



Why retirement savers need more stocks, less bonds

By [Robert Powell](#)

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Rob Arnott, the chairman of Research Affiliates, recently published research suggesting that retirement investors should boost their stock allocation and decrease their bond allocation as they age. In that research, he argued that over 40-year time spans since 1871, this approach has generated better returns. Switching from an 80% equity weighting to 20% gets you a nest egg of \$124,460 while the inverse, switching from 20% to 80% gets you a nest egg of \$152,060. Here's what Arnott had to say about that research and what retirement investors should do with their money given his research.

Question: Conventional wisdom would suggest that investors saving for and living in retirement reduce the percentage they invest in stocks as they age and increase the percentage in bonds. But your recent research suggests that conventional wisdom about portfolio allocations, where one might, say, subtract their age from 100 to determine their stock allocation, might be wrong. What did your research show?

Answer: Our target-date fund (TDF) research ([The Glidepath Illusion...and Potential Solutions](#)) shows that the classic approach to retirement investing — moving from equity-centric to bond-centric investing as we age and the basis for most TDF products — fails its core mission on several levels. It doesn't lead to greater retirement wealth or income; it doesn't decrease the uncertainty about one's retirement wherewithal even just 10 years from retirement; it's valuation indifferent, providing a ready buyer of bonds no matter what the real yield; it exposes young workers to too much risk, when they might need to cash in if they lose their job in a recession.

We find that the classic glide path is inferior to both an inverse glide path (moving from bond-centric to equity-centric investing) and a balanced 50/50 portfolio when compared with the first two above objectives of a retirement saving program: (1) maximizing the real value of our nest eggs, and (2) minimizing uncertainty around the prospective income we'll have at our disposal as we approach our retirement years. Our key findings include:

- Rebalancing to a static mix beats a gradual shift to bonds (or equities for that matter) because the solutions are not linked to expected market environments.
- Adjusting the risk profile within the stock and bond portfolios, rather than across asset classes, reins in risk more constructively than the classic glide path solutions.
- Incorporating valuation-indifferent equity strategies (for example, the Fundamental Index) improves the historical performance of the solutions relative to alternatives built using cap-weighted indexes.

Other researchers, including Michael Kitces and Wade Pfau, have also argued for a rising equity glide path. [Read Reducing Retirement Risk with a Rising Equity Glide Path](#). Do you concur with their research?

Our research focused on the accumulation phase whereas Kitces and Pfau focused on the retirement (or disinvestment) phase, so our research is not directly comparable. For our simulations, we assume all investors accumulate assets over their working life and then annuitize their portfolios at retirement.

This is not our recommendation; it's merely a convenient simplification for purposes of comparing glide path with inverse glide path. We have not extended our research to the disinvestment phase, but our intuition based on our collective experience and research is that the optimal disinvestment portfolio will be a diversified portfolio of assets, including some inflation protection assets (which we label third pillar assets in our work), and will include a meaningful allocation to equities.

Research by [Javier Estrada](#) of Barcelona's IESE Business School replicated our results using international data, and found the same results hold in all 19 countries and 2 regions.

Other researchers, including Putnam's Van Harlow, have suggested that it's best to limit stock allocation to 25% or less at retirement to avoid/mitigate sequence of return risk. What say you to this? See [Optimal Asset Allocation in Retirement: A Downside Risk Perspective](#) and [How to keep stocks from ruining your retirement](#).

Van Harlow has done some terrific work over the years, but I have mixed feelings about this prescription. His paper addresses the appropriate equity allocation in a postretirement portfolio; retirees have different goals than most TDF investors, who are focused on the pre-retirement accumulation phase. He advocates very low allocations to equity for investors who are interested in minimizing the risk of depletion of capital. The challenge to such a conservative allocation is generating real returns sufficient to support the retiree's needs over what may be 20 or 30 years of retirement, especially when bequest goals are taken into account. While we agree with the assertion that retirees have lower risk tolerance, our research shows there are better and simple ways of reducing volatility and preserving real income levels in portfolios than reducing equity allocation in favor of more bonds and cash.

Digging a little deeper, we believe that Van Harlow's results are directly related to assumptions that he makes. One challenge with using optimization is that the desired output, in this case, the asset allocation, is sensitive to input specification. We also find his 7% payout to be dangerous in a low-yield environment, unless the investor is confident that they only need for the money to last perhaps 15 years.

A more prudent payout of 4% to 5% would reduce the risk that investors' plans are demolished. Indeed, my favorite spending rule is $1/t$ (the reciprocal of the number of years you might reasonably expect to need the money). Actuaries tell me that I have about 20-25 years left; if I want to be able to spend \$50,000 a year (after tax), I should keep working until I have \$1 million to \$1.25 million (and more like \$2 million if the money is in a pension, IRA or 401(k) that may be taxed as it's drawn down). No one wants to hear advice like this, so they'll pay good money to be told what they want to hear.

Given that we are in a zero-interest-rate period, would you be more inclined to recommend conventional equity glide paths if interest rates were higher and/or rising?

We're not in a zero-interest-rate period. We're in a period in which central bankers throughout the developed world are pushing short rates to zero, and pushing inflation up to 2% (and much more, if it were correctly measured). So, we're in a negative-real-interest-rate period. These negative real interest rates make bonds far less attractive than they would be in other market environments. The challenge is that equity markets are not dramatically more attractive than bonds on a forward looking basis, given their low yields.

So, for those who demand a simple, rules-based mechanistic approach, we still favor a 50/50 allocation as a more reliable approach for a long-term strategy if equity and bonds are the only asset classes available. Investors can do much better than this, though. Retirement solutions should expand the tool kit to include more asset classes such as what we call "Third Pillar" assets (the first two pillars are mainstream stocks and bonds). These additions to our tool kit would include emerging market stocks and bonds, high yield bonds, REITs and commodities, to name a few.

In your research, you use actual market returns to show that investors with an 80/20 stocks to bonds allocation would accumulate more money than those with a 20/80 split? Would those results be different if you used Monte Carlo simulations instead of actual returns?

Our results held when we used Monte Carlo simulations. Not only that, but Prof. Estrada tested our ideas on 19 countries, going back to 1900. Our thesis held in 19 out of 19 countries. It's fair to say that conventional glide path investing is a trillion-dollar industry built on a foundation of market testing, but no historical or empirical testing. Pretty astounding.

Did your research show what happens to portfolios when investors start withdrawing money at a rate of, say, 4% a year or does it focus only on the accumulation phase?

We only focused on the accumulation phase, and we assume all investors annuitize their portfolios upon retirement. Given your questions, we are strongly considering extending our research to the retirement or disinvestment phase.

Given your findings, what's your bottom line advice to those saving for or living in retirement?

Our advice is simple: traditional allocation strategies that result in bond-centric portfolios for older investors are poor solutions.

At a minimum, investors should have a meaningful allocation to equities and other sources of risk premium, as well as a meaningful allocation to inflation-hedging assets. It's crazy to allocate the majority of a portfolio to bonds, particularly in this negative-real-yield environment, when there are other ways to reduce risk in a portfolio.

We strongly favor adding a bit of a tactical element, so that we can ramp down allocations to individual markets when their real yields become severely depressed, or more sophisticated tactical allocation models that attempt to capture relative

valuation opportunities across the asset classes.

We strongly favor broadening the tool kit, embracing the whole panoply of liquid, sensibly-priced alternative investments. We can even support simple mechanistic approaches that rebalance systematically back to some core mix, as long as that mix doesn't ramp down risk until the very last few years of accumulation.

Robert Powell is editor of [Retirement Weekly](#), published by MarketWatch. [Follow his tweets at RJPiii](#). Got questions about retirement? Get answers. [Send Bob an email here](#).

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