RETHINKING TRADITIONAL Retirement Income

Executive Summary

Over the next 15 years, 10,000 baby boomers will turn 65 each day. As this largest demographic group turns older and transitions from the asset accumulation phase to the asset decumulation phase, these retirees need to rethink their approach to retirement income distribution. Not only should they consider their goals for retirement, they should factor in the challenges of increased longevity, low interest rates, and an increasingly volatile market.

In this current economic environment, traditional retirement income distribution strategies may no longer be able to provide a sustainable income stream. Instead, an approach is needed that combines a needs-based income distribution strategy with a more realistic approach to asset allocation.

Many investors spend a great deal of time thinking about "Investing for Retirement," the wealth accumulation phase, but not enough time thinking about "Investing in Retirement," the wealth decumulation phase. Yet having an effective investment strategy for the decumulation phase, which can last 30 years or more beyond age 65, is key. Investors should not fall into the trap of assuming their retirement savings will last a lifetime. Not only do longevity and increasing medical costs provide challenges, an unpredictable economy with historically low interest rates and heightened volatility adds complexity to an investor's retirement path. The challenge is to create a reliable income to last a lifetime. How will they accomplish this?

What's Not Working

Traditional asset allocation for retirement generally includes a significant fixed income portion with the expectation that coupon interest can generate sufficient income. However, this reliance on fixed income when bond yields are at generational lows with scenarios of prolonged low or rising interest rates, poses a clear and present threat to income longevity. The income needed over a retiree's lifetime may not be reliably generated with this traditional view of fixed income, particularly in a low interest rate environment.

In addition, retirees often may choose to segment their investment assets according to their expected withdrawal dates with specific allocations to short, intermediate, and longer-term time frames. However, this common approach does not factor in the reality of potentially lackluster fixed income yields over extended periods coupled with heightened equity volatility that can quickly erode assets.

A Different Approach is Needed

At EquityCompass Strategies, we believe a more comprehensive and coordinated approach should be considered that focuses on retirees' needs to combine an investment strategy with an efficient withdrawal strategy.

In this white paper, we discuss the merits of a needs-based approach that includes a higher equity weighting. Our goal is to provide a sustainable retirement income designed to last a retiree's lifetime.

Retirement Funding

Understanding retirement funding is our first major consideration. Retirees encounter various expenses during these years. These expenses can be largely grouped into two categories: 1) basic expenses, such as food, shelter, and medical expenses, and 2) lifestyle expenses, including travel, entertainment, and social expenses. A needs-based approach should distinguish between these expenses and segment their source of funding as shown in Figure 1. A thoughtful retirement plan should take into consideration all sources of income in order to provide maximum sustainable income that addresses both basic and lifestyle spending needs for a retiree's lifetime.

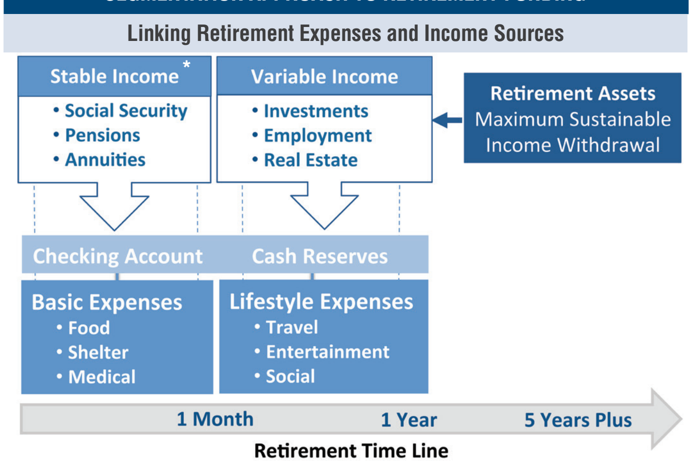
Income is a key focus in maintaining a retiree's lifestyle. As such, we define maximum sustainable income as the highest amount of income that can be withdrawn from retirement assets to counter the following scenarios:

- High likelihood of lasting life expectancy
- Annual cost-of-living expenses
- Tolerate unfavorable investment performance

Our research indicates that a retirement account needs to grow to fund a maximum sustainable income program. While it should be noted that lifestyle expenditures decline fairly precipitously past the age of 75—typically 20% lower at age 80 and 30% lower by age 90—medical costs are another matter.[1] Retirees often have health insurance coverage through Medicare, but they still face substantial out-of-pocket costs for premiums, deductibles, and co-payments. These costs have grown rapidly over time and equal about one-fifth of retirees' income.[2] Medical costs are highly uncertain and can be so severe that they can potentially bankrupt the retiree or other family members.

FIGURE 1

SEGMENTATION APPROACH TO RETIREMENT FUNDING



*Stable income refers to those sources considered to be generally reliable; however, the financial strength of issuing entities could impact the stability.

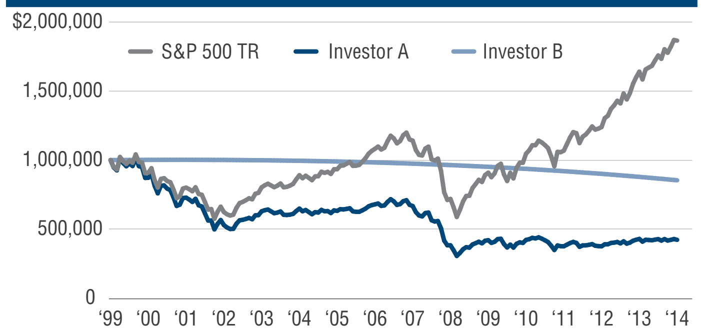
Evaluating Asset Allocation and the 4% Rule

A second consideration impacting whether a retirement program will be successful involves an appropriate withdrawal strategy. In the mid-1990s William Bengen, a financial advisor, advocated what is now widely known as the 4% Rule for retirement income. The 4% Rule identified an asset allocation and withdrawal formula for producing inflation-adjusted income that would last 30 years or more. The asset allocation range prescribed was a diversified portfolio of stocks and bonds appropriate for a moderate risk profile. A 4% withdrawal rate was used the first year, increasing annually by the prior year's inflation rate, which averaged 3% for the past 50 years.

With recent periods of historically low interest rates, the 4% Rule has come up against significant criticism. Studies using more sophisticated mathematical modeling, including the effect of investment costs as well as scenarios less favorable to bond performance, place less than a 50% probability that the 4% Rule can sustain income for 30 years.

FIGURE 2

SEQUENCING RISK OF DISTRIBUTIONS
(Theoretical Performance 12/31/99-12/31/14)



Source: EquityCompass Strategies, Bloomberg
For illustrative purposes only. Theoretical performance is not an indicator of future actual results. Theoretical performance is developed with the benefit of hindsight and has inherent limitations. Actual performance may differ significantly from theoretical performance.

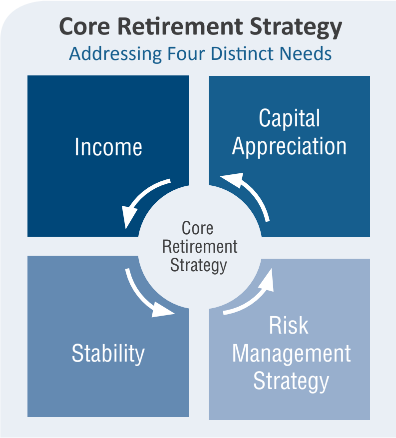
Our research revealed that in addition to the potential erosion resulting from low fixed income yields and investment expenses, withdrawals occurring during market downturns can severely accelerate asset erosion as illustrated above. In our example:

- **Investor A** invested in a vehicle that was designed to track the S&P 500 and achieved a 4.2% annual compounded return from 2000–2014.
- **Investor B** depicts achieving the same return as the S&P 500 but with zero volatility. While not possible to attain in an investment vehicle, this serves an illustrative purpose.
- Both **Investor A** and **Investor B** began with $1,000,000, withdrew 4% of starting capital in 2000, and increased the amount by 3% each year thereafter. At the end of 2014, the portfolio value for **Investor A** was approximately 50% lower than **Investor B**. Even though both achieved the same return and withdrew the same amount, the portfolio volatility experienced by **Investor A** accelerated asset erosion.

Our research indicated that a 4% withdrawal strategy in the first year increasing 3% annually thereafter could not be supported with a static 60/40 equity to fixed income asset allocation. For example, a hypothetical retiree with a beginning balance of $1 million needs approximately $1.9 million to fund the entire retirement. In our opinion, achieving this goal using traditional approaches is not highly probable.

A COMPREHENSIVE NEEDS-BASED APPROACH

Traditional approaches that rely on fixed income or a 60/40 asset allocation strategy have been compromised by low interest rates and increased market volatility. While investors can accept the consequences by lowering their income withdrawal expectations, we believe withdrawals consistent with the 4% Rule can be produced. At EquityCompass Strategies, we take a comprehensive needs-based retirement approach. Our coordinated approach incorporates the investment needs of income, capital appreciation, stability, and risk management strategies to produce a well-diversified portfolio that addresses retirees' requirements for reliable lifetime income. This strategy includes a target 75/25 equity to fixed income allocation designed to:



- Be responsive to market conditions and longer-term trends
- Generate income through high-dividend-paying stocks
- Provide diversification and opportunity through global equity exposure

In addition, this retirement approach is designed to provide growth without adding detrimental volatility, which can compound the negative effect of withdrawals on a portfolio.

The **EquityCompass Core Retirement Strategy** seeks to meet the essential retirement needs in the following ways:

Retirement Need #1 - INCOME

Objective: Funding current withdrawals

The need for current income should be addressed by an income strategy that focuses on high-dividend-yielding stocks rather than low-yielding bonds.

Benefit: High-quality, high-dividend equities may provide attractive income, dividend growth, and lower volatility. This strategy seeks to produce current income that is sufficient for withdrawal needs and that can be increased each year to reflect a cost of living adjustment.

Retirement Need #2 - CAPITAL APPRECIATION

Objective: Generate growth to fund future withdrawals

Invests in globally operating, developed market companies trading at a discount to their long-term intrinsic value and characterized by high and sustainable returns on invested capital, intangible assets, and influential insider ownership.

Benefit: The approach seeks to benefit from the potentially unprecedented growth in worldwide consumer demand while managing potential risks associated with investing directly in foreign markets, especially emerging markets.

Retirement Need #3 - STABILITY

Objective: Counteract volatility

While the current environment of extremely low interest rates has undermined the income objective for bonds, fixed income still has an important role in a retirement portfolio.

Benefit: High-quality intermediate bonds provide stability and a modest degree of income.

Retirement Need #4 - RISK MANAGEMENT STRATEGY

Objective: Mitigate asset erosion in downturns

Tactical adjustments to the equity portion of the portfolio based on forward earnings estimates can help to mitigate risk. We believe tactically shifting equity exposure to a defensive cash position is the most effective way to help protect assets from downside exposure.

Benefit: The goal of a dedicated risk management strategy is to respond to signs of deterioration as they become evident and reduce equity exposure and, conversely, restore equity exposure as signs of improvement emerge.

A SOUND APPROACH TO PROVIDING RETIREMENT INCOME

Retirees want to enjoy their retirement years without being consumed by worry that they will outlive their income. In this decumulation phase, retirement assets need to fund withdrawals for 10, 20, and 30 years or more, while also absorbing asset erosion from downside volatility and increasing inflation-adjusted income. From our perspective, traditional retirement approaches fall short and are ill-equipped to generate the growth and income needed throughout a retiree's lifetime.

The **EquityCompass Core Retirement Strategy** is a comprehensive approach to retirement income distribution that seeks to provide sustainable, reliable income for life.

The asset allocation is designed to be:

- Growth-oriented through equity exposure and rising dividends
- Capital preservation-oriented through tactical re-allocation from equity to cash in periods of market stress

Given today's investment environment, we believe that this strategy provides retirees with the opportunity to maximize an income stream that is both sustainable and reliable and designed to last a lifetime. ■

RICHARD E. CRIPPS, CFA
Chief Investment Officer
EquityCompass Strategies

With over 35 years of experience, Mr. Cripps is the Chief Investment Officer and Senior Portfolio Manager at EquityCompass Strategies. Prior to joining Stifel, Mr. Cripps served as the Chief Market Strategist and Co-Chairman of the investment committee at Legg Mason Wood Walker, Inc. He is a CFA charter holder.

ABOUT EQUITYCOMPASS

EquityCompass Strategies is a Baltimore-based equity investment management team. We offer a broad range of portfolio strategies based on our systematic, research-driven investment process to institutional investors, financial advisors, and individual investors. As of December 31, 2017, EquityCompass provided portfolio strategies with respect to assets of approximately $3.8 billion.

IMPORTANT DISCLOSURES

[1] "Estimating the True Cost of Retirement," David Blanchett, CFA, CFP, Head of Retirement Research. Morningstar Investment Management, Working Paper, November 5, 2013.

[2] "Medicare Spending and Financing: A Primer," Kaiser Family Foundation. 2011. Menlo Park, CA.

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