EVERGREEN WEALTH SOLUTIONS®

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ASSET ALLOCATION

Projecting a Glide Path

Asset Allocation In Retirement

The classic image of retirement investing is that of a retiree putting 100 percent of his or her assets into bonds and clipping coupons from those bonds for income payments. That image goes back to when bondholders had to physically cut coupons off of bond documents and submit them to the issuer to receive the interest that a bond paid.

Just as the days of clipping coupons are long gone, so is the idea that bonds alone constitute a complete retirement investing strategy. Asset allocation--the process of dividing up your portfolio among stocks, bonds, cash, and possibly other types of investments--accounts for most of the ups and downs of a portfolio's returns. That's just as true for your retirement portfolio as it was during the years you've spent trying to build those assets. That means the need for proper asset allocation doesn't stop when you retire. After all, it's possible you could spend roughly as long tapping your nest egg as you've spent creating it.

However, an asset allocation strategy for your portfolio in retirement may be somewhat different from the one you used when saving for retirement. During the accumulation years, you may have made fewer demands on your portfolio. Your task was relatively simple: try to increase the value of your nest egg while minimizing the risk you took trying to reach your savings goal. As a result, your asset allocation may have been focused on long-term growth.

But when you reach retirement, your priorities for and demands on your portfolio are likely to be somewhat different. For example, when you were saving, you may have focused on average annual returns; as long as you were earning an acceptable average return, you may have been happy. However, if you're now planning to rely on your savings to produce an income, the consistency of year-to-year returns and your portfolio's volatility may assume greater importance.

Balancing the need for both immediate income and long-term returns can be a challenge. Invest too conservatively, and your portfolio may not be able to grow enough to maintain your standard of living. Invest too aggressively, and you could find yourself having to withdraw money or sell securities at an inopportune time, jeopardizing future income and undercutting your long-term retirement income plan. Like Goldilocks, you want to get it just right.

One of the many reasons long-term asset allocation planning in retirement is important is that you may have less time to recover from a market downturn. When you're saving for retirement, you may be able to offset the impact of a loss by increasing the amount you save, or simply waiting for a turnaround. If you're relying on the proceeds of your asset allocation process to provide you with living expenses--whether day-to-day, predictable ones, or unexpected life events--you may have less flexibility to adjust your asset allocation to cope with market fluctuations. A market loss that's disturbing when you're years from retirement can be devastating if it occurs when you're on the verge of retiring or recently retired. Asset allocation alone does not guarantee a profit or ensure against a loss, but it can help you manage the level and types of risk you take with your investments based on your specific needs.

In retirement, your asset allocation may need some alterations to ensure that it:

- ⇒ Provides ongoing income needed to pay expenses
- ⇒ Minimizes volatility to assure both reliable and current income and the ability to provide income in the future
- ⇒ Maximizes the likelihood that your portfolio will last as long as you need it to
- ⇒ Keeps pace with inflation in order to maintain purchasing power over time

Caution: *Asset allocation and diversification cannot guarantee a profit or insure against a loss. There is no guarantee that any investment strategy will be successful; all investing involves risk, including the possible loss of principal.*

Why Income Alone Isn't Enough

Retirees who put all their investments into bonds when they retire often find after a few years that doing so doesn't account for the impact of inflation. The need to outpace inflation doesn't end at retirement; in fact, it becomes even more important. In putting together a retirement income plan, you need to make sure your asset allocation strategy takes inflation into account. Otherwise, you may have less buying power in the later years of your retirement because your income doesn't stretch as far. The biggest problem with inflation in retirement is not its immediate impact but its effects over time. Because of inflation, each dollar you've saved will buy less and less as time goes on. At three percent annual inflation, something that costs $100 today would cost $181 in 20 years.

Inflation also has an impact on your net investment returns. Let's say your money is earning four percent. If inflation is running between three to four percent (its historical average), your real return is only one percent at best--and that's before subtracting any account fees, taxes, or other expenses.

That means that retiring is no reason to turn your back on growth-oriented investments. Though past performance is no guarantee of future results, stocks historically have had better long-term returns than bonds or cash. Keeping a portion of your investments invested for growth (generally the role of stocks in a portfolio) gives you the potential for higher returns that can help you at least keep pace with inflation. The tradeoff: equities also generally involve more volatility and risk of loss than income-oriented investments. Effective diversification among various types of investments can help you balance lower-yielding, relatively safe choices that can provide predictable income or preserve capital with those that may be volatile but that offer potential for higher returns.

There are other reasons not to focus exclusively on income investments in retirement. Interest rate risk is one of them. Some retirees are surprised to learn that even though a bond's interest rate may be fixed, bond prices can go up and down (though typically not as much as those of stocks). When interest rates rise, bond prices typically fall. That may not matter if you hold a bond to maturity, but if you must sell a bond before it matures, you could get less than you paid for it. Also, if you hold individual bonds or Certificates of Deposit, and interest rates fall before that investment matures, you may not be able to get the same interest rate if you try to reinvest that money. That could, in turn, affect your income.

Just as your time horizon should influence your asset allocation during your saving years, it also is a factor during the distribution years. The longer you expect to spend in retirement--for example, if you plan to retire early, or have a family history of longevity--the greater the percentage of equities you may need in your portfolio. However, as mentioned previously, having a greater percentage of equities also could increase your portfolio's volatility. A higher equity allocation also might mean a greater possibility of having to liquidate at least some of those assets to meet your income needs. Striking the right balance over time between predictable income, capital preservation, portfolio volatility, portfolio longevity, and the need to maintain purchasing power is the role of a glide path.

What Is A Glide Path?

An equity glide path refers to the process of gradually, methodically adjusting a portfolio over time, generally by reducing the percentage devoted to equities in order to make it more conservative as the portfolio draws closer to a given date. In a way, the glide path resembles that of an airplane as it heads for a landing; your portfolio's glide path attempts to ensure that you reach your goal without stopping short before the end of the runway. As you were saving for retirement, did you become more conservative with your investments as you've gotten closer to retirement? If so, you've had a glide path without even realizing it.

A glide path can apply to any investment portfolio that is managed with a time frame in mind. It's easy to see why a glide path might be important in retirement. As you age and continue to tap your retirement assets, your financial and psychological ability to tolerate risk may be reduced over time; that has implications for the role of equities in your portfolio.

The concept of a glide path is the foundation of so-called lifecycle or target-date mutual funds. For example, a lifecycle fund relies on a glide path to determine how its asset allocation changes over time as the fund gets closer to its specific target date. Funds designed to provide a specific systematic payment over a given time period--for example, those aimed at providing retirement income--also base decisions on a chosen glide path, though the strategy used may be different from that of a fund focused on accumulating assets.

Tip: Remember that each such fund has a unique way of applying a glide path. Before investing in a mutual fund, obtain and read its prospectus (which is available from the fund) so you can carefully consider its investment objectives, risks, charges, and expenses before investing.

A glide path may apply not only to shifting percentages among the three major asset classes--stock, bonds, and cash--but also to specific sectors. For example, a glide path might gradually reduce the percentage of the stock portfolio that is devoted to riskier types of stocks, such as small-cap stocks or emerging-market stocks, and concentrate on larger, well-established domestic companies in an attempt to reduce the portfolio's volatility. It might even eventually eliminate certain asset classes entirely in the portfolio's later years.

Timing Is Key

Volatility is just as critical in retirement as it is when you're accumulating savings--perhaps even more so. Why? Because if stocks must be sold at a reduced price during a down market to help pay expenses, that loss represents reduced future earnings power that can be difficult to replace.

The timing of market volatility can have a profound impact on a portfolio's longevity. Negative returns during the early retirement years have more impact on the likelihood of a portfolio's sustainability than they do later in retirement; conversely, consistent above-average returns early in retirement can substantially minimize the chances of running out of money too early. When multiplied by the miracle of compound interest, higher early returns can lead to a higher overall retirement nest egg. (However, bear in mind that to try for higher returns, you may take on greater risk, which also could increase the chance of a loss, thereby bringing on precisely the opposite result of what you're hoping for.)

That's why a glide path takes volatility into account in establishing and adjusting a target asset allocation over time. However, the way a portfolio is managed at the beginning of its time frame is not the only important factor. The end of the designated time frame is also important, and there are different approaches for dealing with a glide path's final years. For example, some portfolio managers continue to adjust a portfolio's asset allocation even after a particular target date is reached. Others prefer to leave the relative weightings among asset classes fairly constant once the target date is reached. The difference between the two approaches can be significant, especially for a married couple who must consider how to address the income needs of a surviving spouse.

Your asset allocation also may be affected by other retirement-related decisions. For example, if you plan to continue to work part time in retirement, those earnings could help compensate for fluctuating income from a more volatile asset allocation strategy, or cushion the impact of a market downturn early in retirement. Anticipating a sudden influx of money--for example, an inheritance--might also change your perspective on your projected glide path.

Examples Of Asset Allocation & Glide Path Strategies

Your individual strategy will need to be tailored to your own situation and needs, but the following represent some hypothetical examples of various ways to manage asset allocation in retirement. Bear in mind that all investing involves risk, including the possible loss of principal, and there can be no guarantee that any investing strategy will be successful.

- ⇒ Static asset allocation: In some cases, a glide path may be essentially flat. An initial asset allocation is set, then rebalanced periodically to maintain the relative weightings of various types of investments from year to year.
- ⇒ Tactical asset allocation: A portfolio that shifts its asset allocation based on projected market conditions may have no firm glide path at all. In some cases, a portfolio manager may combine approaches by establishing a core asset allocation or glide path while using tactical asset allocation for a portion of the portfolio.
- ⇒ Fixed decreases over time in the percentage of equity investments: This approach gradually reduces the investment in equities by a given percentage at regular intervals. For example, a hypothetical retiree might reduce the equity allotment by two percent each year, or five percent every five years.

- ⇒ Accelerating decreases in the equity portion during the later retirement years: This approach not only would make a portfolio more conservative as the retiree ages; it would gradually speed up the process of doing so. The older the retiree, the more rapidly the equity portion is reduced. Example(s): When John retires, he initially decides to reduce the equities portion of his portfolio by two percent every five years. After he reaches a certain age, he accelerates the process of making his portfolio more conservative by increasing the percentages he shifts out of equities and into other asset classes. He decides to start cutting his equity allocation by four percent every other year, and to go even further by cutting seven percent from his equity allocation each year once he's been retired for 20 years.
- ⇒ Slowing the process of reducing equity allocations in later retirement years: This is the opposite of the above strategy. Instead of gradually increasing the rate at which equities are reduced, this strategy instead continues to reduce equity investments, but at a slower pace. A similar approach is often used by target-date mutual funds. Example(s): When she retires at age 62, Jane begins to reduce her equity allocation by six percent every five years. After 15 years, she is concerned that if she continues at that pace, her portfolio eventually might not be able to maintain her standard of living in later years. She continues to reduce her equity investments, but now cuts it by only four percent every five years, eventually bringing down the percentage shifted out of equities to one percent every other year.

Glide Paths, Sustainability, & Withdrawal Rates

Your glide path strategy will affect your portfolio's returns, the amount available for living expenses, and the probability that the portfolio will last throughout the projected time frame. One study of various distribution glide path strategies for retirement portfolios (“Dynamic Allocation Strategies for Distribution Portfolios:

Determining the Optimal Distribution Glide Path," by David M. Blanchett, Journal of Financial Planning , December 2007) indicated that the shorter the withdrawal period and the lower the withdrawal rate, the less impact asset allocation had on the results. However, the longer the withdrawal period and the higher the withdrawal rate, the more critical asset allocation and the chosen glide path became to the portfolio's chances of lasting. In most cases, the study indicated, a static asset allocation was effective; however, reducing the equity portion more rapidly as time goes on also had a high probability of success.

Bear in mind that the study was based on historical returns for those asset classes, and there's no guarantee that future returns would yield the same results. Also, the study was not intended as financial advice. No one glide path is appropriate for everyone. An asset allocation strategy that might be highly suitable for someone with a ten-year time frame might have a much lower probability of success over a longer period. And even if a given glide path produces higher long-term returns, it may not be sustainable if the portfolio is too volatile for your individual comfort level, or cannot produce an income that's reliable enough from year to year to cover needed expenses. Any projected glide path should take into account your ability to implement that strategy and stick to it over the long term.

Though a retirement portfolio's glide path and its withdrawal rate are different, the two are interdependent. The higher a withdrawal rate, the greater the challenge of creating an asset allocation that can produce a return high enough to sustain those withdrawals. That in turn will affect your asset allocation. Similarly, a portfolio's glide path will affect its level of volatility and overall returns over time, which in turn can affect how sustainable a given withdrawal rate is. Constructed properly, a glide path should enable you to establish a sustainable withdrawal rate that will minimize the portfolio's chances of being exhausted prematurely.

Estimating Rates Of Return For Various Asset Classes

Constructing a glide path that will produce the needed annual return requires making some assumptions about returns for various asset classes. As seen above, those assumptions typically rely on historical rates of return for the major asset classes, such as stocks, bonds, and cash, as well as for subcategories within each class. However, the phrase "past performance is no guarantee of future results" is especially applicable when it comes to asset allocation in retirement. If your investment returns are forecast based on a recent period when stocks have been particularly buoyant, assuming those returns will continue could lead to an asset allocation strategy and withdrawal rate in the early years of retirement that is overly optimistic and not sustainable if returns return to normal or fall below their historical averages. Also, projecting returns based on too short a time frame could lead to estimates that are either too positive or too negative.

EVERGREEN®
WEALTH SOLUTIONS

www.evergreenwealthsolutions.com

info@egwealth.com

1000 Commerce Park Drive, Suite 416
Williamsport, PA 17701

Phone: 570.601.6960 | Fax: 570.651.9032