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Investing in retirement

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Pension freedoms mean that the question of how to invest in retirement is more important than ever before. This is worrying, because two traditional rules of thumb for doing so are in fact mistaken.

One is the 4 per cent rule - the idea that it's safe to take 4 per cent per year out of your wealth to spend.

The problem with this is that real returns on cash and bonds are now so low that such a drawdown rate means that anyone with a reasonably cautious asset allocation is certain to run down their wealth over time. As Hargreaves Lansdown's drawdown calculator shows, you'll end up with nothing if you live for a reasonable length of time.

The second dangerous principle is lifecycle investing - the idea that we should own more equities when we are young and shift to safer assets as we age.

The problem with this is that if shares fall early in our retirement, we'd suffer a horrible loss, one which we might not recoup if we are drawing down our wealth and shifting into safer assets. Research by Osei Wiafe at Griffith Business School in Brisbane has shown that lifecycle investing actually does worse than its opposite - increasing exposure to equities as you age.

Popular rules of thumb are therefore an unreliable guide to investing in retirement. To clarify how we should invest, we should perhaps forget old wives' tales and instead consider four questions.

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First, how long will we live? The combination of a long life, low returns on safe assets and a reasonable drawdown rate makes it certain that conservative asset allocation strategies will cause us to run out of money. We therefore need equity exposure - whether in the form of a high or rising weighting.

Secondly, what consumption path are you planning? Standard advice is based on the assumption of a flat path in real terms. But there is a case for spending more when you are young and less as you age. Doing so can build up a stock of happy memories as we reflect upon holidays or consumption capital as we enjoy music we discovered years ago. And the joy we get from spending declines as our health deteriorates: you can't enjoy holidays so much if your mobility is restricted or eyesight is failing.

This is a case for increasing equity exposure over time. This is because you might want the financial security of safe assets so that you can spend freely in the short term, but a greater equity weighting later so that you have a better chance of rebuilding your wealth.

Thirdly, how concerned are you about leaving a bequest? Clearly, the more you want to do so, the less you can spend and more you need to invest in equities. However, the bequest motive is also a reason for increasing equity exposure over time because as Javier Estrada at IESE Business School in Barcelona has shown, this strategy increases your chances of maximizing wealth at the end of your life.

Fourthly, how great is the threat of secular stagnation? Standard advice assumes that the future will resemble the past and that shares will significantly outperform safe assets on average over the long term; this is what I've assumed so far. However, this is not certain. Economic theory tells us that equities should only slightly out-perform bonds - a theory that has been correct for most of the past 30 years.

Worse still, Japan's experience - where the Nikkei 225 is more than 50 per cent lower than 25 years ago - shows that stock markets can fall for decades. If western economies get stuck in secular stagnation, equity returns could be negative for long periods. This points to the need for low drawdown rates and cautious asset allocations. And it suggests that lifecycle investing is especially dangerous, as it mandates having a high equity weighting now when prices might fall a lot.

These questions suggest that savers in retirement face massive uncertainties. There are, however, two things we can do to lift the fog.

One is to remember that we don't need a long-term plan. Short-term strategies can work well. Seasonal investing - buying on Halloween and selling on May Day - might continue to work. Or at least, its chances of failing are probably independent of the other risks we face. And the policy of selling shares when prices are below their 10-month (or 200-day)

moving average can protect us from the risk of secular stagnation. As its proposer Mebane Faber has said, such a rule "can avoid lengthy and protracted bear markets".

Secondly, we can buy insurance against secular stagnation and longevity risk simply by buying annuities, which give us a guaranteed lifetime income.

Yes, these are expensive now - but then insurance is expensive when it is most needed.

Annuities have existed for over 2000 years - a fact that should remind us that they meet some important needs.

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