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# Key Ingredients for Successful Retirement Portfolios

University of Wisconsin-Madison Retirement Association

× **Christine Benz**  
Director of Personal Finance, Morningstar, Inc.

September 18, 2012

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## The Changing Landscape for Retirement Planning

- In the past, many retirees were able to live on a combination of pensions plus whatever income their portfolios delivered.
- But that's changing...
- For starters, pensions are slowly ebbing away; most employers are switching to defined contribution plans like 401(k)s and 403(b)s.
  - 40% of workers were covered by pensions in 1980\*
  - By 2008, that number had dropped to 21%\*
  - Defined-contribution plans have become the retirement vehicle of choice for most companies

\*Source: Bureau of Labor Statistics

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## The Changing Landscape for Retirement Planning

CD rates have also plummeted.

Average 6-month CD rates in 1970: 9.1%\*

Average 6-month CD rates in 1980: 13.4%\*

Average 6-month CD rates in 1990: 8.2%\*

Average 6-month CD rates in 2000: 6.2%\*

Average 6-month CD rates in 2012: **0.5%\***

\*Source: Forecastchart.com

**This trend is clearly not a retiree's friend...**

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## The Changing Landscape for Retirement Planning

Yields aren't particularly encouraging for those willing to buy longer-duration bonds.

Yield\* for Barclays Aggregate Bond Index: 1.9%\*\*

Yield\* for Intermediate-Term Treasury Bonds: 0.87%\*\*\*

Yield\* for Intermediate Municipal Bonds: 1.85%\*\*\*\*

Yield\* for Barclays U.S. Long Government/Credit Float Adjusted Index: 3.66%\*\*\*\*\*

\*30-day SEC yield (past month's yield, annualized)

\*\*iShares Barclays Aggregate Bond ETF, less expenses, used as proxy. Source: iShares, August 20, 2012.

\*\*\*Vanguard Intermediate-Term Treasury, less expenses, used as proxy. Source: Vanguard, August 20, 2012.

\*\*\*\*Vanguard Intermediate-Term Tax-Exempt, less expenses, used as proxy. Source: Vanguard, August 20, 2012.

\*\*\*\*\*Vanguard Long-Term Bond Index, less expenses, used as proxy. Source: Vanguard, August 20, 2012.

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## The Changing Landscape for Retirement Planning

Yields are somewhat better for those willing to venture further out on the risk spectrum, but the downside potential is much greater.

### High-Yield Bonds

Current Yield: ~6-8%

2008 Return: -24%

### Preferred Stock

Current Yield: 6.28%\*

2008 Return: -26%

### Real Estate/REITs (U.S.)

Current Yield: 3.34%\*\*

2008 Return: -40%

### Multisector Bond Fund

Current Yield: 3.5%

2008 Return: -15%

Source: Morningstar Direct fund category averages unless otherwise indicated. All data as of August 20, 2012.

\*iShares S&P U.S. Preferred Stock Index, less expenses, used as proxy.

\*\*Vanguard REIT Index, less expenses, used as proxy.

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## So what are the key ingredients for retiree portfolios today?

- A focus on total return, not just income
- A component of guaranteed income
- A sustainable withdrawal rate
- A stable pool of assets from which to draw additional living expenses
- A measure of inflation protection
- A growth component for longevity
- The ability to put your plan on cruise control
- Attention to tax efficiency

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# A Focus on Total Return, Not Just Income

## Why you need it:

- In current environment, it's difficult to wring a livable income stream from a portfolio unless you have a LOT of assets or are willing to take a lot of risk
- A total return approach helps ensure that you don't forsake risk controls in the search for yield

## Where to get it:

- A portfolio plan that enables you to draw income from a number of sources: dividend and interest income, tax-loss sales, required minimum distributions, rebalancing

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# A Component of Guaranteed Income

## Why you need it:

- To provide for basic living expenses regardless of how your investments perform

## Where to get it:

- Social Security
- Pension, if you have one
- Fixed immediate annuity (aka, single premium immediate annuity, or SPIA)



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# A Sustainable Withdrawal Rate

## Why you need it:

- To ensure a livable spending rate without running the risk of prematurely depleting your assets.

## Where to get it:

- Use “the 4% rule” as a starting point; tweak based on time horizon, asset allocation  
*or*
- Withdraw a fixed percentage of your portfolio on an annual basis, with “ceiling” and “floor” built in.

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## **A Stable Pool of Assets from Which to Draw Additional Living Expenses (1-2 Years' Worth)**

### **Why you need it:**

- To supplement your fixed sources of income without having to tap your longer-term, more volatile assets (i.e., stocks) during a market downturn

### **Where to get it:**

- CDs
- Money market account or fund
- Bank checking, savings account
- A high-quality short-term bond fund used in concert with above instruments

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# A Measure of Inflation Protection

## Why you need it:

- To keep rising prices from eroding the purchasing power of money drawn from your investment accounts
- To help make up for the fact that you no longer are eligible for cost-of-living adjustments after you've stopped working

## Where to get it:

- Social Security
- Treasury Inflation-Protected Securities or I-Bonds
- Stocks
- Commodities
- Floating-rate/bank-loan funds

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## **A Growth Component for Longevity**

### **Why you need it:**

- To help address the fact that you may be retired for 25-30 years or more (or your spouse may be)
- To help provide for other goals, including a legacy for children and grandchildren

### **Where to get it:**

- Stocks, diversified by size, style, and sector
- Alternative bond types, including high-yield and foreign bonds

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# The Ability to Put Your Plan On Cruise Control

## Why you need it:

- Most retirees would rather not devote a significant share of time to overseeing their investments
- Your spouse or other loved ones might not have the same investment savvy that you do

## Where to get it:

- A portfolio that could “run itself” for a while if need be
- Individual investments that deliver a lot of diversification in a single shot

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## Attention to Tax Efficiency

### Why you need it:

- Taxes can extract a sizable percentage from your portfolio's return
- Managing for tax efficiency is one of the easiest ways to exert control over your portfolio's results

### Where to get it:

- A tax-efficient plan for asset location and sequencing your withdrawals
- Hold tax-efficient investments in your taxable accounts (index funds, ETFs, municipal-bond funds)

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## The Bucket Approach Helps Bring It All Together

- Allows you to build a portfolio that's well-diversified across asset classes; you don't have to focus on income at the expense of total return
- Enables you to cope amid a very low yield environment
- Helps you back into an appropriate asset allocation based on your income needs and time horizon
- Lets you ride out the volatility of your long-term (stock) assets, knowing that your near-term cash needs are covered by safe investments
- Includes components to deliver current income, income with inflation protection, and longevity protection/long-term growth

# The Bucket Approach in Action



## **Bucket 1**

Years 1 and 2  
Holds: Cash  
Goal: Fund Living Expenses



## **Bucket 2**

Years 3-10  
Holds: Bonds,  
Balanced Funds  
Goal: Stability with  
Income, Growth



## **Bucket 3**

Years 10+  
Holds: Stocks, Higher-  
Risk Bonds, "Other"  
Goal: Long-Term  
Growth



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## Step 1: Determine the Paycheck You Need from Your Portfolio

- Total your income needs for living expenses, either on a monthly or annual basis.
- Subtract steady sources of income, such as Social Security, pension income, annuity payouts.
- What's left is the amount of income your portfolio will need to replace.

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## Step 2: Make Sure Your Withdrawal Rate Is Sustainable

- The traditional rule of thumb is that 4% with an annual inflation adjustment is a safe withdrawal rate for most.
- For someone with an \$800,000 portfolio:
  - Year 1 Withdrawal: \$32,000
  - Year 2 Withdrawal: \$32,960 (assuming 3% inflation)
- If you're not comfortable with withdrawing a fixed dollar amount regardless of market performance, you could:
  - Reduce your withdrawals during weak market environments/forego inflation adjustments
  - Employ a fixed-percentage withdrawal rate (with ceiling and floor to reduce the potential for dramatically different payouts)

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## Step 3: Create Bucket 1: Income Reserves

- Bucket 1 will hold enough income to cover two years' worth of living expenses.
- Bucket 1 should hold liquid investments—CDs, money market accounts, money market funds, checking, savings.
- Your returns will be minimal. But the goal for Bucket 1 is stability, not high returns.
- If you'd like Bucket 1 to be larger (for example, holding 3-5 years' worth of living expenses), you could build a two-parter consisting of:
  - Cash (CDs, money market funds, etc.)
  - A short-term bond fund like T. Rowe Price Short-Term Bond (PRWBX) or PIMCO Enhanced Short Maturity Strategy ETF (MINT).

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## Step 4: Create Bucket 2: Intermediate Assets

- Bucket 2 will consist of living expenses for ~years 3-10 (or more) of retirement.
- Because you won't be tapping it imminently, it can consist of slightly higher-risk investments: intermediate-term bonds and even small percentages of equity holdings.
- Some favorite investments for bucket #2 include:
  - Harbor Bond (HABDX)/PIMCO Total Return (PTTRX)
  - Metropolitan West Total Return Bond (MWTRX)
  - Harbor Real Return (HARRX)
  - iShares Barclays TIPS Bond (TIP)
  - Vanguard Wellesley Income (VWINX)
  - Dodge & Cox Balanced (DODBX)

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## Step 5: Create Bucket 3: Long-Term Assets

- Bucket 3 will consist of income for years 10 and beyond of your retirement, as well as assets for your heirs.
- This is the long-term, higher-risk/higher-reward portion of your portfolio.
- Some favorite investments for Bucket 3 include:
  - Vanguard Total Stock Market Index (VTSMX or VXUS)
  - Vanguard Dividend Growth (VDIGX) or Appreciation (VIG)
  - Vanguard Total International Stock Market (VGTSX)
  - Dodge & Cox Stock (DODGX)
  - T. Rowe Price Equity-Income (PRFDX)
  - Oakmark International (OAKIX)

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## Additional Buckets to Consider

- A separate bucket for emergency expenses during retirement (leaky roofs, new cars, unforeseen medical expenses). (Holds short- and intermediate-term assets such as bonds.)
- A bucket to help cover long-term care costs.
- “Mad money” bucket: 50<sup>th</sup> anniversary cruise, special gift for spouse, etc.
- Legacy bucket.

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## Income Meets the Buckets: Why Can't We All Just Get Along?

- Note that filling Bucket 1 doesn't necessarily involve selling assets.
- You can refill Bucket 1 from a variety of sources, including:
  - **Distributions from income-producing securities** such as bonds or dividend-paying stocks held in Buckets 2 and 3.
  - Capital gains distributions from Buckets 2 and 3.
  - Rebalancing proceeds from Buckets 2 and 3.
  - Proceeds from tax-loss harvesting in Buckets 2 and 3.
  - Required minimum distributions from accounts held in Buckets 2 and 3.

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## **Income-Producing Securities Can and Should Be Part of Your Mix**

**Some favorite income-producing stocks include:**

- Abbott Labs ABT
- Exelon Corp EXC
- Novartis NVS
- Rio Tinto RIO

**Some favorite income-producing funds and ETFs include:**

- Vanguard Dividend Growth VIG
- Vanguard Equity-Income VEIPX



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## Step 6: Plan “Bucket Maintenance”

- In addition to periodically filling up Bucket 1, you also need to find a time for “bucket maintenance.”
- Deplete one year’s worth of living expenses from Bucket 1 →
- Move one year’s worth of living expenses from Buckets 2 or 3 to 1 →
- Move one year’s worth of living expenses from Bucket 3 to 2.
- Ideally, “bucket maintenance” is annual or even quarterly, depending on your income distributions.

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## Mind Tax Management for Buckets

- If you're 70-1/2 and taking required minimum distributions (RMDs) from your IRAs or 401(k)s, some or all of your near-term paycheck should come from those accounts.
- If you're not yet 70-1/2 or your RMDs won't cover your cash needs, turn to your taxable accounts.
- If your RMDs and taxable accounts won't cover near-term living expenses, turn to IRAs or company retirement plans to fund living expenses.
- Save Roth IRAs for last. (Tax benefits are the greatest.)
- This sequence of withdrawals will affect what types of assets you hold where.

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# Sample In-Retirement Portfolio Using Bucket Approach

## Assumptions

- 65 year-old-couple with \$1.5 million portfolio
- 4% withdrawal rate with annual 3% inflation adjustment (\$60,000 first-year withdrawal)
- Anticipated time horizon: 25 years
- Fairly aggressive/high risk tolerance

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## **Sample In-Retirement Portfolio Using Bucket Approach**

### **Bucket 1: Liquidity Portfolio for Years 1 and 2: \$120,000**

\$120,000 in CDs, money market accounts/funds, other cash

### **Bucket 2: Intermediate Portfolio for Years 3-10: \$480,000**

\$130,000 in T. Rowe Price Short-Term Bond PRWBX

\$150,000 in Harbor Bond HABDX

\$100,000 in Harbor Real Return HARRX

\$100,000 in Vanguard Wellesley Income VWINX

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## **Sample In-Retirement Portfolio Using Bucket Approach**

### **Bucket 3: Growth Portfolio for Years 11 and Beyond: \$900,000**

\$400,000 in Vanguard Dividend Growth VDIGX

\$200,000 in Harbor International HAINX: \$200,000

\$100,000 in Vanguard Total Stock Market Index VTSMX

\$125,000 in Loomis Sayles Bond LSBDX

\$75,000 in Harbor Commodity Real Return HACMX

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## **Sample In-Retirement Portfolio: The ETF Version**

### **Bucket 1: Liquidity Portfolio for Years 1 and 2: \$120,000**

\$120,000 in CDs, money market accounts/funds, other cash

### **Bucket 2: Intermediate Portfolio for Years 3-10: \$480,000**

\$100,000 in Vanguard Short-Term Bond ETF BSV

\$150,000 in Vanguard Total Bond Market ETF BND

\$50,000 in iShares iBoxx\$ Investment Grade Corporate Bond LQD

\$100,000 in iShares Barclays TIPS Bond TIP

\$80,000 in Vanguard Dividend Appreciation VIG

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## **Sample In-Retirement Portfolio: The ETF Version**

### **Bucket 3: Growth Portfolio for Years 11 and Beyond: \$900,000**

\$350,000 in Vanguard Dividend Appreciation VIG

\$200,000 in Vanguard Total Stock Market Index VTI

\$200,000 in Vanguard Total International Stock Market Index VXUS

\$75,000 in SPDR Barclays Capital High Yield Bond JNK

\$75,000 in PowerShares DB Commodity Index Tracking DBC

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**Questions?**

**Email me at [christine.benz@morningstar.com](mailto:christine.benz@morningstar.com)**

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