Here's How to Handle A Bear in Retirement

Retirees risk outliving their savings if market returns remain subpar. But bonds and cash can help savers improve their portfolios' durability.

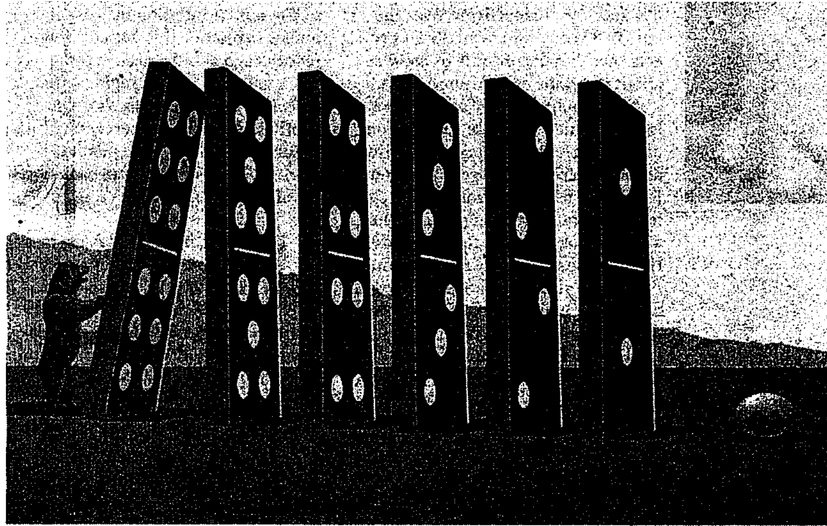


Illustration by Michael Glenwood

BY ELIZABETH O'BRIEN

One of the biggest dangers facing near-retirees and those early in retirement is sequence-of-return risk. That term describes the bad luck of retiring into a bear market, and the idea that the overall market returns that you experience in retirement matter less than the order in which those returns occur. The risk of retiring in a bear market is being forced to make withdrawals on a declining portfolio balance—in other words, being in a position where you must "sell low" to generate enough income to live on.

And the markets this year have stirred up a perfect storm as inflation has soared, with stocks down more than 20% and bonds down about 10%. "When we talk about sequence-of-return risk, we're talking about a scenario exactly like we're seeing right now," says Christine Benz, director of personal finance and retirement planning at Morningstar.

But the real danger of sequence risk isn't a sharp decline followed by a swift rebound. Rather it's a "lost decade" or more, like the stretch between 1966 and 1982 when the Dow struggled to breach 1,000, or the one that some on Wall Street are predicting is now under way. Morningstar Investment Management, for instance, predicts that U.S. stocks will earn 3.7% over the next decade—a historically below-average return.

There are steps you can take to mitigate sequence-of-return risk, whether you're approaching retirement or already there.

Address Your Allocation Mix

To mitigate volatility and sequence-of-return risk, advisors recommend that investors shift more of their money into cash and bonds as they approach retirement. If you're in a target-date mutual fund, the fund will adjust the allocation for you, becoming more conservative as retirement approaches—though it's worth examining whether that one-size-fits-all mix meets your needs.

The average target date fund has 43.1% in stocks in the investor's retirement year, according to Morningstar Direct. These funds are structured like an all-in-one solution—and for many investors, they do represent the bulk of retirement savings—but those with outside assets should evaluate their target-date fund in the context of their overall portfolio.

Rand Spero, president of Street Smart Financial in Lexington, Mass., says his rough goal is a 45/55 stock and bond split for clients entering retirement. He dials each amount up or down depending on individual circumstances. Someone with a generous pension can probably afford to take more risk in the stock market, for example, while a wealthy person with a low risk tolerance might sleep better dialing the equity allocation down to, say, 35%.

Build a Bond Tent

To be sure, bonds this year haven't acted like the ballast that they typically do in down stock markets. Fixed income has been volatile, and bonds have joined stocks on the way down.

But that doesn't mean you should throw out your bonds, says Michael Kitces, head of planning strategy for Buckingham Wealth Partners in Reston, Va. He suggests creating a "bond tent" in retirement, increasing pre-retirees' bond allocation sharply from about 40% of the portfolio to a little over 70% from ages 55 to 65, then spending it back down to 40% from ages 65 to 80 (the exact allocations may vary with an investor's risk tolerance).

Even though the bonds in the tent haven't performed that well this year, they've still outperformed the stocks outside that they're meant to protect against, Kitces says. This will leave investors with an increased allocation to stocks in later retirement, a strategy called the "rising equity glide path" that Kitces and other proponents say can help investors' money last as long as they do.

Construct a Cash Cache

Along with beefing up your bond allocation, advisors recommend building a cash cushion to cover the first few years' worth of retirement spending so that you don't have to touch your portfolio in a down market. To arrive at the right amount, calculate how much you spend every year and then subtract the income you'll receive from other sources, like Social Security or a pension.

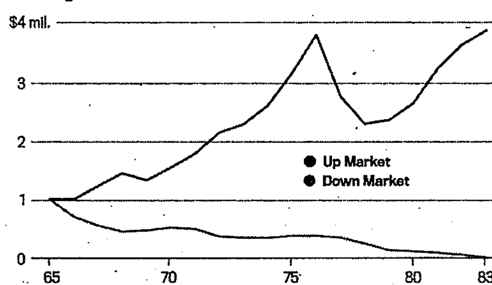
The cash bucket can hold anywhere from around one to three years of expenses, Benz said. Cash buys peace of mind, she added, but it comes with an opportunity cost of potential lost market returns. Weigh your risk tolerance and your portfolio size to see how much cash you're comfortable holding—people with sizable nest eggs can better withstand the potential opportunity cost of staying out of the market.

But what if you made no portfolio adjustments in recent years and plowed into retirement with, say, 70% or more in equities? It's not too late to make a plan, Spero says. You still need a target allocation to move toward, and you might adjust gradually. Dollar-cost-averaging is best known as a way to smooth risk on the way into markets, but it can also to smooth risk when rebalancing on the way out, says Ben Carlson, director of institutional asset management at Ritholtz Wealth Management. What's more, your portfolio doesn't have to do all the work. Lifestyle changes can also help your money last, like taking up part-time work or lowering your expenses.

The most important thing, financial pros stress, is to not make any rash moves. It may be tempting, in the midst of big life changes and market upheaval, to pull all of your money out of stocks, for example. But smaller adjustments are the way to go. "Going to extremes is where people make mistakes," Carlson says. ■

Divergent Outcomes

Two retirees start with a portfolio of $1 million. The one who retires into positive stock returns doesn't run out of money.



Source: Baird