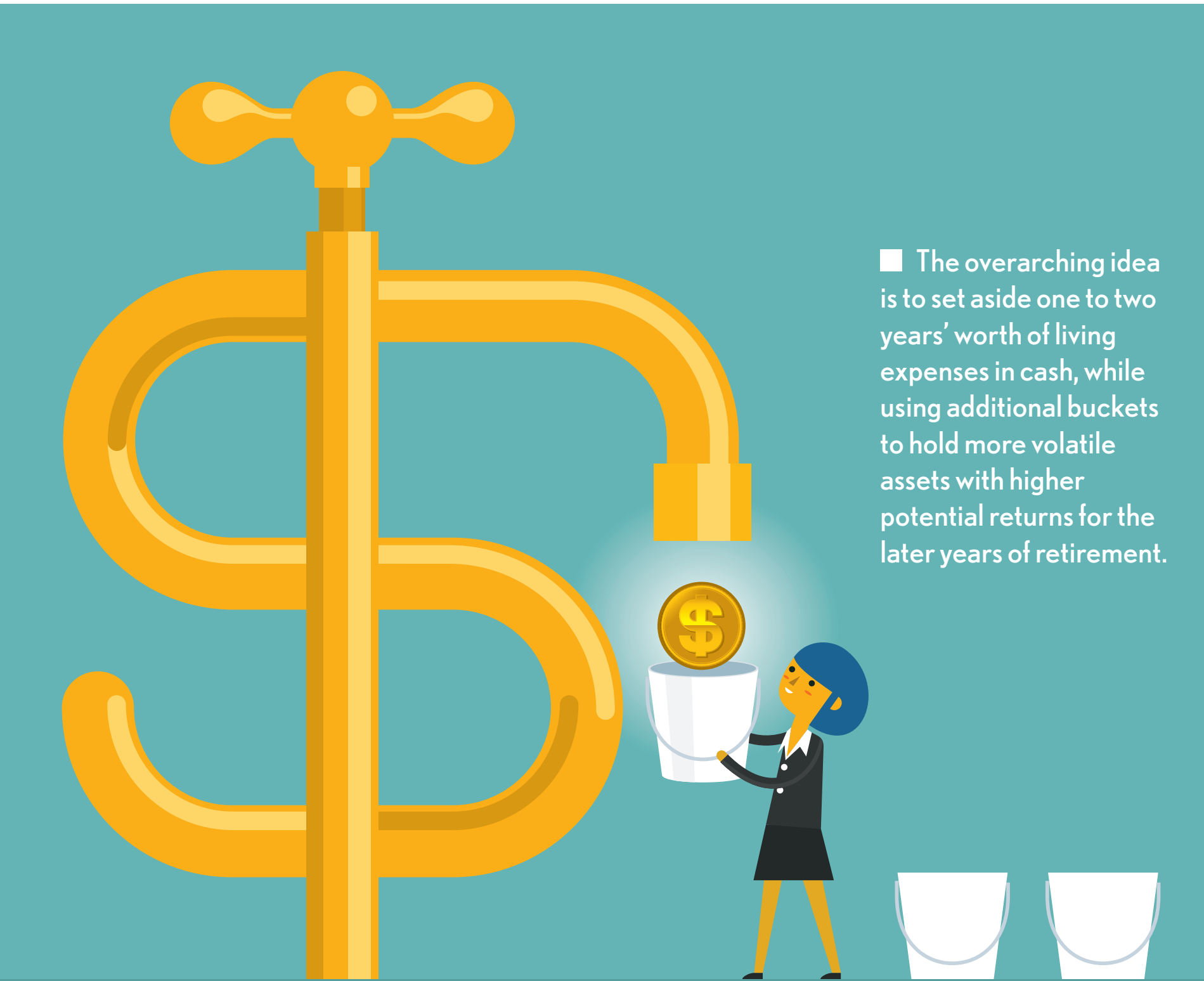


■ RETIREES



■ The overarching idea is to set aside one to two years’ worth of living expenses in cash, while using additional buckets to hold more volatile assets with higher potential returns for the later years of retirement.

BUCKET PORTFOLIOS

FOR RETIRED INVESTORS

The Bucket Approach is a strategy for funding retirement cash-flow needs while also maintaining a diversified portfolio of stocks, bonds and cash. The overarching idea is to set aside one to two years’ worth of living expenses in cash (Bucket 1), while using additional buckets to hold more volatile assets with higher potential returns for the later years of retirement.

Morningstar has created a series of hypothetical portfolios that showcase how one might implement the bucket strategy. Each portfolio includes a cash component (Bucket 1), an intermediate-term component consisting mainly of bonds and balanced funds (Bucket 2) and a long-term component for growth, featuring stocks and higher-risk bond types (Bucket 3). The size of the buckets varies by time horizon. The portfolios are popular with funds that are favorites among Morningstar’s analysts.

Here we’ll share the series composed of traditional mutual funds — featuring aggressive, moderate, and conservative asset-allocation mixes.

Although the portfolios have only been around since late 2012, we conducted some performance tests to see how they would have withstood various market environments. Did they fund retirees’ cash-flow needs while also holding principal steady, or even growing it? The answer is yes. We stress-tested several scenarios and time periods — 2007-2012, 2000-2013, and varying implementation and rebalancing strategies — and found that the portfolios generally met their goals of providing in-retirement cash flow and growing principal.

Bucket basics

In each scenario — aggressive, moderate and conservative — we’re assuming a 4 percent withdrawal in year one of retirement, with that dollar amount adjusted upward to keep pace with inflation in subsequent years. Investors can, of course, apply their own starting withdrawal rates as needed; that will determine what percentage of their portfolios they hold in Bucket 1. As Bucket 1

- AGGRESSIVE BUCKET**
- This portfolio is geared toward retirees with a time horizon (life expectancy) of 25 years or more and who have an ability to withstand the volatility that comes along with a 50 percent stock weighting.
- Bucket 1: Years 1-2**
8 percent: Cash (certificates of deposit, money market accounts, and so on)
 - Bucket 2: Years 3-10**
8 percent: Fidelity Short-Term Bond (FSHBX)
10 percent: Harbor Bond (HABDX)
4 percent: Vanguard Short-Term Inflation-Protected Securities Index (VTAPX)
10 percent: Vanguard Wellesley Income (VWINX)
 - Bucket 3: Years 11 and Beyond**
10 percent: Vanguard Total Stock Market Index (VTSAX)
24 percent: Vanguard Dividend Appreciation (VDADX)
13 percent: Harbor International (HIINX)
8 percent: Loomis Sayles Bond (LSBRX)
5 percent: Harbor Commodity Real Return (HACMX)

is depleted to meet living expenses, the retiree would refill it using income and dividend distributions and/or rebalancing proceeds.

In all instances, Bucket 1 is designed to cover living expenses in years one and two 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.

Bucket 2 is next in line to supply living expenses once Bucket 1 has been depleted. The goal for Bucket 2 is stability and inflation protection as well as income and a modest amount of capital growth. In all instances, Bucket 2 is an-

- MODERATE BUCKET**
- This portfolio assumes a 20-year time horizon and less of an appetite for short-term volatility. It targets a weighting of 50 percent in stocks and 50 percent in bonds and cash.
- Bucket 1: Years 1-2**
10 percent: Cash (certificates of deposit, money market accounts, and so on)
 - Bucket 2: Years 3-10**
10 percent: Fidelity Short-Term Bond (FSHBX)
5 percent: Fidelity Floating Rate High Income (FFRHX)
15 percent: Harbor Bond (HABDX)
5 percent: Vanguard Short-Term Inflation-Protected Securities Index (VTAPX)
5 percent: Vanguard Wellesley Income (VWIAX)
 - Bucket 3: Years 11 and Beyond**
20 percent: Vanguard Dividend Appreciation (VDADX)
10 percent: Vanguard Total Stock Market Index (VTSMX)
10 percent: Harbor International (HIINX)
5 percent: Harbor Commodity Real Return (HACMX)
5 percent: Loomis Sayles Bond (LSBRX)

chored by two sturdy, flexible core bond funds: one short-term and the other intermediate. In addition, it includes exposure to inflation-protected securities and a hybrid stock/bond fund (Vanguard Wellesley Income) to provide income with a shot of stock exposure. And in the Moderate and Conservative portfolios, we’ve added a small stake in a bank-loan (or floating-rate) fund, Fidelity Floating Rate High Income, which will tend to have limited interest-rate sensitivity and might also offer a measure of inflation protection. (Note that the Aggressive portfolio doesn’t include the bank-loan fund; because the Aggressive portfolio’s bond stake is smaller than the other two portfolios, it sticks with plain-vanilla bond funds.)

Because Bucket 3 will remain untouched for the next decade, the assets here are primarily invested in equities, with smaller stakes in high-risk bonds

- CONSERVATIVE BUCKET**
- This portfolio assumes a 15-year time horizon. It targets a weighting of 40 percent in stocks and 60 percent in bonds and cash.
- Bucket 1: Years 1-2**
12 percent: Cash (certificates of deposit, money market accounts, and so on)
 - Bucket 2: Years 3-10**
12 percent: Fidelity Short-Term Bond (FSHBX)
5 percent: Fidelity Floating Rate High Income (FFRHX)
20 percent: Harbor Bond (HABDX)
6 percent: Vanguard Short-Term Inflation-Protected Bond Index (VTAPX)
5 percent: Vanguard Wellesley Income (VWIAX)
 - Bucket 3: Years 11 and Beyond**
23 percent: Vanguard Dividend Appreciation (VDADX)
7 percent: Harbor International (HIINX)
5 percent: Harbor Commodity Real Return (HACMX)
5 percent: Loomis Sayles Bond (LSBRX)

(Loomis Sayles Bond) and commodities for inflation protection. This bucket is the growth engine of the portfolios, but note that the core stock holding — Vanguard Dividend Appreciation — focuses on high-quality names and tends to offer better downside protection than many large-cap stock funds. The Aggressive and Moderate portfolios also include positions in a total stock market index fund to provide exposure to sectors that Vanguard Dividend Growth is light on, such as technology; the Conservative portfolio omits that position because its stock stake is smaller overall. This portion of the portfolios also includes exposure to 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.