ROUTE 360

A New Approach to Owning Stocks in Retirement

Turning conventional wisdom on its head, two experts say retirees should start with about 20 percent in stocks and gradually bulk up

posted by Kerry Hannon, October 31, 2013 More by this author

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I remember the phone call well. It was 2008 and my good friend, who had recently retired with his wife, was freaking about the 2008 market implosion.

He said the two of them were bailing out of stocks and moving all — and I mean *all* — their retirement savings into “safe” government bonds and money markets. I tried to calm him down, explaining that the markets would, in time, bounce back and that they should sit tight.

He wouldn’t hear it.

Of course you know what happened: my friend and his wife got out of the market at the worst possible time and took a serious hit. They had lots of company.

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The Big Fear Retirees Have

It was terrifying for new retirees to watch their savings disappear seemingly overnight just when they’d need it the most.

I’m telling you all this because of a new contrarian study about owning stocks in retirement that just might change the way you think about investing.

Unconventional Thinking About Retirement Investing

Written by Michael Kitces, director of research at the Pinnacle Advisory Group in Columbia, Md., and Wade Pfau, a professor of retirement income at the American College of Financial Services, the study found that your money is likely to last a few years longer if you hold as little as 20 percent in stocks when you retire and then slowly add 1 percent a year compared to the conventional wisdom of starting out with 50 to 60 percent in stocks and then gradually reducing that percentage.

What's more, the authors say, their strategy would result in a less bumpy ride during choppy markets like in 2008.

To put this system in place, you'd live off your fixed income (such as bonds, CDs, annuities, pensions and money market funds or accounts) in the early years.

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Here's the authors' rationale: If stocks *do* nosedive during your early years of retirement, you'll be buying more shares as they get cheaper. That, in turn, will give you a kick later on, when you'll be less likely to be working and more apt to need extra cash.

In the financial world, this is called avoiding "sequence-of-return" risk: Investors are more vulnerable to big market drops when their portfolios are larger, typically at the the beginning of retirement, because there's a bigger impact on the money they've accumulated.

My Initial Impression of the Study

I have to say that the Kitces/Pfau strategy jolted me. After all, for years I've heard — and told people — that equity exposure should *drop* throughout retirement as your time horizon (and life expectancy) shrinks.

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"We're merely suggesting a U-turn," Kitces told me.

By that he means if you gradually reduce your stock holdings to, say, 20 to 40 percent before retirement, they'd be at their lowest point in your early retirement years — the bottom of the U. Then you'd increase them incrementally after that until you wind up with 50 to 60 percent in equities towards the end of your life.

Why You Might Find Their Idea Appealing

The strategy could be especially appealing to people who worry about a market crash at the start of their retirement, with little chance of recovering their losses. Indeed, a recent Gallup poll conducted for Wells Fargo found that Americans are more worried about another financial crisis occurring during their retirement than they were about running out of money.

"If your fear is owning 60 percent of equities at the end of retirement, I don't know why you would be more comfortable owning more stocks when your portfolio is biggest," Kitces said.

He's got a valid point.

I see a certain appeal to this approach. If my friend and his wife had kept a smaller percentage of their portfolio in stocks during the early days of their retirement, the market collapse would not have been so painful and they probably would have regained any losses by now — and then some.

Of course, if you follow this system and you're fortunate enough to retire at a time when the stock market is robust, you will clearly earn less than if you went the conventional route.

3 Questions You'll Want to Answer

I decided to call a few other financial experts for their opinion about this provocative study. They posed three questions to consider if you find the Kitces/Pfau idea compelling:

1. Do you have the stomach for buying stocks late into retirement? You'll need to decide if you'd be comfortable with a stock-heavy portfolio when you're in your 70s and beyond.

As the authors write: "Notably, the clear caveat and concern of this approach is that it may also create concerns for seniors in their later years, who may not be comfortable from a risk tolerance perspective handling the greater equity exposures implied by this approach."

Kimberly Foss, founder and president of Empyrion Wealth Management in Roseville, Calif., is concerned about the strategy for just that reason. "Low savings rates and increasing longevity are often cited as reason for a higher final equity allocation in retirement," she says. "However, increasing portfolio risk to offset increased longevity is dangerous."

2. Do you have the fortitude to purchase shares in a bad market? The hardest part of the Kitces/Pfau strategy may be staying the course if stocks head south.

Lisa A.K. Kirchenbauer, president of Omega Wealth Management in Arlington, Va. and I both think that women might have trouble with the idea of building up a stock portfolio throughout retirement because they tend to be more risk averse than men.

But I think adding just 1 percent more in stocks each year seems manageable.

3. Do you have a financial adviser? Even if you're keen to start retirement with a conservative portfolio and slowly juice it up, you'd be well-advised to have a sharp financial planner at your side to help navigate this path.

"There are no 'set it and forget it' strategies, said Foss.

I agree.