

EDITOR'S NOTE

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Navigating the Risks of Investing in Retirement

Differences among retirement investing schools of thought tend to focus on two things: longevity risk and sequence risk. They are both interrelated but different. How an investor should deal with these dual risks is an ongoing source of debate.

Longevity risk is the risk of outliving your savings. In an economically perfect world, you will die with just one penny left in addition to what you intend to bequeath. We don't live in this world.

Sequence risk, or sequence of returns risk, is the risk of a bad period of returns—particularly early in retirement. The 30-year period of 1965–1994 is a good example. Large-cap stocks fell by 10.1% in 1966 (year 2 of retirement), 8.5% in 1969 (year 5), 14.7% in 1973 (year 9) and 26.5% in 1974 (year 10).

This was a rough way to start retirement. It was also a period when traditional inflation-adjusted withdrawal strategies either failed or barely made it through the 30 years.

We investors have no way of predicting what market conditions will be during our retirement years. Yes, there are market indicators. There are also many prognosticators with opinions and forecasts, but nothing can accurately predict what will happen.

This is why there is so much debate about how investors should allocate their portfolios in retirement. Strategies start at the conservative end and range to aggressive.

The conservative end calls for ensuring all cash flow needs required for nondiscretionary spending (housing, food, etc.) are covered by so-called guaranteed sources of cash flow (Social Security, pensions, annuities, etc.). The aggressive end calls for allocating nearly all of a portfolio to stocks with long-term potential for growth. AAII founder James Cloonan's Level3 strategy is an example of this.

In between are a range of strategies.

Contributing editor Craig L. Israelsen, Ph.D., steps into the debate by looking at four different retirement allocations. They range from very conservative (20% stocks/80% bonds and cash) to aggressive (80% stocks/20% bonds and cash).

He finds that a conservative allocation provides the best protection against sequence risk during the first five years of retirement. While this may seem desirable, it also introduces size of returns risk. Put another way, by trying to lessen the effect of sequence risk too much, you end up exposing yourself more to longevity risk. This is because your savings are not growing fast enough.

Israelsen offers suggestions for striking a middle ground on page 7. One of them is controlling your withdrawal rates. This is a drum I've been continually beating. The more flexibility you have in terms of withdrawing less during down years (or at least capping any annual increases), the greater the odds of not outliving your portfolio. The guidance works with any allocation you follow.

Exploring Active Strategy Opportunities

We focus on active management in two articles in this month's issue.

The first is by contributing editor Brian Haughey, CFA, FRM, CAIA. Haughey suggests index funds may be making the stock market even more inefficient. Such funds must buy stocks according to their weight within an index regardless of their current valuation and prospects. This leads to stock prices veering further away from reflecting all known information. It also widens the opportunity for active strategies to outperform. Haughey's article starts on page 11.

Cynthia McLaughlin, meanwhile, looks at outperforming actively managed mutual funds and exchange-traded funds (ETFs). Despite the hurdles, there are some that outperform. Most are in either less widely followed groups like small-cap value or in areas that are harder to replicate with an index like bonds. McLaughlin's article on active funds appears on page 19.

It is still not easy for an active manager to beat an index fund, however. Index funds have a big cost advantage. They are also run by managers who are not worried about being fired because of performance.

Although some active funds outperform, picking them in advance remains very difficult. Suggestions we have for improving your odds are looking at areas of the market that are harder to index and seeking out differentiated strategies.

Wishing you prosperity and good health,