hit with two years of bad returns. (Think 2001-02 and 2007-08.) If Year 1 socks you with a loss of 25 percent and Year 2 follows with a 20 percent drop, your $1 million nest egg is now down to $600,000, a loss of 40 percent. With your savings now replacing your pre-retirement salary, you're spending down a significantly diminished portfolio. Welcome to "sequence risk," where bear markets at the wrong time can have a devastating effect on equity-heavy retirement portfolios.

Think of it this way. A 26-year old with a $20,000 retirement account could take a 40 percent hit, and still have another 40-plus years of contributions and market growth to more than recoup that $8,000 loss. The new retiree, however, has lost $400,000, and is forced to fund living expenses from significantly reduced assets. Each dollar spent is a dollar that won't be there to grow when the market recovers. Outliving your assets is now a real concern.

Turbulence ahead

Markets periodically undergo significant corrections. Given that the S&P 500 has risen 170 percent since bottoming five years ago, and the bond market has had an exceptionally strong 30-year run, a significant pullback in both asset classes wouldn't be unexpected. In fact, we're about due for a major correction. So if you're nearing retirement or recently retired, a stock-heavy portfolio could be hazardous to your retirement wealth.

An approach to weather most storms

Unless you're a very wealthy retiree, an all-bond portfolio won't grow enough to support a 30-year retirement. You need some equity exposure. But stocks have a greater risk of loss, so what's the best compromise?

Recent research by Michael Kitces and Wade Pfau (2014) offers an interesting alternative. They found that starting retirement with a 20 to 30 percent allocation to stocks, and then increasing stock ownership by 1 to 2 percent each year, resulted in a higher likelihood of not outliving your assets than using a fixed or decreasing equity allocation during retirement. In aviation "glide path" terms, it's like getting closer to the ground at retirement than originally planned, but then adjusting the wing flaps to start gradually heading back up.

By reducing portfolio risk early in your retirement when your assets are at a peak and you have thirty or more years of living expenses to fund, severe market downturns will inflict less damage. A loss when you're 85 is less of a problem because of your shorter life expectancy at that age. This is similar to the "bucket strategy" – drawing spending from a cash bucket, and thus not having to sell equities in a down market – that I described in my November 2011 column.

Stay flexible: alter your flight plan

The thing about crises, both financial and personal, is that they're hard to schedule. Manage your "glide path" for both safety and longevity, but also tailor your discretionary retirement spending to account for market performance, both up and down. Make sure that you pay for your "wants" from what you can safely spend, and not risk outliving your savings.

George Gagliardi is a fee-only financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*