Using the Bucket Approach With Your Retirement Portfolio

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How can you make sure you never run out of money in retirement, even though you don't know exactly how long you'll need it?

In the past, one simple and elegant solution to the above problem was to buy an immediate annuity that would pay you a stream of income for the rest of your life. One other intuitively appealing idea is to sink your portfolio into income-producing investments, such as bonds and dividend-paying stocks and live off whatever yield they generate.

Given that each of those approaches has become more challenging in the current low-interest-rate environment, it's no wonder that so many retirees and pre-retirees have been receptive to another strategy: "bucketing" their portfolio for retirement. Bucketing is a total-return approach in which you segment your portfolio based on when you expect to need your money. Money for near-term income needs is parked in cash and short-term bonds while money needed for longer-range income needs remains in bonds and stocks.

The Beauty of Buckets

Why has bucketing become so popular? First, it bows to reality by acknowledging that all but very wealthy investors will need to tap their principal during retirement; second, it provides a sensible and easy-to-use framework for doing so. And given that many retirees will live for 25 or more years in retirement, the bucket approach provides a necessary dose of long-term growth potential, enabling you to hold stocks as well as safer securities for nearer-term income needs.

Bucketing also helps address some key psychological roadblocks. By carving out a cash position in your portfolios and automating withdrawals from that account, you can receive a steady paycheck, month in and month out, just like you received when you were still working. Knowing that a predictable stream of income is coming in the door can provide great peace of mind.

Moreover, holding a cash component (Bucket 1) can help you ride out periodic downturns in your long-term portfolios without panicking. If you know your near-term income needs are covered in the cash bucket—and, in a worst-case scenario, in your bond bucket as the next-line reserve—you're likely to be less rattled the next time stocks plunge.

Bucketing also helps you get away from the income-only mindset, which may not lead to an optimal outcome. Many retired investors make a strict distinction between their principal and the interest it kicks off. The former is sacrosanct, never to be touched and, ideally, left to heirs. The latter is what they must rely on to meet their living expenses. Yet never touching principal might lead you to underspend, forsaking quality-of-life considerations and leaving more to heirs than would be optimal. Perhaps even more significantly, as yields on safe securities have shrunk to lower than 2% to 3% during the past few years, income-only investors have found themselves with a stark choice: Either stick with cash and high-quality bonds and reduce their standard of living or venture into securities that promise a higher payout with higher volatility to boot.

Instead of relying on dividends and bond income to supply living expenses, using a bucket approach you can be unrestrictive about how you replenish the cash in Bucket 1 once it becomes depleted. You could rely on bond and dividend income to fulfill some of your living expenses, but also, use rebalancing proceeds, tax-loss harvesting proceeds, and so forth.

Finally, bucketing is compelling because it’s flexible. A bucket portfolio can incorporate many of your existing holdings, and a bucket plan can be readily customized to suit your own specifications. For example, an older retiree with an expected 10-year time horizon might have just two buckets—one for very short-term needs and another bucket earmarked for the medium term. A younger retiree with a longer time horizon, meanwhile, might have similarly positioned short- and intermediate-term buckets as well as a sizable equity bucket for long-term growth.

A Model Bucket Portfolio

To help illustrate what an actual bucketed portfolio might look like, imagine a soon-to-retire couple with the following attributes: They have a $1.5 million portfolio.

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- Their time horizon is 25 years, and they have a very high risk capacity.
- They plan to withdraw 4% of their initial balance in year 1 of retirement ($60,000), then inflation-adjust that amount every year.

Given those variables, Christine Benz of Morningstar built a sample bucketed portfolio employing some of Morningstar analysts’ favorite funds. Note that because this portfolio is geared toward risk-tolerant investors with a very long time horizon, it’s quite equity-heavy, with a roughly 50% stock/50% bond asset allocation. This profile will be too aggressive for many retirees.

Bucket 1: Years 1 and 2

- $60,000: Cash (certificates of deposit, money market accounts, and so on)
- $60,000: PIMCO Enhanced Short Maturity ETF (MINT)

This portion of the portfolio is designed to cover living expenses in years 1 and 2 of retirement. Its goal is stability of principal with modest income production. Risk-averse investors who want an explicit guarantee of principal stability will want to stick with FDIC-insured products for this sleeve of the portfolio.

On the flip side, investors comfortable with slight fluctuations in their principal values may steer less than a year's worth of living expenses to true cash instruments. The model portfolio splits the difference, investing a year's worth of living expenses in true cash instruments and another year's worth of living expenses in an ultra short-term bond exchange-traded fund.

Bucket 2: Years 3 to 10

- $130,0000: T. Rowe Price Short-Term Bond (PRWBX)
- $150,000: Harbor Bond Institutional Class (HABDX)
- $100,000: Harbor Real Return Institutional Class (HARRX)
- $100,000: Vanguard Wellesley Income Investor Shares (VWINX)

The goal for Bucket 2 is stability and inflation protection as well as income and a modest amount of capital growth. It's anchored by two sturdy, flexible core bond funds—one short-term and the other intermediate. [Harbor Bond is a no-load near-clone of PIMCO Total Return Institutional Class (PTTRX).]

In addition, it includes exposure to inflation-protected securities (Harbor Real Return) and a hybrid stock/bond fund (Vanguard Wellesley Income) to provide income with a shot of equity exposure.

Bucket 3: Years 11 to 25

- $400,000: Vanguard Dividend Growth Investor Shares (VDIGX)
- $200,000: Harbor International Institutional Class (HAINX)
- $100,000: Vanguard Total Stock Market Index Investor Shares (VTSMX)
- $125,000: Loomis Sayles Bond Institutional Class (LSBDX)
- $75,000: Harbor Commodity Real Return Strategy Institutional Class (HACMX)

Because this component of the portfolio will remain untouched for the next decade, save for rebalancing, the assets here are primarily invested in equities. This component of the portfolio also includes smaller stakes in high-risk bonds (Loomis Sayles Bond) and commodities for inflation protection.

This is the growth engine of the portfolio, but note that the core equity holding—Vanguard Dividend Growth—focuses on high-quality names and tends to offer better downside protection than many large-cap equity funds. This portion of the portfolio also includes a fairly high stake in foreign stocks, which have the potential to add to the portfolio's volatility level, in part because of currency fluctuations. Risk-conscious investors might, therefore, consider scaling back the foreign-stock portion of the portfolio.

Bucket Maintenance

The result you achieve with a bucket portfolio will depend on the securities you employ, as well as your approach to bucket maintenance—where you go for cash to meet your living expenses, as well as how you rebalance.

Should you simply transfer money from Bucket 3 (stocks) to Bucket 2 (bonds) to Bucket 1 (cash) on a regular, preset basis? Or should you take a more eclectic, opportunistic approach, refilling your cash bucket (Bucket 1) with income and dividends from bonds and stocks, rebalancing proceeds, tax-loss harvesting, and so forth? Alternatively, should you take a truly total-return or income-oriented approach to bucket maintenance?

Each of these strategies has its pros and cons, as outlined below. Ultimately, a few of these approaches run counter to the central premises of bucketing and are therefore less than optimal. The "strict constructionist total-return" and "opportunistic" approaches will generally make the most sense for retirees wishing to employ a bucket strategy.

The Mechanical Approach

Under a strategy such as this, you would move assets from Bucket 2 (bonds) to Bucket 1 (cash), and from Bucket 3 (stocks) to Bucket 2 on an annual basis (on some other time-period-based frequency). The entire portfolio would become progressively more conservative as the assets in Bucket 3 are depleted.

Pros: The strategy is simple to understand. And because the equity portion (Bucket 3) is apt to decline as a percentage of the portfolio over time, it reduces risk in the portfolio as your time horizon grows shorter. That's something some—but not all—retirees may find desirable.

Cons: The big drawback to mechanically selling stocks and bonds on a calendar-year basis is that it doesn't take into account whether it's an opportune time to sell a given asset class. For example, strictly adhering to mechanical approach to bucket maintenance would have meant that you sold stocks and bonds throughout the 2007–2009 bear market and moved the proceeds into cash, thereby leaving fewer long-term securities in place to rebound in the subsequent bull market. In this respect, such a maintenance strategy undermines one of the central attractions of bucketing: The cash sleeve is there to keep you from selling long-term assets at the wrong time. For that reason, such a mechanical approach to bucket maintenance isn't advisable.

The Income-Only Approach

Using this strategy, Bucket 1 is refilled with whatever income the cash, bond, and stock holdings kick off.

Pros: Because it doesn't involve tapping principal, this approach guarantees not only that you won't outlive your assets, but also that there will be principal left over for heirs or for in-retirement splurges. In addition, an income-centric approach is the lowest-maintenance, as it's easy to automate the income distributions into Bucket 1.

Cons: One of the central attractions of the bucket approach is that it helps smooth your income stream by holding a static amount in Bucket 1, based on real-life living expenses. But by relying only on income distributions to refill Bucket 1, you are apt to find that the income stream varies based on the prevailing yield environment. Moreover, the income-generating securities in a portfolio may not generate a livable yield at various points in time (like right now), leaving you with no choice but to withdraw principal.

The Strict Constructionist Total-Return Approach

Under this strategy, you reinvest all income, dividends, and capital gains back into your holdings. You regularly rebalance, periodically scaling back on those holdings that have performed the best, whether they are stock or bonds, to bring the total portfolio's asset-class exposures back in line with targets. (Those targets may gradually grow more conservative over time, depending on the asset-allocation glide path you are using.) You can use those rebalancing proceeds to meet living expenses, augmenting them with withdrawals from Bucket 1 (cash) on an as-needed basis.

Pros: The big advantage to the total-return approach, in contrast with the one outlined above, is that it's extremely plugged into market movements and valuation, forcing you to sell appreciated assets on a regular basis while leaving the underperforming assets in place or even adding to them. Using this strategy during the bear market, for example, you would have been trimming high-quality bond holdings to meet living expenses and/or to refill Bucket 1, leaving potentially undervalued equity assets intact.

Cons: Rebalancing too often may prompt you to prematurely scale back on an asset class, thus reducing the portfolio's total-return potential. That argues for holding, at least, two to three years' worth of living expenses in Bucket 1, thereby giving you more discretion over when to sell assets for rebalancing.

The Opportunistic Approach

Under this strategy, you take a unrestrictive approach to refilling Bucket 1. Income distributions from cash holdings, bonds and dividend-paying stocks are automatically transferred to Bucket 1. If those distributions are insufficient to refill Bucket 1, you can look to rebalancing proceeds, tax-loss harvesting and required minimum distributions from Bucket 2 and Bucket 3 to top up depleted cash stakes.

Pros: By directing income and dividend distributions into Bucket 1, this approach provides a baseline of income for living expenses. Those income distributions may also trend up in periods of market distress, as yields often move in the inverse direction of prices. That extra income, in turn, could help you avoid tapping principal during a market downturn.

Cons: Because income and dividend distributions aren't being reinvested, the long-term portfolio's total-return potential is apt to be less than is the case with the strict constructionist total-return approach.

Tailoring the Strategy

Real-life bucket setup and maintenance is going to be more complex than is the case for the single portfolio featured here, owing to asset-location and withdrawal-sequencing issues and the need to take required minimum distributions from tax-deferred accounts, among other considerations.

These factors shouldn't deter you from employing buckets in your own retirement distribution plan, but they do mean you should consider your own financial situation when implementing such a system.

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