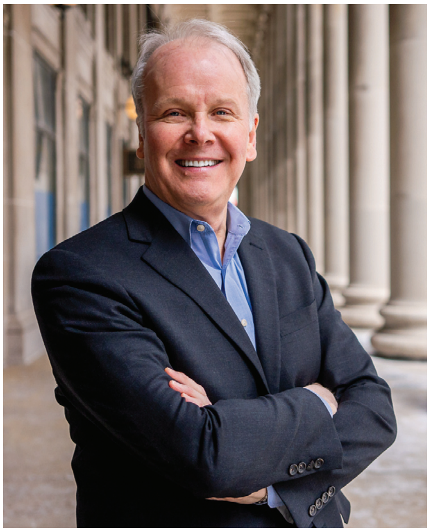

3 Investing Strategies for the 'Peak 65 Zone'

A growing segment of the population will be turning 65 this year, forcing financial advisors to rethink their clients' retirement investment strategies—here are three to consider.

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According to the Alliance for Lifetime Income, over 4.1 million Americans will turn age 65 this year. It's the start of what the Alliance refers to as the "Peak 65 Zone." Most of these folks will become fully or partially retired between now and 2029. These sheer numbers, along with the millions of older baby boomers who've already retired, have forced financial advisors to rethink their clients' investment strategies.

As most of us know, investing for the decumulation of assets (i.e., the spending down of wealth) is meaningfully different than investing for the accumulation of assets. According to a 2022 article published by Wellington Management, "[T]he defining characteristic of a decumulation [portfolio] strategy is the need to support regular withdrawals from a portfolio regardless of the performance of the underlying investments." Many years ago, portfolio withdrawals tended to be relatively small and of less consequence to retirees because defined benefit pension plans and Social Security made up the lion's share of an individual's required source of income to meet living expenses. Today, those types of income payments tend to make up a relatively smaller portion of a retiree's cash flow needs—and in the case of pension payments, usually nothing. Instead, defined contribution plans, like 401(k) plans and individual retirement accounts have taken the place of defined benefit plans.

Ultimately, retired individuals must navigate the volatility of the markets when considering how to withdraw living expenses from their accounts. If one invests too aggressively, they run the risk of needing to sell too many shares of a stock or stock fund to meet expenses during a time when prices are temporarily depressed. If one invests too conservatively, there's the risk that there may not be a large enough pool of assets to meet future cash needs.

Here are three investing strategies to consider for this growing segment of the population:

1. THE 4% RULE, AND THE BUCKET APPROACH

This strategy was first identified by financial planner William Bengen in 1994 after extensive trial-and-error testing. Bengen determined that an investment portfolio that allocated 50% to equities (S&P 500) and 50% to fixed income (intermediate term United States Treasury bonds) would last for at least 30 years if the initial year's withdrawal was equal to 4% of the portfolio value, and each subsequent year's withdrawals were increased (or decreased) by the rate of inflation (or deflation), and the portfolio was rebalanced annually.

Since 1994, Bengen and others have expanded the research. Bengen introduced small cap stocks into the equity mix and concluded that the initial withdrawal rate can increase to 4.7%. Others have tweaked the data to report that 5% is a sustainable initial withdrawal rate.

My take on this methodology is that it's elegant in its simplicity—it's easy for clients to understand. I employ this strategy alongside an approach sometimes referred to as the "bucket strategy." To the extent possible, I try to set aside 6-18 months of withdrawals in cash (bucket No. 1,) another 2-5 years of withdrawals in bonds or bond funds (bucket No.2,), and the balance of the portfolio in equities (bucket No. 3). I follow this approach to further reduce the risk of liquidating securities at an inopportune time when prices have fallen. In the current interest rate environment, I believe there's little risk to holding some cash in lieu of intermediate term bonds.

2. INCREASING EQUITIES AS THE RETIREE AGES

Of course, the 4% rule can be difficult for both the advisor and client to live with during a period of market losses. For example, it'll call for an increase in withdrawals in line with the change in the Consumer Price Index, even if the portfolio value has fallen on account of market losses. If carried out, the investor will liquidate more securities at declining prices and therefore own fewer shares when their price rebounds.

Instead, it might prove wiser to hold fewer equity shares at the onset of decumulation and increase the equity allocation as time passes and the planning horizon begins to shorten. This is the concept behind the strategy of increasing equities as the retiree ages. The premise is that holding more rather than less equities in the early years of portfolio withdrawals is especially risky. Losses in those early years can be difficult to fully recover from because any future portfolio gains must occur on a smaller basis. Instead, a retiree should hold substantially fewer equities, therefore, reducing the risk that market losses will damage the portfolio.

At first, this concept may seem counterintuitive. Most of us have heard that the older one gets, the less they should invest in stocks and the more they should invest in bonds and cash. However, upon further review, the concept passes the smell test. Here's why: A 75-year-old person has a shorter life expectancy to plan for than a 65-year-old person. Therefore, the 75-year-old can afford to take on more risk than the 65-year-old can because the assets of the 75-year-old don't have to last as long.

In 2014, two well-respected financial planning researchers, Michael Kitces and Wade Pfau, determined that a typical decumulation portfolio (investing a constant 60% in equities and subject to a 4% withdrawal rate) was successful at providing funds to last an investor's lifetime 93.2% of the time. Holding the withdrawal rate and portfolio size constant, only modifying the asset allocation to reflect a 30% equity allocation at the start of withdrawals and increasing to 70% equities by the end of the investor's life, resulted in a 95.1% probability of success, with an average equity investment of only 50%. This means a better outcome was achieved while modestly reducing portfolio risk.

3. INCORPORATING ANNUITIES INTO THE MIX

This strategy is really an adjunct practice to employ, as appropriate, with either of the strategies discussed above. It can be helpful to own one or more immediate or deferred annuities, along with an investor's retirement portfolio, when the pool of investment assets alone is insufficiently large to support withdrawals to meet living expenses. This is for at least two reasons.

1. Withdrawals are guaranteed and subject to the terms of the contract. Well-established and well-funded insurers have a long track record of paying out promised benefits. In addition, each state maintains a guaranty association that'll pay policyholders if an insolvent insurer is unable to do so. In Illinois, the state fund guarantees up to $300,000 per individual.
2. An insurer can afford to permit an initial withdrawal rate well in excess of 4% (think up to 9% or more, depending on the level of interest rates at the time the contract is written) because it can take advantage of the pooled risk and mortality credits of its insured policyholders. Basically, the insurer can afford to offer a higher payout because it knows that some number of their insured policyholders will never draw down on their insurance contract (or collect relatively little of the contract), while others will draw down far more than they invested in the contract.

Overall, most financial planning experts believe there's a place for some type of annuity in most retirees' income plans—and fortunately, the products available today are far superior to those of a generation ago.

Above all, it's important to recognize that planning for the decumulation of an investment portfolio to meet living expenses is more complicated than planning to grow an accumulation portfolio. The good news is that there's plenty of research, and products, to help your clients navigate the complexity—and hopefully, these three investing strategies can lend an extra hand.