It's all to do with performance

The documentary '28 Up' gave JIM OTAR the clue to portfolio construction

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 and economic background at ages seven, 14, 21 and 28. He observed the changes in their lives as they reach these ages. It convinced me that whatever dreams, personalities and ethics children develop by age seven, they pretty well carry these for the rest of their lives.

What does this have to do with retirement portfolios? This story has one thing in common with retirement portfolios: How a portfolio performs in its first four years (we will use a four-year cycle to match the US Presidential cycle), sets the tone for the rest of its life. After the first four years, you can pretty well tell whether your client's portfolio will last them a lifetime or not.

Here is how it goes: Assume your client has saved $500,000 for their retirement in investments. Now they are retiring. They say they need $30,000 from this portfolio during the first year of their retirement, indexed annually for inflation.

The initial withdrawal rate is six per cent, calculated as $30,000 divided by $500,000. For this example, I assumed that the asset mix is 60 per cent equities and 40 per cent fixed income and this portfolio is rebalanced annually.

I calculated the portfolio value over time if one 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 ('Winners') included only the portfolios that had a higher market value after four years.

Group 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 the 20th year of retirement in Group L.

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

AVERAGE PORTFOLIO LIFE

Initial Withdrawal Rate	Average Portfolio Life, years		Difference
	Group W	Group L	
4%	28.7	26.9	6.7%
5%	27.1	21.0	29.0%
6%	24.9	17.8	39.9%
8%	19.6	13.7	43.1%

PROBABILITY OF DEPLETION

Initial Withdrawal Rate	After 20 years		After 25 years	
	Group W	Group L	Group W	Group L
4%	0%	0%	13%	27%
5%	5%	45%	26%	87%
6%	15%	70%	44%	91%
8%	48%	90%	91%	98%

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 (trading) range; or
- it may be a high inflation environment.

Remember, when you are taking income out of an investment portfolio, a sideways market acts as a bear market for a retiree because of the negative effects of reverse-dollar-cost-averaging.

The internal reasons are:

- the asset mix may not be set to optimum for the income taken out;
- the asset mix may be rebalanced too often;
- the investments may be chronically underperforming; income may be taken out from volatile investments,

which amplifies the effects of reverse-dollar cost averaging; or

➤ portfolio expenses may be too high.

Regardless of the reason, the bottom line is, if your client's portfolio has a lower market value four years after the start of their retirement, the chances are its average life will be between 30 per cent and 40 per cent less than a portfolio that has a higher market value.

This should ring alarm bells, because if you continue with your existing strategy, your client will likely run out of money prematurely.

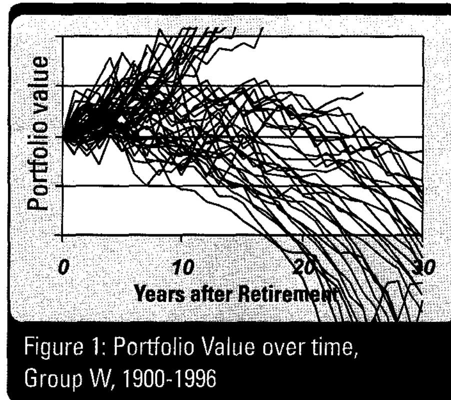

Figure 1: Portfolio Value over time, Group W, 1900-1996

Keep in mind, history shows that mega-bull markets usually don't come back so fast, as we have just left one behind in 1999 – the longest one of the last century. Annuities should be considered as more reliable income sources.

Portfolios must be reviewed four years after your client's retirement from this angle. If its value is less than what you started with, your client's definition of long-term may be a lot shorter than its classic definition. Be cautious. ✤

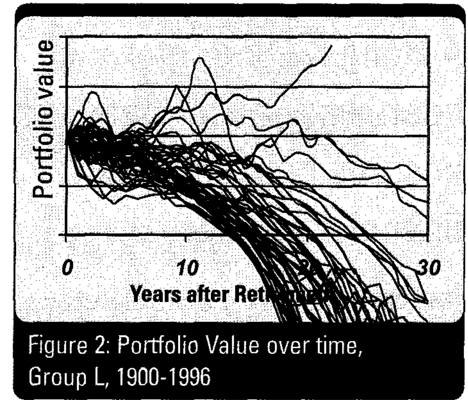

Figure 2: Portfolio Value over time, Group L, 1900-1996

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