Opinion: Want to retire someday? How to plan ahead for the next 40 years

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Handling uncertainty when you’re investing for the long term

The best laid plans of mice and men often go awry, as the poet Robert Burns famously reminded us.

And nowhere is this more true than when planning for retirement, which can involve forecasts for the subsequent 40 years. Even if you have a well-crafted financial plan (a big “if”), and even if you follow its recommendations to the letter (an even bigger “if”), you can still fall far short of the portfolio size you have determined is necessary to retire.

The culprit, of course, is how the markets behave along the way. New research has come up with some fascinating strategies for dealing with that uncertainty.

The research in question, from Javier Estrada, a professor of finance at IESE Business School in Barcelona, is entitled “Managing To Target: Dynamic Adjustments for Accumulation Strategies.” The study is forthcoming in the Journal of Financial Planning. You may recall that earlier this year I devoted a separate column to another of Estrada’s studies—on how various so-called bucket strategies often fall short.

In this new study, Estrada measures the probability of falling short when following a strategy that, on paper, should never fall short. This hypothetical strategy is designed for a 25-year-old who commits to investing each year whatever constant inflation-adjusted amount is necessary to have $1 million in today’s dollars by the time he reaches 65. This flat amount is calculated on the assumption that his investments appreciate at a constant 5% annualized rate above inflation—the rate, more or less, that a 60% equities/40% Treasury bond portfolio has produced historically.

This steady return of 5% each and every year is clearly unrealistic, of course, since the stock and bond markets produce returns that are widely variable. The first step in Estrada’s analysis was to calculate the likelihood of your falling short if stocks and bonds in the future have the same average long-term return and yearly variability as they have in the past.
Estrada found surprisingly high odds of falling at least 10% less short of this $1 million goal upon your reaching 65 years of age: A one-in-four chance, in fact.

One suggested strategy for reducing those odds that Estrada analyzed is to become more aggressive in your investments whenever your portfolio falls behind of where it should be in order to be on track to reach $1 million at age 65. Specifically, he allowed for your equity allocation to grow to as much as 90% when your portfolio is behind, and to as low as 30% when it is well ahead. But Estrada found that this solution actually made things worse: Now there is a 39% probability of falling short by at least 10%.

This result is surprising, since this suggested solution is a variant of periodic portfolio rebalancing—which we’re taught is a prudent thing to do. But rebalancing works only to the extent there is what statisticians refer to as “regression to the mean” over the frequency with which you rebalance—that is, when one period’s outperformers are likely to be the next period’s underperformers, and vice versa.

This is not always the case, however. For example, Estrada told me in an email, rebalancing can make things far worse when you are behind where you should be, “make the allocation more aggressive, and the market drops sharply.”

A third possibility that Estrada analyzed is adjusting your annual retirement contribution according to whether your retirement portfolio is ahead or behind of where it needs to be to stay on track. Specifically, he allowed for the yearly contribution to be as much as 50% higher than the originally-determined flat rate when you fall well behind, and as much as 50% lower when your retirement portfolio is well ahead.

This third approach did improve odds—from a 25% probability of being at least 10% short when you reach age 65, to 20%.

You may find this third approach unappealing because it requires you in some years to invest significantly more than in other years. Bear in mind, however, that in other years you get to invest significantly less. It’s possible (though not guaranteed) that your average yearly contribution ends up being no different than in the hypothetical simulation of a constant inflation-adjusted amount each and every year.

In any case, bear in mind that the perfect may be the enemy of the good here. It is clear from Estrada’s research that you are likely to be reducing your odds of a successful retirement if you refuse to change your annual retirement contribution according to whether or not you’re on track.

As Estrada puts it: “It pays off for an individual to periodically assess whether his retirement plan is on track, and to introduce adjustments to the periodic contributions when it is not. These dynamic adjustments…should help individuals improve the performance of their retirement portfolios. And that is what financial planning is largely about.”

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