The Mental Math of Retirement

*Seeking to eliminate the “what ifs” utilizing the bucket approach*

Retirement can be described as a time when you stop working for your money and your money starts working for you. For this reason, it is imperative investors allocate their assets in a manner that meets the needs required to fund not only current withdrawals, but also to preserve the purchasing power of future withdrawals.

Retirees currently face an environment not experienced in nearly 40 years—rising inflation. Inflationary pressures, at a time when interest rates are still near historical lows, have generated increased market volatility and reduced real income as monetary policy tightening is now upon us.

A “bucket approach” framework can help investors address both the near-term challenges of inflationary pressures and the potential for heightened volatility, while also maintaining the longer-term perspective of a retirement that could last 30 or more years. Each bucket addresses specific needs throughout various distribution phases of retirement and seeks to provide flexibility based on market performance.

While our companion presentation, “The Mental Math of Retirement,” examines the bucket approach construct in greater detail, the primary tenets are as follows.

**Bucket #1: Immediate Needs**

*Cash or High Quality Short Duration Bonds Seek To Provide Ballast*

The immediate needs bucket is meant to provide liquidity and should not be subject to market volatility. Little-to-no price risk is required of these assets.

Since 1980, the S&P 500 average intra-year decline has been 14.3%—representing more price volatility than some may realize. Setting aside the equivalent of two years of withdrawals can help eliminate potential asset liquidation when markets decline—a major risk to income sustainability in retirement.

**Bucket #2: Intermediate-Term**

*Dividends To Support Cash Flow and Maintain Purchasing Power*

The intermediate-term bucket seeks to provide an income stream that is reliant on a company’s cash flow instead of stock price volatility.

The inability of savings rates to keep pace with inflation is a major concern for pre-retirees and retirees. Investing in a portfolio of companies that consistently demonstrates the willingness and ability to return capital to shareholders in the form of dividend payments can help offset the inflationary pressures of future increases in living expenses, while also making current distributions less reliant on asset liquidations.

**Bucket #3: Long-Term**

*Balanced Growth to Enhance Value Over Time*

The long-term bucket is intended to provide long-term capital appreciation as well as a measure of risk mitigation. While the odds of negative returns for equity markets is 25% in any given year, over a 10-year time horizon the probability declines to less than 6%.

Retirees are concerned about losing purchasing power gradually. Therefore, these investments should address the needs of wealth accumulation, income enhancement, and relative stability in order to support a 4% withdrawal, growing annually by 3%, to maintain an income stream that may need to last for 30 years or longer.

**Lasting a Lifetime**

A needs-based “bucket approach” requires a not-so-insignificant shift in mindset as investors switch gears from accumulation to decumulation.

The success of a retiree’s investment plan should not be measured against the short-term performance of an arbitrary benchmark, but rather by the ability of one’s hard-earned savings to generate a distribution stream that seeks to last a lifetime.
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Bernard J. Kavanagh III, CMT® is a Senior Portfolio Manager and a senior member of the investment management team. Bernie is responsible for developing and researching EquityCompass’ quantitative portfolio strategies. He also writes extensively on market and portfolio strategy. Prior to joining EquityCompass in May 2011, Bernie was a member of Stifel’s Institutional Equity Sales group from the time Stifel acquired Legg Mason’s Capital Markets Group in December of 2005. At Legg Mason, Bernie began his career in May 2000 as an associate in the Equity Marketing and Strategy Group. Prior to Legg Mason, he was an associate at T. Rowe Price beginning in 1997. Bernie has a Master of Science in Finance from Loyola University Maryland and a B.S. from Rutgers University. He holds the Chartered Market Technician designation.

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The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization. The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.

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