

■ PRE-RETIREEES

CASE STUDY:

Portfolio for conservative retirement savings

BY CHRISTINE BENZ

Seventy-five years ago, the average remaining life expectancy for a man reaching age 65 was 12.7 years, and 14.7 years for a 65-year-old woman, according to Social Security Administration data. Fast-forward to today and those numbers have increased to 19.3 years and 21.6 years, respectively.

Those life expectancy gains are, of course, largely a positive. But when you combine longer life spans with the fact that more and more people are coming into retirement with Social Security as their only guaranteed income source, it's not hard to see why such a large swath of the population is concerned about out-living its assets.

Because low bond yields portend meager returns from the asset class in the decades ahead, a very conservative, cash- and bond-heavy portfolio is unlikely to cut it for most pre-retirees. To help improve their portfolios' long-term return potential and preserve purchasing power, people closing in on or already in retirement absolutely need to hold a healthy allocation to stocks.

That thinking explains why the Conservative Saver portfolios—geared toward still-working individuals who expect to retire in 2020 or thereabouts—maintains a more than 50 percent weighting in stocks. As with previous portfolios, I used Morningstar's Lifetime Allocation Indexes to help set the baseline allocations.

Portfolio details

For the Conservative Saver Portfolio, I targeted a roughly 50 percent stock weighting. For equity exposure, I held on to the same funds employed in the Moderate Saver Portfolio, albeit in smaller allocations.

Individuals at this life stage might also start setting up their portfolios by anticipated income needs, as demonstrated with the bucket approach, which is covered in the next section of this guide. With retirement five to 10 years into the future, it's too early to start raising cash for in-retirement living expenses; at today's very low yields, the opportunity cost of doing so is simply too great. But pre-retirees might consider steering part of their fixed-income sleeves to a short-term bond fund that could be readily converted into cash. After all, having sufficient short-term assets in the portfolio can help mitigate sequencing risk—the chance that a retiree could encounter a lousy market right out of the box.

The mutual fund portfolio

- 10%: Primecap Odyssey Growth (POGRX)
- 10%: Vanguard Dividend Appreciation (VDADX)
- 10%: Oakmark Fund (OAKMX)
- 7%: Vanguard Extended Market Index (VEXAX)
- 10%: Vanguard Total International Stock Index (VTIAX)
- 4%: Oakmark International Small Cap (OAKEX)
- 30%: Metropolitan West Total Return Bond (MWTRX)
- 7%: Fidelity Short-Term Bond (FSHBX)
- • 12%: Vanguard Inflation-Protected Securities (VAIPX)

The ETF portfolio

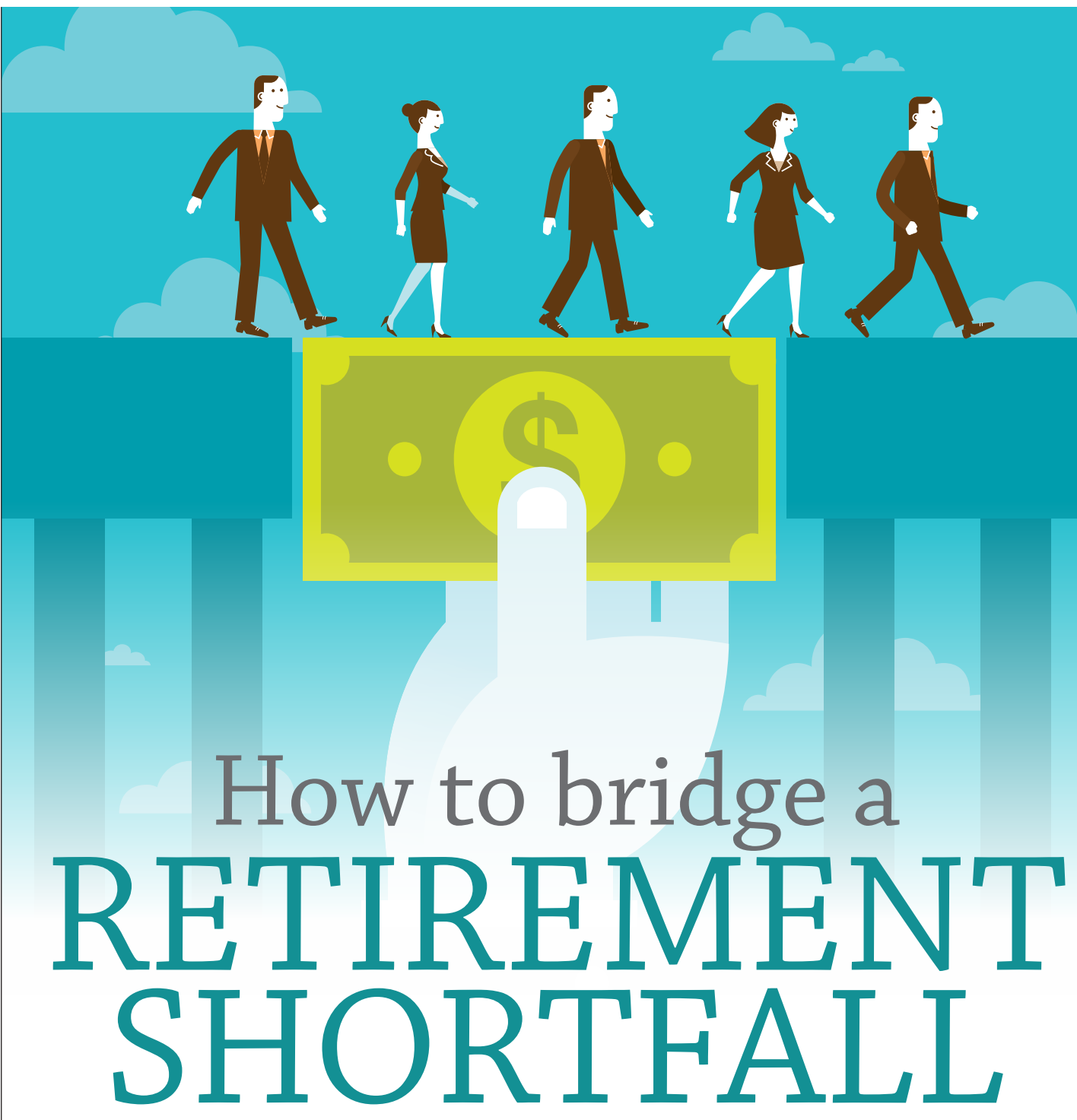
- 33%: Vanguard Total Stock Market Index ETF (VTI)
- 5%: Vanguard Small-Cap Value ETF (VBR)
- 10%: Vanguard FTSE Developed Markets ETF (VEA)
- 4%: Vanguard FTSE Emerging Markets ETF (VWO)
- 30%: iShares Core Total USD Bond Market ETF (IUSB)
- 11%: Vanguard Short-Term Inflation Protected Securities ETF (VTIP)
- 7%: Vanguard Short-Term Bond ETF (BSV)

How to use

The key goal of all of my model portfolios is to depict sound asset-allocation and portfolio-management principles. Thus, individuals who are closing in on retirement can use the Conservative Saver portfolios to help assess their portfolios' positioning. But it's worth noting that the portfolios won't be a good fit for all pre-retirees. For example, those who will be relying on pensions for much of their in-retirement living expenses, or those who know they can handle the volatility that comes along with a stock-heavy portfolio, will likely want to steer more than half of their portfolios to stocks.

I also developed the portfolios without consideration for tax efficiency—that is, I assumed they would be held inside of a tax-sheltered wrapper of some kind, such as an IRA. Investors who intend to hold their portfolios inside of a taxable account would want to put a greater emphasis on tax efficiency, emphasizing index funds and ETFs on the equity side, for example.

Morningstar



How to bridge a

RETIREMENT SHORTFALL

BY CHRISTINE BENZ

If you want to get yourself thoroughly depressed, spend a little time looking at statistics about Americans' retirement preparedness. True, retirement-account balances have rebounded significantly since the financial crisis, contributing to an increase in workers' confidence that they'll be able to afford a comfortable retirement.

But other data are more sobering. Fidelity's Retirement Preparedness Measure, which takes into account current savings rates and account balances, shows that less than half of all Americans are going to be able to maintain their current standards of living in retirement. A recent report from the U.S. Government Accountability Office issued noted that about half of all Americans age 55 or older have no retirement savings, such as IRAs or 401(k)s.

Clearly, many people are hurtling toward a shortfall or living through one. And for people who are dramatically undersaved and largely reliant on Social Security for in-retirement living expenses, there's no getting around the fact that their standard of living in retirement is going to be lower than it was when they were working.

Many other workers have some retirement savings—just not enough. I've noticed that people in that position tend to adopt one of a handful of tactics. The first set is defeatist: "My kids will just have to take care of me." The second set is scrappy: "I'm just going to keep on working." The last group of people are looking to their investment portfolios to do the heavy lifting, hoping against hope that some combination of the right asset allocation and good investment picks will help make up for the shortfall.

I'd propose a fourth course of action. Rather than looking to a single blockbuster solution to help make up for a savings gap, what if you were to

consider a little bit of several prudent strategies—being willing to cut your standard of living a bit in retirement, working a bit longer, and investing a bit better, for example? The virtue of taking several small steps—rather than relying on a single "Hail Mary" action—is that if one of the variables doesn't play out as you thought it would, you may still be able to save your plan.

Meet the shortfall coverers

Let's run through the key variables that investors have to choose from if, based on their current savings and savings rates, it looks like there's a risk that their retirement assets will fall short.

**Work longer:** As pre-retirees have no doubt heard, working even a few years past traditional retirement age can deliver a three-fer on the financial front, allowing additional savings, fewer years of portfolio drawdown, and perhaps delayed Social Security filing. Yet as attractive as working longer looks by the numbers, it's a poor idea to make it the sole fallback plan, as many workers who plan to work longer are not able to.

**Delay Social Security:** This is another exceptionally powerful lever, allowing individuals to pick up a roughly 8 percent increase in benefits for every year they delay Social Security filing beyond their full retirement ages up until age 70. In order to pull this off, however, an individual may need to work longer or draw from the portfolio earlier.

**Save more before retirement:** The good news is that from a household budgetary standpoint, many individuals are best equipped to crank up their savings rates later in their careers. They're often in their peak earnings years, and other big-ticket pre-retirement expenses, such as home purchases and college funding, may be in the rearview mirror. The bad news is that with a shorter time horizon, those newly invested dollars will have less time to compound before they'll need to withdraw them; the tax benefits that

one gets from using tax-advantaged retirement savings vehicles like IRAs and 401(k)s also matter less (especially for tax-deferred contributions that entail RMDs) later in life. That doesn't mean that late-start retirees shouldn't bother with additional contributions if they can swing them, though: Even an additional \$5,000 invested annually for 10 years, earning a modest average return of 4 percent, would translate into more than \$60,000 additional dollars in retirement.

**Spend less during retirement:** Generally speaking, people who earned higher incomes will have more wiggle room in lowering their in-retirement expenses than people with lower incomes. The simple reason is that the former group is apt to have more discretionary expenses—and therefore could do more belt-tightening—than the latter group. Being willing to relocate to a cheaper home and/or a less-expensive location can deliver one of the biggest-ticket cost savings available to retirees.

**Tweak investments:** Many pre-retirees confronting a shortfall focus their energies here, and a portfolio with a heavier stock mix will tend to have a higher long-term return than a more conservative one. Yet it's a mistake not to temper a pre-retirement portfolio's asset mix with safer investments, and that's particularly true in market environments that feature not-cheap equity valuations (like the current one).

**Lower investment costs:** This one's a gimme. Lower mutual fund expenses are correlated with better returns, so why wouldn't you work to bring your portfolio's total costs down? Lowering costs can be particularly advantageous as you enlarge your portfolio's stake in safer investments like bonds, where absolute investment returns are apt to be fairly low and the differential between very strong- and very poor-performing investments can boil down to expenses.

Morningstar

■ PRE-RETIREEES: Road Map

It's no wonder that so many investors seek out extra guidance at this life stage, because decumulation is fundamentally more complicated than building up a portfolio in advance of retirement. Investors hurtling toward retirement quite reasonably wonder about the viability of their plans—whether they'll have enough and how much they can take out of their portfolios each year—as well as the structure of their portfolios. In an era in which yields have dropped steadily downward for the better part of three decades, it's not intuitively apparent how to structure a portfolio to deliver the necessary cash flows for retirement.

As you plot out your strategy at this life stage, here are the key tasks to tackle.

Nourish your human capital

In previous articles in this guide geared toward early- and mid-career accumulators, we emphasized the importance of continuing to invest in your human capital—your lifetime earnings power. Keeping abreast of the latest technology developments—both

inside and outside of your workplace—also is crucial. After all, the best thing you can do to improve the financial viability of your retirement plan is to put in as many years in the workplace as you can.

Start mulling your Social Security strategy

Staying in the workforce up to or beyond traditional retirement age has another salutary benefit: It can help you delay filing for Social Security, thereby enlarging your benefit when you eventually do file. The Social Security Administration's Retirement Estimator allows you to model out your Social Security benefits based on various Social Security start dates. Married couples should take special care to strategize about Social Security together, with an eye toward enlarging their total lifetime benefits from the program. (If one spouse is younger and will gain a larger benefit from a spousal benefit than his or her own benefit, delaying receipt of benefits will be particularly advantageous for the older, higher-earning spouse.)

Maintain your safety net

The usual insurance recommendations apply for the years leading up to retirement: property and casualty, personal liability, and health and disability, of course. If your children are grown and off your payroll, it's also wise to revisit your need for life insurance at this stage.

Long-term care insurance may be prohibitively expensive by the time you reach your early 60s, or you may have encountered a health condition that disqualifies you from buying it. But it's still worth pricing out coverage, especially if you have built up a sizable but not enormous nest egg.

Maintaining an adequate emergency fund remains important at this life stage. Because higher-income and/or more specialized jobs often are more difficult to replace than is the case for people who are earlier in their careers, consider holding at least a year's worth of living expenses in liquid assets. There's an opportunity cost to holding too much cash, of course, but having an adequate cushion will keep you from having to raid your retirement assets prematurely.

Morningstar