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Why the “Bucket Approach” to Retirement Income Planning is Conceptually Unsound

by Walter Woerheide, PhD, ChFC®, CFP®

Examine the deceptive nature of the bucket approach to creating a retirement income plan.

THE BUCKET APPROACH (ALSO called age-bandung) to retirement income planning is the idea that we think about a client’s retirement years in segments. A simple strategy would be to develop a 30-year retirement income plan for a 65-year-old client with three buckets, each of which covers a 10-year period. For each decade, we then identify the client’s projected annual expenses and construct a portfolio designed to provide the cash to meet the client’s needs for that interval.

Naturally, the portfolio for the first decade would be highly conservative as it is intended to pay for immediate expenses. The second portfolio will not pay for any expenses until 10 years have elapsed, and thus can be more aggressive. The third portfolio would be the most aggressive as it will not pay for any expenses for 20 years. To keep the discussion simple, let’s assume that, based on the time frames and risk tolerance of the client, we decide that the first decade’s portfolio should be 100 percent money market instruments; the second decade’s portfolio should be 50 percent bonds and 50 percent equities, and the third decade’s portfolio should be 100 percent equities. (Note: these are not portfolio recommendations, just hypotheticals for illustrative purposes.)

Another way to see the flaw in this bucket approach is to define the buckets with one-year intervals.

This sounds like a meaningful approach to retirement income planning, but I believe it is flawed. Let’s consider what happens after one year. At this time, our first decade’s portfolio has provided cash for the first year’s expenses, and now needs the
amount of assets necessary to finance the remaining nine years of this decade. The more interesting issue is what happens to our second decade’s portfolio. If the original allocation of 50/50 was perfect for a portfolio designed to provide cash withdrawals starting in 10 years, then surely it is no longer a perfect allocation if the withdrawals will be starting in nine years. One might say the allocation is still okay because there is no significant difference between a portfolio needed in nine years and one needed in 10 years, but with each passing year this becomes a less plausible argument. When nine years have elapsed, arguing that a portfolio designed to provide withdrawals starting in one year should look more like a portfolio designed to provide withdrawals starting in 10 years than one designed to provide withdrawals starting immediately would be truly awkward. The point is, for these later buckets, asset reallocation should be occurring on a regular basis, which means the portfolio asset allocations are not permanent.

Another way to see the flaw in this bucket approach is to define the buckets with one-year intervals. Thus, a 30-year retirement horizon would require 30 portfolios, each designed to finance the cash to meet one year’s worth of expenses. The first portfolio might be 100 percent money market instruments. The second portfolio might be 90 percent money market instruments and 10 percent bonds. The 30th portfolio might be 100 percent equities.

After the first year, the first portfolio is cashed out, and the second year’s portfolio becomes the new first year’s portfolio. Technically, each portfolio moves forward one year in terms of its asset allocation, which means there is asset reallocation in all 29 portfolios. Or, at least, that is how it appears.

There is another way to visualize what is happening. The second year’s portfolio actually remains the new second year’s portfolio, the third year’s portfolio remains the new third year’s portfolio, and so on. Similarly, what had been the 29th year’s portfolio will remain the portfolio for our 29th year. In effect, none of these portfolios are reallocated. So, what becomes of the 30th year’s portfolio? Effectively, it’s the one liquidated to provide the 100 percent investment in money market instruments for what is now the current year’s portfolio. In other words, if each portfolio’s asset allocation is considered optimal based on the number of years until it is liquidated, then each year we are effectively liquidating our longest remaining term portfolio to pay for our new investment in our shortest term portfolio!

Not only is the use of buckets deceptive, it can lead to a substantially inferior asset allocation. With the buckets approach outlined here, the overall portfolio, the sum of the individual buckets, would become increasingly conservative over time. Why? One of the main objectives of bucket portfolios is to have the assets supporting the near-term withdrawals be more conservative. Thus, the overall portfolio for someone using the bucket approach at the time of retirement when that person has a 30-year time horizon will be more aggressive than the portfolio the person would hold when 10 years have elapsed and the individual now has a 20-year time horizon, and so on. In effect, the portfolio is on a “glide path.” A glide path refers to the concept of a portfolio becoming more conservative as a person moves through the retirement years. Glide paths are designed to avoid the perceived problem of a person who is 90 years old and deep into retirement having the same asset allocation as the person who is 65 years old and just starting retirement.

As intuitive as a glide path might sound, research has consistently demonstrated that this strategy of becoming more conservative over time is less effective than the strategy of sticking with one’s original asset allocation over the entire time period. So, if the original allocation were 60 percent stocks, 30 percent bonds and 10 percent money market instruments, then as the client’s portfolio waxes and wanes in value over the next 30 years, maintaining this asset allocation actually produces the highest probability of assuring that the client will not exhaust his or her portfolio, or at least cause it to so drop in value that future withdrawals would be substantially impaired.

Not only is the bucket approach deceiving as to the safety of one’s portfolios, but it also leads to an overall inferior asset allocation.

The bucket approach is deceiving as to the safety of one’s portfolios.