#77

Allocate Assets in the Active Stage of Retirement

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With good health, you'll be active and living independently for the majority of your retirement. You may plan to travel, spend time with family and friends, pursue your favorite hobbies, volunteer, or even start your own business. To fund those dreams, you now need to structure your nest egg to provide regular income that meets the following criteria:

- It adequately supplements pension and/or Social Security income to fund your desired standard of living.
- It'll be there in both good and uncertain economic time periods throughout your retirement.
- It lasts as long as you need it to.

This strategy explains how to get your portfolio management off to a good start as you begin tapping into your nest egg.

Understand Retirement Uncertainty

Knowing which uncertainties will impact the success of your retirement can help you better plan and manage your assets and your income. Here are several risks you need to consider:

- **Longevity risk:** The risk that you'll run out of dollars before you run out of breaths
- **Inflation risk:** The risk that the cost of everything will go up faster than your income

- **Market risk:** The risk that you'll have to sell investments when they're down in value in order to produce needed income
- **Timing risk:** The risk that you'll experience large investment losses in the first three to five years of retirement

Your best defense is to hold off on retiring until you have a comprehensive plan to protect against these four risks. Asset allocation is your primary tool to manage them. Monitoring your plan and making periodic adjustments is also part of the process.

Decide Whether to Use Annuities

Allocating some of your nest egg to an immediate annuity creates a stream of income you can't outlive. Such a strategy can help overcome longevity risk. (For info on fixed and variable annuities, see Strategies #19 and #22.) If you're married, buy a joint and survivor benefit so the surviving spouse will continue to receive income.

REMEMBER

Before putting your all or a portion of you nest egg into an annuity, even one that'll keep pace with inflation and fully fund your desired standard of living, understand that with an annuity, you give your money to an insurance company in exchange for the promise of a lifetime income. Once initiated, or *annuitized,* annuity income can't be stopped or changed, even if you no longer need that income or need additional money for unexpected expenses. Be sure to read the annuity policy and ask questions about how the policy works.

Deciding how much of your nest egg to allocate to an annuity is a real challenge. You have to assess the following to make a wise decision:

- The probability that you'll burn through your assets prematurely
- Your tolerance for investment risk
- The long-term trend of the stock market

TIP

If the probability of exhausting your assets prematurely is high, your tolerance for investment risk is low, or the stock market appears to be peaking or in the early stages of a downswing, consider allocating 60 to 80 percent of your nest egg to an immediate annuity.

Allocate Your Nest Egg to Stocks, Bonds, and Cash

Longevity and inflation risk mandate that you allocate at least some of your nest egg to risky assets — stocks and bonds. These assets can help you stay ahead of inflation, although their returns aren't guaranteed. At the same time, investing in stocks and bonds can increase the uncertainties that may cause your accounts to decrease in value. This section explains how to find — and keep — the right balance.

Decide on your target balance

The first asset allocation decision you have to make is how much to invest in stocks versus bonds and/or cash. As an early stage retiree, a reasonable cash-bond-stock allocation is to keep

- Three years' worth of annual income in cash
- Three to five years' worth in bonds
- The rest in stocks

Using this strategy provides you with income for seven years. You get the opportunity to sell stocks when they're up in order to replace cash and bond assets that are used up by income withdrawals. Meanwhile, the bonds and cash investments help protect you against the large losses the stock market occasionally delivers. Bonds often provide positive returns when stocks are performing negatively, which helps reduce the negative impact on your total investment portfolio.

In early retirement, an allocation of 45 to 60 percent of your portfolio in stocks is reasonable. Allocating more than 60 percent to stocks in the early stages of retirement increases the risk of experiencing large losses, and allocating less than 45 percent increases the risk of depleting your portfolio due to feeble growth.

Diversify your investments

After you choose your overall allocation, you have to actually choose your investments. Here are few bond suggestions:

- Diversify and buy lots of different types of bonds, keeping your investment in high-yield bonds relatively low.
- The majority of your bonds should be intermediate maturity — between five and ten years. Avoid owning too many bonds or bond funds with maturity dates longer than ten years because these tend to fluctuate in value more dramatically than intermediate- and short-term bonds.
- Consider putting 15 to 40 percent of your bond allocation in bonds designed to provide inflation protection. (See Strategy #18 for more information.)

Your stocks should make up 60 percent or less of your total portfolio. As you choose stocks, make sure you adequately diversify into the different classes of stocks, including the following (see Strategies #42 through #45 for more info on diversifying your stock portfolio):

- Domestic and foreign
- Small and large cap
- Growth and value

REMEMBER

Generally, growth stocks tend to be riskier than value stocks, international stocks tend to be riskier than domestic stocks, and small company stocks tend to be riskier than large company stocks.

For the cash portion of this portfolio, pursue the highest interest rates available, short of tying up your money in long-maturity CDs. Check out Strategy #17 to help you decide which cash savings vehicles to use during retirement.

Rebalance your investment portfolio

Because you'll be regularly depleting the cash portion of your investment portfolio, you need to periodically adjust the amounts you have in bonds and stocks so that the percentage of each in your total portfolio equals your target asset allocation.

WARNING!

Rebalancing within a taxable account can have potentially expensive tax ramifications. For taxable accounts, you may want to seek the help of a financial advisor who's experienced in retirement investing and taxation.

However, rebalancing within a 401(k) or IRA has no immediate tax ramifications, so the decision to rebalance is much simpler. For early stage retirees who've allocated three years of nest-egg withdrawals to cash and another five years to bonds, the concern is when to replenish the cash reserve. Here are three principles to remember for rebalancing:

- **Cash:** Replenish your cash stash at least every two years back to the three-year amount. To increase your cash, liquidate bond assets when stocks have performed poorly or use stock assets if they've done well.
- **Bonds:** Replenish your allocation to bonds back up to three to five years' worth of living expenses when the amount falls below two years' worth. If your bond portfolio exceeds five years' worth of withdrawals, divert assets first to cash and then to stocks to reestablish the target balance.
- **Stock:** Make sure your stock allocation stays between 45 and 60 percent of your total portfolio. It's better to have more than five to seven years' worth of living expenses in bonds and cash if necessary to keep your stock allocation in check.

If you find that you can no longer maintain at least 45 percent of your portfolio in stocks after restocking your cash and bond reserves, this is a red flag that you may be consuming your nest egg too quickly. Do a comprehensive review of your retirement income plan to see what adjustments you need to make.

If you experience large losses in the first two to five years of retirement, you need to redesign your retirement income plan. You may want to reconsider the role of immediate annuities in your plan. Seek help from an experienced financial planner if your confidence is shaken.