# On Retiring into a Bear Market

*by Jonathan Guyton, CFP®*

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**In early November,** a colleague from Illinois sent an email. His client nearing retirement was concerned about a market decline "impacting one's ability to draw income from an asset base over a long number of years." Would they still be okay? Given equity market behavior since then, this question is prescient and offers an opportunity to review some key aspects of retirement income planning that now seem especially relevant.

## Affected and Unaffected Assets

Why do sustainable withdrawal strategies work in the first place? (Like Icarus, they seek to fly without coming too close to the sun.) Any approach balancing the priorities of lifetime sustainability and maximum income generation must successfully navigate challenging market conditions at various times, likely both early and later in retirement. We all know this, of course, but I've learned that we can't remind clients of such things too often.

What gets successful strategies through such times are their holdings that maintain value at precisely the time(s) when other assets lose value. In other words, these "unaffected" assets are just as important as the "affected" assets that fund the majority of total withdrawals and provide the higher long-term returns that fuel such withdrawal amounts in the first place. Research over the past 25 years consistently pegs the affected/unaffected "sweet spot" at 55 percent to 65 percent equities.

Clients can be surprised how long a portfolio of 40 percent "unaffected" assets will sustain their income without needing to draw against "affected" assets.

Consider a plan to withdraw 5 percent annually at the start of a prolonged 30 percent market decline/recovery period, where withdrawals are constant throughout. Assuming an overall 2 percent portfolio yield between equities and bonds, it would take just over 10 years to fully exhaust the unaffected assets. That's a long time, and it can offer real peace of mind to get through downturns. (It's even longer if distributions follow a model that uses dynamic withdrawal policies.[1]) This is why these strategies hold up except under the most dire simulations, the likes of which post-Depression realities haven't begun to approach.

Just make sure the portfolio's "unaffected" assets are truly unaffected at the times they most need to be uncorrelated with equity returns. And remember, any research you cite almost certainly used exclusively U.S. government securities for non-equity holdings.

## Communicating During Uncertainty

Such times are when sound decision-making in real-time matters most. Questions like, "How will we know if we're still okay?" and "What if this time it's different?" always raise the pressure to just do something. That's why returning to the previous points can be so powerful. However, turning this around and communicating to clients what could, in fact, wreck their plan can also be effective.

At Cornerstone, we say that as long as this isn't the first time in modern financial history that stocks decline and never recover, or that government bonds pay less than face value at maturity, evidence-based withdrawal strategies remain solid.

It's also a time when decision rules that modestly adjust spending can be particularly powerful. In truth, we can't know until later if a spending adjustment is really needed. Decision rules get triggered when real-time conditions make the portfolio withdrawal amount potentially unsustainable, were those conditions to continue long enough. Clients feel these conditions emotionally, even though such times have always self-corrected.

Think of 2000–2003 and 2008–2009. "Doing something" at such times feels right. Back in 2008 and 2009, retired clients routinely asked, "Is that all?" when shown their dynamic adjustment. Moreover, research shows that such decision rules also produce higher sustainable withdrawal rates/amounts. Ironically, this benefit may be the lesser one that decision rules provide.

## Effects of the Great Recession

The Great Recession provided insight into what can happen for clients in

real life. Though all retirees experienced the financial and emotional impact of 2008–2009, they didn't all respond similarly.

In mid-2010, FPA surveyed planners about what they did and how their clients fared in the (then) annual *Financial Adviser Retirement Income Planning Experiences, Strategies, and Recommendations Study.*[2] Planners reported using one of three different approaches to generate retirement income: (1) structured systematic withdrawals, including dynamic decision rules to adjust withdrawals; (2) time-based segmentation "buckets" where assets for near-term withdrawals are held in short-term bonds or cash, and assets for withdrawals in the future are held in separate "buckets" in longer-term bonds and stocks; and (3) essential-versus-discretionary, where retirement savings to fund essential expenses go into assets that produce guaranteed income, and remaining savings for discretionary expenses go into a bucket of mostly equity assets.

Planners were asked: given the Great Recession, what portion of your retired clients experienced a "significant lifestyle change," defined as returning to work, selling their home, etc. The findings? "Among planners who primarily use(d) an essential-versus-discretionary approach, an average of 25 percent of their clients in or near retirement had to significantly adjust their lifestyle in 2010—the highest percentage of any income strategy used." Interesting.

Delving more deeply into the Great Recession's ripple effects in the next year's (2011) study, planners who always employed a dynamic systematic withdrawal approach were 60 percent to 75 percent less likely to see their clients experience a significant lifestyle change than the clients of planners who primarily employed the other two approaches.[3]

## Reconsidering the Essential Versus Discretionary Approach

You should draw your own conclusions, but I had two key takeaways. First, retirees actually consider most so-called "discretionary" spending essential to their retirement; they are clearly not ambivalent about things like travel and overall quality-of-life. As one pre-retiree once told me, "I don't want to retire until I can afford a retirement worth living."

Second, any approach that isolates a more volatile bucket of assets can cause clients to prematurely overreact compared to following pre-determined policies that say: this is what we need to adjust now; if things get worse, we'll adjust again next year.

Keep this in mind as interest rates rise and annuitization rates follow suit. As they do, research will show that scenarios combining above-average longevity and below-average equity returns may benefit from replacing some or all of a portfolio's fixed income allocation with immediate annuities. Keep in mind the research showing that any benefit from annuitization's mortality credits occur further in the future than many realize.[4]

Furthermore, a 60/40 portfolio with half the bonds annuitized leaves a remaining 75/25 mix, which is what a client sees. In their book, *Nudge*, Richard Thaler and Cass Sunstein distinguish two types of decision-makers: Econs and Humans. In this dichotomy, the 20 percent of people pegged as "Econs" will behave rationally, regardless of the 75/25 account's volatility, remembering to factor in the annuity's "fixed-ness." The other 80 percent—the "Humans"—may not; and as a consequence, they may choose to upend their lives both significantly and unnecessarily.

## Downshifting for Retirement

Finally, a word for clients retiring relatively soon. Most who save steadily for retirement will at some point downshift from a more aggressive allocation to one more suited for generating sustainable retirement income. The questions are how and when.

Obviously, "how" can be gradually, all at once, or in some combination. "When"—of course— brings up matters of market timing. A client who is five years from retirement with $1 million, an 80/20 allocation, and who adds $40,000 annually to retirement plans can raise their current $200,000 of bonds and cash to about $525,000, if their contributions all go to fixed income, stocks dividends aren't reinvested, and bonds yield 3 percent. However, if the $800,000 in stocks earn 6 percent annually ex-dividends, this becomes about $1,075,000, still leaving about two-thirds in equities. Unless you and your client want to choose the right time(s) to lower the equity allocation, implement a "downshift" plan five to seven years before portfolio income generation begins.

Retiring into a bear market won't feel as good as you or your clients would like. But with forethought and diligence, even times like these will not waylay the best-laid plans for retirement. ■

## Endnotes

1. See "Achieving a Higher Safe Withdrawal Rate with the Target Percentage Adjustment," by David Zolt in the January 2013 *Journal*; and "Decision Rules and Maximum Initial Withdrawal Rates," by Jonathan Guyton and William Klinger in the March 2006 *Journal*.
2. See "Planners Find Success with Retirement Income Strategies," by Carly Schulaka in the December 2010 *Journal*.
3. See the December 2011 FPA Research Center white paper "Financial Adviser Retirement Income Planning Experiences, Strategies, and Recommendations," available at OneFPA.org.
4. See the July 2013 paper "The True Impact of Immediate Annuities on Retirement Sustainability: A Total Wealth Perspective," by Michael Kitces and Wade Pfau on SSRN, and subsequently published in the *Retirement Management Journal.*