Swedroe: Declining Or Rising Equity Strategy In Retirement?

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Traditional retirement planning calls for gradually reducing an investor's equity allocation and increasing the allocation to safe bonds.

Perhaps the most well-known example of this concept is the adage that your stock allocation should be equal to 100 minus your age (or with now-longer life expectancies, 110 minus your age). The gradually declining equity (DE) allocation strategy is used by typical life cycle funds, or target-date funds.

Recently, this conventional wisdom has been challenged. In their paper, "Reducing Retirement Risk with a Rising Equity Glide Path," published in the January 2014 issue of the Journal of Financial Planning, Wade Pfau and Michael Kitces argue that a rising equity (RE) glide path lowers the probability of failure relative to a DE glide path. In other words, retirees adopting the RE strategy face a lower probability of running out of money in retirement than they would with the DE strategy employed by target-date funds.

Need To Balance Two Competing Issues

In planning for retirement, investors must balance two competing issues. The first is spending too much and risking that you will outlive your savings. The second is unnecessarily suppressing spending and leaving a larger-than-desired bequest. Much has been written on the subject.

One part deals with the spending rate, or what is called the "safe withdrawal rate." The other part addresses the equity/bond allocation. Until recently, the standard rule of thumb was that a 4% spending rate would

result in a minimal chance of outliving your portfolio. Annual spending could be 4% of the portfolio's starting balance, and then adjusted for inflation so the real spending level could be maintained. The original research in this area assumed an equity allocation of at least 50%.

Unfortunately for today's investors, the finding that 4% was a safe withdrawal rate was based on historical data, when stock valuations were lower and bond yields were higher. Given currently higher equity valuations (which project lower future returns) and lower bond yields, forward-looking return expectations suggest that a 3% safe withdrawal rate is more prudent for investors with a 30-year horizon.

Of course, those with a greater ability to reduce spending if outcomes in the early years of retirement (the period of most danger) are highly negative can choose a higher withdrawal rate.

Choosing A Prudent Glide Path

Having decided on the withdrawal rate still leaves open the question about choosing the right equity allocation, as well as selecting the most prudent glide path. Javier Estrada contributes to the research with his paper, "The Retirement Glidepath: An International Perspective," which appeared in the Summer 2016 issue of The Journal of Investing.

Prior literature had focused solely on U.S. data. Estrada provides us with out-of-sample data to avoid the problem that has been called the "triumph of the optimists" (the U.S. outcomes might just have been the lucky draw from an entire basket of possible outcomes). Estrada's data covered 19 countries over the 110-year period ending in 2009.

For example, Estrada shows that the 4% rule, while demonstrating low failure rates for Canada (0%), New Zealand (0%), Denmark (1.2%), South Africa (2.5%), Australia (3.7%) and the U.S. (3.7%), had a high failure rate in Belgium (50.6%), France (56.8%) and Italy (64.2%). The average failure rate was an unacceptably high 26.4%.

Following is a summary of Estrada's findings.

First, U.S. failure rates were substantially lower for DE strategies than for RE strategies. Second, perhaps surprisingly, DE strategies accumulated more wealth. Third, and perhaps most importantly, DE strategies offered more downside protection when tail risks arose.

Estrada did find that DE strategies kept retirees more uncertain about their terminal wealth (there was a higher standard deviation). However, he also found that the more volatile DE strategies provided both higher upside potential and better downside protection when tail risks struck than RE strategies did. Estrada found very similar results for world markets, with DE strategies having substantially lower failure rates.

Estrada also looked at a static 60% stock/40% bond allocation. He found that for the U.S., the failure rate was somewhat smaller for a DE strategy (4.9% versus 6.2%). And terminal wealth was higher. In the world markets, the failure rates were almost identical, and the mean terminal wealth was in fact identical (though the median terminal wealth was higher for the static strategy).

Estrada: Choose The DE Glide Path

Estrada concluded: "When deciding exclusively between these two types of strategies, retirees should choose the DE glidepath. In fact, making their portfolios increasingly conservative (rather than aggressive) during retirement would help retirees to lower the probability of portfolio failure, increase their expected bequest, and obtain better downside protection when tail risks strike."

While Estrada provides empirical evidence supporting a DE strategy over an RE strategy, there is another important consideration. Many retirees, if not an overwhelming majority, would be reluctant to hold portfolios with relatively high equity allocations as they age. And that would make either an RE or static 60/40 portfolio untenable.

First, they no longer have any labor capital that can replace losses. Second, their ability to absorb the stomach acid that large losses bring, which is often accompanied by panic selling, tends to decrease with age. Third, even if they can avoid panicked selling, they must still deal with the emotional issues that come with large losses, and will be less likely to be able to enjoy life. Fourth, even static strategies require rebalancing.

The result is that, to adhere to their plans, retirees will be required to buy more stock after periods of large losses. My more than 20 years of experience has made clear that only a minority of retirees would be able to adhere to such a plan if they had just experienced large losses. Thus, the theoretical results found in the research would likely never have been achieved by many investors.

In Conclusion

To summarize, while Estrada presents evidence favoring the use of a DE glide path over a rising one, and also shows that a static 60/40 allocation is preferable to an RE portfolio, the most prudent strategy of all is not to "set it and forget it" with any of these options.

The most prudent approach is to adapt a strategy to actual market returns and valuations. In other words, as returns are experienced and valuations change, the investment strategy should be adjusted to reflect the new circumstances. This is best done by running new Monte Carlo simulations whenever returns have been significantly different than the original assumptions built into the plan. That way the plan can then be adapted to your own personal ability, willingness and need to take risk (which varies as returns are experienced and valuations, and thus future expected returns, change).

While both static and glide path strategies have the benefit of simplicity, it's true that "everything should be made as simple as possible, but not simpler" (a quote often attributed to Albert Einstein). A dynamic approach that can adapt to your changing ability, willingness and need to take risk is the most prudent.

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