

Build Your Retirement Portfolio to Last

If you're a conservative-to-moderate investor in retirement and want a high level of confidence that you'll maintain your inflation-adjusted standard of retirement living for 30 years, the rule of thumb is this: Shoot for a portfolio approximately 25 times as large as your first-year withdrawal. This translates into roughly a 4% withdrawal rate in the *first year of retirement only*. After that, the goal is to grow the first-year *dollar amount* for inflation each year throughout retirement.

Why not go conservative?

If the portfolio target for the same level of spending is about the same whether you take a conservative or a moderate approach, then why should you take on more risk for a similar probability of success? Why not just go conservative? Because, in addition to spending confidence, you might also want to increase your odds of ending up with more than you bargained for.

Conservative, moderately conservative and moderate portfolio retirees can each withdraw roughly 4% of the portfolio's value in the first year of retirement and have about a 90% probability of adjusting that amount for inflation over 30 years. However, without sacrificing the withdrawal rate, a moderately conservative or moderate retiree has the chance to end up with more money, as the following table shows:

Potential ending wealth for a retiree with a 30-year horizon

	Conservative	Moderately Conservative	Moderate
Initial investment	\$1,500,000	\$1,500,000	\$1,500,000
First-year withdrawal rate (grown for inflation)	3.8% (\$57,000)	4% (\$60,000)	4% (\$60,000)
Ending wealth after 30 years			
90% confidence level	\$0	\$0	\$0
75% confidence level	\$490,000	\$1,030,000	\$1,515,000
50% confidence level	\$1,225,000	\$2,700,000	\$4,470,000
25%	\$2,120,000	\$5,065,000	\$9,100,000

confidence level			
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Ending wealth assumes 2.7% inflation. Table excludes moderately aggressive and aggressive portfolios, in part because of the drop-off in sustainable spending relative to potential ending wealth, and in part because they are unsuitable for most retirees.

Okay, so why not go moderate?

Before you answer (based on the best-case scenario in the table above), notice that it's based on a 25% confidence level—75% of the outcomes are expected to be worse. What's more, a moderate portfolio, being riskier, is more likely to run out of money prematurely if we boost the confidence level to 95%.

How soon might your money run out at a 95% confident level?

	Conservative	Moderately Conservative	Moderate
Years before money runs out	28	27	26

Splitting your retirement into stages

Ultimately, the best asset allocation for your retirement portfolio will depend on your own circumstances and tolerance for risk. Of course, there's no rule that says you can't change your allocation over time. In fact, it's generally a good idea to do so. For example, let's say you're 60 and you expect to live at least 30 years in retirement. As your retirement time horizon gets shorter and your needs change, you may decide to position your portfolio more conservatively. After all, the need for long-term growth should diminish as life expectancy becomes shorter. Why take more risk than you need to, assuming sustainable spending is your primary goal?

How you might reposition your retirement portfolio over time

Age	Asset allocation	Stocks vs. bonds/cash
60–69	Moderate	60% stocks, 40% bonds/cash
70–79	Moderately conservative	40% stocks, 60% bonds/cash
80–?	Conservative	20% stocks, 80% bonds/cash

The shift to a more conservative allocation doesn't necessarily occur at a specific point in time. In practice, it's a good idea to move gradually, adjusting your portfolio along the way to suit your circumstances and ever-changing time horizon. You could even decide to put such allocation shifts on autopilot, through the use of a retirement “target” mutual fund.

Set aside some cash as a cushion against bear markets

No matter which asset allocation you choose to start with, try to set aside enough cash in a money market fund, savings account or short-term certificates of deposit to cover your spending needs for at least one year (minus what you expect from your non-portfolio sources of income, such as Social Security, pensions and so on). If you can, consider placing an additional two to four years' worth of cash savings in longer-term CDs, a deferred fixed annuity, an ultra-short bond fund or high-quality short-term bonds.

As long as your portfolio performs as expected, you can keep rolling over these investments. But in the event of a long bear market, you can cash them out instead of having to withdraw from the equity component of your retirement portfolio at the worst possible time.

Sensible ways to manage your retirement portfolio

With your short-term cushion in reserve and an additional cushion within the fixed income portion of your asset allocation, here are some sensible ways to manage your retirement portfolio:

- **Diversify your portfolio** across and within asset classes.
- **Consider a “laddered” mix of high-quality bonds** or bond funds with maturities of one to seven years.
- **Keep tax-efficient investments in taxable accounts.** This includes stocks held over one year, tax-managed funds, index funds, qualified dividend-paying stocks and mutual funds, and municipal bonds (if they make sense for your tax bracket).
- **Keep tax-inefficient investments in tax-deferred accounts.** This includes stocks held one year or less, actively managed funds, taxable bonds and real estate investment trusts (REITs).

Cash flow in the first 10 years

For many retirees, the first 10 years of retirement are the most active, which can translate into higher spending needs. It's also the time when a bear market can have the biggest impact on the future value of your portfolio because potential compound growth is lost.

Here's one solution for even more reliable income (and a higher portfolio confidence level) during the first 10 years of retirement: Take perhaps 25% of your fixed income allocation and buy a ladder of high-quality bonds, CDs and/or a low-cost immediate fixed annuity designed to pay out for a certain period—10 years, for instance.

There are any number of alternatives. Just make sure to crunch the numbers based on the available fixed income options, current interest rate environment and your risk tolerance, comfort level and objectives.

Hypothetical example: cash flow in the first 10 years of retirement

- Early retiree, age 55
- Moderate investor: 60% stocks, 40% fixed income
- Expects 6.9% total annual return
- \$1 million portfolio value
- Needs an annual \$40,000 total cash flow beginning in the first year of retirement (and adjusted for 2.7% inflation each year going forward)
- Wants to ensure annual cash flow of at least \$12,000 for the first 10 years of retirement

Take \$100,000—25% of the fixed income portion of the portfolio—and purchase an immediate fixed annuity that guarantees annual payments for the next 10 years. Or, set up a ladder of high-quality bonds and/or CDs for the same period. Assuming an average interest rate of 3.5%, either option should provide a total cash flow return (interest and principal) of \$12,000 per year for each of the first 10 years of retirement (leaving \$0 of the original \$100,000 at the end of 10 years).

Our retiree now has \$12,000 of the \$40,000 needed in the first year. The other \$28,000 comes from the rest of the portfolio, now worth \$900,000. By the time the first 10 years are up, Social Security kicks in. Here's what it might look like, assuming the 6.9% average annual long-term return and inflation expectations stayed constant year-to-year:

Age	Fixed payment	Social Security	Portfolio withdrawal		Total cash	Portfolio value*
			\$	%		
						\$900,000
55	\$12,000		\$28,000	3.11%	\$40,000	\$932,168
56	\$12,000		\$29,080	3.12%	\$41,080	\$965,401
57	\$12,000		\$30,189	3.13%	\$42,189	\$999,742
58	\$12,000		\$31,328	3.13%	\$43,328	\$1,035,234
59	\$12,000		\$32,498	3.14%	\$44,498	\$1,071,924
60	\$12,000		\$33,700	3.14%	\$45,700	\$1,109,862
61	\$12,000		\$34,933	3.15%	\$46,933	\$1,149,099
62	\$12,000		\$36,201	3.15%	\$48,201	\$1,189,688
63	\$12,000		\$37,502	3.15%	\$49,502	\$1,231,687
64	\$12,000		\$38,839	3.15%	\$50,839	\$1,275,155
65		\$20,000	\$32,211	2.53%	\$52,211	\$1,328,707
66		\$20,540	\$33,081	2.49%	\$53,621	\$1,385,024
67		\$21,095	\$33,974	2.45%	\$55,069	\$1,444,272

68		\$21,664	\$34,891	2.42%	\$56,556	\$1,506,628
69		\$22,249	\$35,834	2.38%	\$58,083	\$1,572,279
70		\$22,850	\$36,801	2.34%	\$59,651	\$1,641,426

*\$1 million beginning portfolio, less \$100,000, equals \$900,000. End-of-year values shown, assuming withdrawals at the beginning of the year. Based on the Schwab Center for Financial Research's Long-Term Market Prospects for Stocks and Bonds. Amounts rounded.

Of course, we know that in the real world “average” annual returns are just that—average. From year to year, actual returns could vary widely. That's why it's a good idea to incorporate potential volatility into your long-term planning with a Monte Carlo probability analysis, and then stay flexible over the shorter term (where anything can happen).

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