WEEKLY INSIGHT

Telltale Signs of a Failing Retirement Plan

BY CEMIL OTAR

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Several years ago, I saw a wonderful movie called "28 Up". It was a biographical documentary directed by Michael Apted. He interviewed 14 British children diverse in gender, race, economic background and in age groups of 7, 14, 21 and 28. He observed the changes in their lives as they reached these ages. To make a long story short, it convinced me that whatever dreams, personalities and ethics children develop by age 7, they pretty well carry these for the rest of their lives.

What does this have to do with retirement portfolios? This magazine is not about film reviews! That is correct. However, this story has one thing in common with retirement portfolios, i.e. how your portfolio performs in its first four years (we will use a four-year cycle to match the U.S. presidential cycle of equity markets) sets the tone for the rest of your retirement years. After the four years, you can pretty well tell whether your portfolio will last you a lifetime or not.

Here is how it goes. Assume you have saved $500,000 for your retirement in investments. Now you are retiring. You need $30,000 from this portfolio during the first year of your retirement, indexed annually for inflation. The initial withdrawal rate is 6%, calculated as $30,000 divided by $500,000. For this example, I assumed that you have an asset mix of 60% equities, 40% fixed income and you rebalance this portfolio annually. I calculated the portfolio value over time if you were to retire in each of the years between 1900 and 1996. Then, I observed the portfolio values four years after the year of retirement. I divided these portfolios into two groups: Group W (W – "Winners") included only the portfolios that had a higher market value after four years and Group L (L – "Losers") included only the portfolios with a lower market value after the same time period. Figure 1 shows all the portfolio values in Group W between 1900 and 1996. Figure 2 shows the same for Group L. You can see clearly in Figure 2 that most portfolios run out of money between the 13th year and 20th year of retirement.

The average portfolio life was 24.9 years for Group W and 17.8 years for Group L. After 20 years, only 15% of the portfolios in Group W ran out of money whereas in Group L, 70% of the portfolios did so. These numbers are based on our example of 6% initial withdrawal rate. The statistics for different initial withdrawal rates are as follows:

Why does the performance of a portfolio, during its first four years, set the tone for the rest of its life? There are external and internal reasons. External reasons are the markets may be in a secular bear mode, markets may be in a multi-year sideways range, or it may be a high inflation environment. For a retiree, a sideways market is considered a bear market because of the effects of reverse dollar-cost-averaging.

Internal reasons are your asset mix may not be set at the optimum mix for the income taken ou, you may be rebalancing too frequently, your investments may be chronically underperforming, you may be taking your income from volatile investments amplifying the effects of reverse dollar-cost-averaging or your portfolio expenses may be too high.

Regardless of the reason, the bottom line is, if your portfolio value has a lower market value four years after the start of your retirement, the chances are its average life will be between 30% and

40% less than a portfolio that has a higher market value. This understanding should ring alarm bells because, if you continue with your existing strategy, you will likely run out of money prematurely. Keep in mind, history shows that megabull markets usually don't come back so fast – we have just left one behind in 2000 – the longest one of the last century. Annuities could be considered as more reliable income sources.

In conclusion, if you retired four years ago and your portfolio value is less than what you started with and your advisor is telling you to hang on for the "long term", your definition of "long term" may be a lot shorter than his. Be cautious.

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