Securing Retirement Income at Low Risk

Massachusetts Institute of Technology economics professor and Nobel Laureate, Dr. Robert C. Merton, recently published a paper in the Harvard Business Review encouraging investors to think differently about retirement savings. In his view, the pervasiveness of 401k plans and regulations surrounding them have trained most long-term investors to be overly focused on returns. However, he believes investors should focus on *retirement income stream* instead. Specifically, we should be building portfolios for a secure level of desired income in retirement and primarily discuss portfolios in those terms.[1]

The team at Sharper Granite met with Dr. Merton this quarter to continue discussion of our mutual philosophy on retirement income planning. In this meeting he emphasized, “Your goal in retirement is to sustain the standard of living you have enjoyed in the latter part of your working life. And standard of living is an income measure.” An investor needs to think of only three things in this regard: “your retirement income goals, how much you are prepared to contribute from your current income, and how long you plan to work. With these three objectives identified, your advisor can use advance portfolio theory to construct and manage the assets to achieve this.” [2]

Your Sharper Granite advisor complements this approach with customized financial model projections and retirement glidepath methodology to aid in planning for a secure retirement income stream.

Financial Model Projections

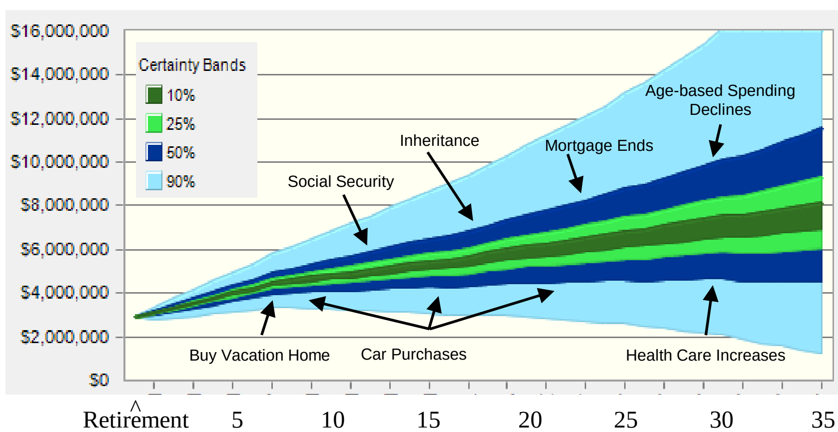
The three key objectives (income goals, saving plan/contributions, and years until retirement) are important inputs to your custom financial model projection. Once a portfolio is constructed, Sharper Granite builds a customized financial model to project probabilities of outcomes with respect to your goal.

While many "canned" savings calculators exist, we believe customized models are far more powerful. By doing this we can factor various life events, such as the timing of retirement, vacation home purchases, and customized Social Security strategies. We can even assign probabilities to different events. Finally, we model the *interaction* of economic probabilities (e.g. inflation and bond returns) for more realistic scenarios.

After building a client-specific model, we use Oracle's Crystal Ball simulation software to generate thousands of realistic financial lives based on a world of possible outcomes. From this simulation, we create a likely distribution of possibilities. This detailed process produces impactful, highly customized information for clients and shows with high confidence the standard of living achievable in retirement. An example of a financial model projection is shown below.

During our clients' pre- and retirement years, we use these projections along with our retirement glidepath methodology to control risk over the course of retirement while allowing for sufficient portfolio growth to support goals. In fact, we make asset adjustments throughout retirement to secure a desired income stream at a comfortable risk level balanced against growth needs.

Sample Retirement Model Projection

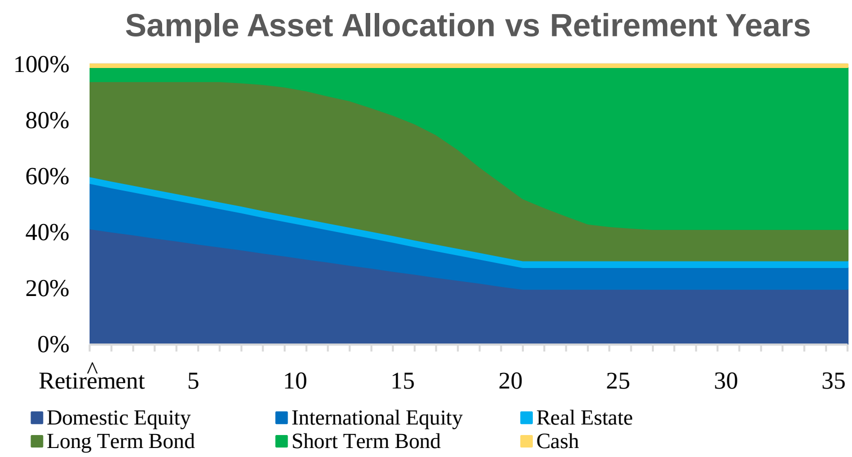


Retirement Glidepath

During retirement, asset allocation within a portfolio must intentionally shift to ensure the desired income stream throughout the remaining years. At Sharper Granite, equity exposure is throttled back near the investor's designated retirement year. We typically recommend an asset allocation near 60% equity at the onset of retirement, inclusive of U.S. stocks, international stocks, and real estate. This may be gradually reduced over the next 15 to 20 years to roughly 30% equity allocation.

This initial retirement allocation recognizes that recent retirees still have the ability -- though far less so than younger investors -- to alter their retirement plans. Modest exposure to equities diversifies a portfolio and helps maintain the long-term goal of secure retirement income. This also balances expected risk/return with that portion of retirement income from inflation-adjusted Social Security cash benefits.

Then, moving through retirement our rebalancing process becomes tailored for each client's goals, risk tolerance, tax situation, and the detailed income projection (sample above) we develop for every client.



As shown in the example to the right, we look to preserve the portfolio value and income stream throughout retirement by reducing equity (and risk) gradually over time.

Tapering equity exposure throughout retirement addresses stock market risk. We also take steps to minimize inflation risk and interest rate risk, which can have profound effects on retirement income. To do this, we may employ a technique known as "bond laddering" within the fixed income allocation. Bond ladders are comprised of bonds that mature over different years. This strategy provides income while minimizing exposure to interest rate fluctuations.

As you approach retirement, the Sharper Granite team will work with you to develop your customized projection model and retirement glidepath, which together can lower risk throughout retirement while maintaining your retirement income stream. These tools enable your advisor to focus on the appropriate measures to secure your standard of living which, according to Dr. Merton, is the measure that matters most.

Notes and Acknowledgements:

1. "The Crisis in Retirement Planning," Robert C. Merton, Harvard Business Review, July – August 2014
2. Meeting Commentary, Robert C. Merton, Santa Monica, California, May 25, 2018