Don’t Underestimate Equities in Retirement

Many retirees reflexively believe that they can live off of the interest from their investments while preserving principal.

Using interest payments alone to fund one’s living expenses in retirement may have been possible in decades past when life expectancies all but guaranteed a shorter retirement and yields on the 10-year Treasury note were in the high single digits. But it is virtually impossible today in light of increasing life expectancies and the backdrop of ultra-low rates brought on by the Federal Reserve’s response to the 2008 financial crisis.

Meanwhile, some investors, financial advisers and even the news media continue to advance the idea that dialing down risk is simply a matter of reducing equity exposure in favor of fixed-income holdings and short-term investments like cash. In truth, by “overshooting” and reducing equity exposure too much in retirement, investors are simply trading a potential reduction in short-term volatility for other risks, such as not keeping up with the rising cost of living over time—or worse still, outliving their assets.

Risk is, in fact, multidimensional, and retirees, in particular, must carefully manage short-term volatility while also managing the threat posed by inflation. Over time, inflation can erode the real value of assets, make future purchases more expensive, and increase the likelihood that a retirement portfolio will run dry.

That is why retirees should consider boosting their allocations to equities. Equities have been a proven hedge against inflation. The S&P 500 index, for example, has beaten the most widely used measure of inflation in the United States, the Consumer Price Index (CPI), in 95% of all 15-year periods since 1926—by an average margin of eight percentage points, according to an analysis of Ibbotson data by T. Rowe Price. (The returns are for the period of January 1926 through December 2013, with a new 15-year period starting each calendar month.)

Nonetheless, retirees remain under-allocated to equities as they shift into their retirement years. Recent market history and the nature of retirement itself play a role. Many retirees and preretirees were deeply scarred by steep stock market losses in 2008.

Although markets have rebounded, the impression persists that the basic rules of investing were forever altered, fueled by apocalyptic crisis-era headlines ranging from “Everything you thought you knew about diversification is wrong” to “Advisers ditch ‘buy and hold’ for new tactics.” In reality, investing principles such as asset allocation, diversification and the wisdom of shifting methodically, not drastically, from stocks to bonds as one ages not only survived the crisis but were fully validated by subsequent market performance.

There is another dynamic in play, as well. When investors create a plan for buying a house or paying for a child's college education, they are essentially saving and investing for a singular event: the day they write a big check and take possession of the home, or the relatively brief, four-year period (one hopes!) during which they write large checks to a university. Retirement is inherently different. Although many people approach the transition as if it's a singular event that unfolds the day they turn 67, retirement is one of the few "purchases" in which all the money isn't spent at once.

So how should you view your retirement portfolio?

From a financial planning perspective, retirement is composed of a multitude of time horizons, each containing different spending goals, whether it is a scuba-diving vacation and monthly visits with the grandkids or day-to-day living expenses and the cost of a knee replacement.

To simplify how retirees think about their time horizons, it's best to break a 30-year retirement into just two distinct 15-year periods. Viewing it this way helps bring the appropriate role of equities into sharper focus. Conceptually, since about than half of a retiree's assets won't likely be needed until the second 15-year horizon, this portion of the retirement portfolio must be invested appropriately and that, generally speaking, means allocating the funds almost exclusively to equities.

If history is any guide, investors can take comfort in such a decision. Of all the rolling 15-calendar-year periods beginning in 1926 and ending in 2014, the S&P 500 index has never had a negative period. Even during the tumultuous decade-and-a-half that included the bursting of the tech and telecom bubble and the fallout from the global financial crisis—from October 1999 to September 2014, to be precise—the S&P 500 index delivered more than a 55% cumulative return to investors who stayed the course, as shown in Figure 1.

Figure 1. Performance of the S&P 500 Over the Last 15 Years

Investors who maintain a healthy allocation to equities in retirement may be able to reduce their likelihood of running out of money—and may generate higher ending account balances after 30 years of annual retirement withdrawals.

A study by T. Rowe Price compared two glide path strategies of target date portfolios: one with a 55% allocation to stocks and one with a 46.5% allocation to stocks at the retirement date. The higher equity glide path resulted in fewer 30-year periods in which the asset allocation was not able to support annual withdrawals ranging from 4% to 5%. Additionally, the evidence suggests that target date portfolios with more exposure to equities are more likely to deliver higher residual wealth after 30 years of annual withdrawals across a range of historical rolling periods.

For retirees, stock market volatility may feel like the most important, or only, risk. But it is only one of several key risks that must be effectively managed over what is, increasingly, a long planning horizon. A retiree’s asset allocation strategy must balance protection against short-term volatility with protection from longevity and inflation risk. To be sure, retiree asset allocations should likely include a substantial allocation to bonds and short-term investments which, by definition, are less susceptible to short-term volatility.

But now more than ever, retirees need a healthy exposure to equities, with that exposure sensibly decreased over time in order to keep market risk in check.

→ **Stuart Ritter,** a certified financial planner, is a vice president of T. Rowe Price Investment

Services Inc.

The full version of this article originally appeared in the ***June 2015*** *issue of the* AAII Journal*.*

> If you are not an AAII member and want to gain access to all the **benefits** of membership, simply take a **risk-free 30-day Trial AAII Membership** and start becoming an effective manager of your own assets.