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RETIREES ASK: NOW WHAT?

It has been a long time since retirees have faced such perplexing decisions concerning how to manage their retirement nest eggs. Yields on fixed income instruments are at lifetime lows for most and economists have even dusted off an old term called *deflation*. One of the most important questions retirees are asking is, "How do I get adequate income from my portfolio?"

Most experts agree that an annual withdrawal rate of no more than 5% should be used in a retirement portfolio. However, this rate of return in bonds or CDs is not realistic in the current interest rate environment. And although it is far from our thinking in recent years, inflation will continue to be a major factor to consider when positioning a portfolio for maximum income. If you doubt this, ask yourself: "Will I pay more or less for a postage stamp, a car, or a house 10 years from today?" The answer is invariably 'yes.' It is only a matter of *how much* more. Because of the perceived 'safety' of fixed income investments such as utilities, preferred stocks, and even high yield bonds, most will pursue *yield* rather than *total return* when they are considering their income from a portfolio. This can be detrimental.

In order to get an adequate yield in a low interest rate environment, longer-term securities are usually required. The eventual direction of rates must be *up*. This means the value of long term fixed income securities must be *down*. This creates two problems: 1.) Liquidity. You cannot sell unless you are willing to forfeit principal because as rates go up, values go down. You will have the equivalent of long-term certificates of deposit paying very low yields. Do you like the prospect of owning CDs that are paying 3 to 4% for 15 or 20 years? 2.) Because of the liquidity problem you have created with fixed income securities, you will likely not sell and therefore miss out on any opportunity to reinvest in higher yields or a rising stock market. This would be a very frustrating experience and could even jeopardize your retirement nest egg's long-term viability.

By taking a *total return* approach to this problem, a retiree can effectively avoid this situation. By maintaining an adequate amount of the portfolio in *ultra* short bonds (less than one year average duration) the loss of principal problem is eliminated because ultra short bonds can react quickly if rates climb. Additionally, by holding an adequate portion in stocks this will allow a hedge against inflation and also help with income taxes at capital gains rates of 20% (with stocks) vs. nearly 40% in the top bracket as ordinary income (with bonds).

When retirees are told to employ a total return approach to managing their money they always ask the question: "What if I need money to live on? I don't want to have to sell stocks if they are down." Good point. By having 3 to 6 months cash on hand and then liquating ultra short bonds, you will never likely be in a position of selling a security when it is "down." When this methodology is utilized, a rebalancing of the portfolio should occur every six months to get the portfolio back in line with your *Investment Policy Statement.* (Don't have an IPS? Shame on you.) The beauty of this automatic rebalancing is that it virtually ensures that you will always sell high and buy low.

Think about it. Say the large U.S. portion of the portfolio has done well for six months and the large International has lagged behind. By automatically chopping off the top of the U.S large and moving it to the International large asset class you are selling high – that which has done well – and buying low – that which has not done as well and is therefore cheaper to buy. This is the type of systematic discipline that allows any investor, but especially retirees, to have a consistent and enjoyable long term investing experience.

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