Fall 2011

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Sense and Nonsense Regarding Distribution Portfolios

by Walt Woerheide, ChFC®, CFP®, Ph.D.

> Strategies involved in managing a senior’s distribution portfolio

We classify most personal portfolios as being for accumulation or distribution. In an accumulation portfolio, the client is accruing wealth toward a particular objective, such as retirement. In a distribution portfolio, the client is withdrawing cash on a consistent basis. A key task of the financial planner is to make sure that the riskiness of either type of portfolio is consistent with both the client’s risk tolerance and risk capacity. There are no hard and fast rules. Much data exists on how to do this with accumulation portfolios. We are still in the early stages of deciding how a client’s risk tolerance and risk capacity would affect the design and implementation of a distribution portfolio. What follows is a discussion of the central issues for planners making decisions about the optimal risk-return choices for distribution portfolios.

DEFINITION OF TERMS

The annual return for an accumulation portfolio is usually the sum of investment income and the change in the portfolio’s value divided by the portfolio’s value at the start of that period, with adjustments for cash additions and withdrawals. We normally measure the risk of an accumulation portfolio using the standard deviation of returns. However, measures of return and risk when analyzing distribution portfolios differ. Return for a distribution portfolio is usually measured as the cash withdrawn from the portfolio, and risk as either the probability of the portfolio failing to last a specific number of years (usually 30) or a portfolio dying before the investor does.

Portfolio failure is either the portfolio dying before the client dies or the portfolio dying before a specified number of years.

The most common error in terminology regarding distribution portfolios concerns the withdrawal rate, which should more properly be labeled initial withdrawal rate (IWR). We measure the IWR as the amount of money withdrawn during the first year of retirement, divided by the value of the portfolio on the date of retirement. After the first year, we adjust the withdrawals based on a withdrawal strategy, one being that each withdrawal is the same dollar amount. We call this the fixed annuity strategy. Another is that the amount withdrawn each year increases by the inflation rate of the prior year. We call this the inflation-adjusted annuity strategy. A third option is to apply the IWR each year to the value of the portfolio at the start of each year. We refer to this as a performance-based annuity strategy, as each year’s withdrawals will go up or down by the...
rate of return on the portfolio the prior year. This is the only strategy in which we can apply the term “withdrawal rate” to both the initial withdrawal and all subsequent withdrawals. It is also the only strategy that assures the client will not dissipate the portfolio, although withdrawals may drop to unacceptable levels. Finally, there are combination inflation-adjusted, performance-based strategies in which an inflation adjustment is made, but only if the portfolio achieves certain performance targets.

The key parameters for a distribution portfolio are asset allocation, the IWR, the withdrawal strategy and “the number,” which is the value of the distribution portfolio on the date of retirement. Discussions about the rate and the number will sometimes suggest criteria about the minimum acceptable probability of portfolio success or maximum probability of portfolio failure, which are complements. Portfolio failure, again, is either the portfolio dying before the client dies or the portfolio dying before a specified number of years.

**ASSET ALLOCATION IS THE EASY CHOICE**

Most, but not all, research about distribution portfolios has consistently supported an optimal asset allocation of no less than 50 percent equities and no more than 75 percent equities. With less in equities, substantial risk exists that inflation adjustments will overwhelm the portfolio and wipe it out prematurely. With more in equities, there is substantial risk that a prolonged bear market will likewise deplete the portfolio. A traditional rule of thumb for asset allocation for older clients is the percentage in equities equals something like 100 minus one’s age. Little research has looked at the impact of such a rule on the probability of portfolio failure, but the 50 percent to 75 percent range would likely dominate an age-adjustment asset allocation rule.

**NEED AND RISK TOLERANCE**

As the most commonly suggested withdrawal strategy is the inflation-adjusted annuity, let us focus on this strategy. Clearly, the lower the IWR, the larger the number has to be to generate a specified amount of income in the first year. Thus, an annual initial withdrawal of $60,000 can be made with an IWR of 3 percent and a $2 million portfolio, a 4 percent IWR and a $1.5 million portfolio, or a 5 percent IWR and a $1.2 million portfolio. A larger IWR provides more annual income for a client (return), but increases the probability of portfolio failure (risk). The key point is that a planner can not make a recommendation as to “the number” without knowing the IWR, and cannot recommend an IWR without due consideration of the client’s need for return, the mix of required...
and optional expenses, and the client’s risk tolerance and risk capacity.

Let us assume for illustrative purposes that Client A projects $80,000 in mandatory expenses (such as housing) and $20,000 in optional expenses the client would like to incur (such as vacations), but are not essential to daily living. Assume, also, that the client would like to leave a substantial estate to beneficiaries. Suppose the client has $75,000 in non-portfolio income, such as Social Security, pensions and annuities. If the client has a $500,000 portfolio and plans a 5 percent withdrawal rate, then this combination will produce the $100,000 desired income and allows the client to accept an aggressive investment exposure to try to generate a larger estate. Simply put, because of the amount of fixed income relative to mandatory expenses, the client could afford to take on the lower probability of success associated with the 5 percent rate and a more aggressive asset allocation to have a greater chance of a larger estate. In other words, this client has substantial risk capacity, and may have a high tolerance for risk with the estate wishes.

Client A may not have a strong desire for a large estate, but may well care to spend more on optional activities than the $20,000 initially identified. With a high-risk tolerance, this client could consider a withdrawal rate larger than 5 percent. If Client A opts for this higher rate and things do not go well, the client has the capacity to reduce the withdrawal rate before putting at risk the income necessary to meet required expenses.

Now, assume Client B also projects a need to spend $100,000 per year, with $80,000 of that required and the remaining $20,000 desired but optional. The difference is that Client B has only $25,000 of annual non-portfolio income but has a portfolio worth $1.5 million. With a 5 percent withdrawal rate, the client can still generate the desired $100,000 income. However, because the portfolio withdrawals are the primary source of the client’s mandatory expenses, a substantial drop in the portfolio’s value would be catastrophic. This client has no risk capacity, and may well have little tolerance for risk. This client would do well to consider a reduction in the withdrawal rate, even though this would mean, a lower standard of living than what he or she would desire, at least initially.

Simply stated, talking about the number and the rate as if all clients have the same risk capacity, risk tolerance and mix of mandatory and optional expenses is inappropriate. As these two simple examples illustrate, risk capacity and tolerance are situational and should be assessed by a financial advisor competent in retirement planning.

OTHER ISSUES AFFECTING THE RATE AND THE NUMBER

Ample documentation proves that there is a difference between the young-old and the old-old. At some point, retirees become more sedentary. We all know people in their 90s who remain active and people in their 60s who are nearly incapacitated. Nonetheless, on average, most people tend to become less active around their mid-70s. This lower activity usually
When a person reaches his desired retirement age, the number is a reality, no longer a goal.

means a lower need for income. However, little research incorporates the implications of this fact into distribution portfolios. Thus, for a client who is 65, the likelihood of a less active, less expensive lifestyle in 10 years or so would mean the client could take on more risk initially than would otherwise be considered appropriate. This greater risk could take the form of a larger IWR and/or a lower number in developing a retirement income plan.

A second and rarely discussed issue is the near sacredness of income stability in retirement. A reduction in income is sad for anyone, whether it happens to a married breadwinner with small children, a person at the peak of the income-earning years or someone in retirement. The breadwinner losing his or her job likely means the family will reduce their standard of living. Everyone would understand. Research on retirement income typically assumes that once a person selects a withdrawal strategy such as an inflation-adjusted annuity, the person will stick with that strategy regardless of what happens to the portfolio. Thus, if there is a serious market collapse in the first few years of retirement, the assumption is that the individual will continue to make inflation-adjusted withdrawals. I suggest that just as the breadwinner has to give up certain things because of losing a job, a retiree may also have to cut expenses if the market tanks in a manner that puts the retirement portfolio at risk. Retirees understand this point; note how much is written in a recession for retirees about ways to save money.

Naturally, one can argue that starting with a higher number and/or a lower withdrawal rate will reduce the risk of giving up a dream retirement. However, when a person reaches his or her desired retirement age, the number is a reality, no longer a goal. A lower IWR than is reasonable to build in more certainty of income only means the client is giving up some income in the early years of retirement to reduce the risk of a larger reduction later. Whether all retirees would want to make this choice is unclear.

Although the most commonly researched withdrawal strategy is the inflation-adjusted annuity, there is a lack of research showing whether this is what all or most clients really want or need. Considering that for some a large portion of their retirement expenses are fixed, some clients can substitute less expensive purchases for more expensive ones, and that most people will see a reduction in living expenses during retirement, the client may not always need an inflation-adjusted income stream.

LOGICAL NEXT STEPS
Suggesting there is an optimal withdrawal rate, an optimal portfolio value, or even a minimum acceptable probability of portfolio success or a maximum acceptable probability of portfolio failure, is simplistic. These variables interact, and they are dependent on a client’s risk tolerance and risk capacity. Just as there are many good questionnaires for determining risk tolerance for clients with accumulation portfolios, the planning profession needs to develop good instruments for identifying risk tolerance and risk capacity for clients with distribution portfolios. A major area of research would be to determine how the scores on these instruments would relate to the parameters for distribution portfolios.