

## Building and Managing a Retirement Portfolio - Part Four

One of the most important decisions investors face is the asset allocation of their portfolio. For the retiree, the asset allocation will be inextricably tied to a second critical decision: the spending strategy to be employed during retirement.

**Asset allocation.** Asset allocation is simply the percentage of a portfolio invested in the various asset classes such as stocks, bonds, and cash investments. It should be the top priority in constructing and managing a portfolio, because it determines almost all of the investment risk and performance an investor experiences, and therefore greatly affects the chances of meeting their goals. Since we can't predict the future and we don't know which assets classes will perform best, we can't know in advance what that optimal allocation will be. We can however, apply sensible investing principles and build a portfolio that is broadly diversified, tax-efficient and consistent with the goals and investing temperament.

As retirement approaches, investors often shift more of their assets toward income producing investments such as bonds, and away from more volatile ones such as stocks. In general this is a sound practice for retirees who rely on investment income (rather than working income) and have less time to recover from market declines. However, retirees often take this concept too far and fail to balance the need for both current income and long-term growth thereby running the risk of depleting their portfolios prematurely.

**Spending strategies.** Investors typically employ one of two spending approaches during retirement: the *income* method or the *total return* method.

Using the income method, investors spend only the income (interest, dividends, and capital gains) generated by the portfolio. However, unless they have a substantial investment portfolio or very low spending needs, they will need to increase the allocation to bonds, and/or dividend paying stocks. Unfortunately this is not an effective strategy for maintaining the retiree's inflation-adjusted spending or the capital appreciation of the portfolio. In other words, this approach can initially generate a

fairly high income, but at the expense of the after-inflation purchasing power of that income and the after-inflation value of the portfolio itself, both of which will be eroded over time. This increases the likelihood that the portfolio will be depleted prematurely. In addition, because the income approach ignores the important asset allocation decision, and therefore lacks the diversification provided by other available asset classes, it unnecessarily increases the portfolio's risk.

The preferred alternative to spending income only is a total return spending approach, where the income (interest, dividends, and capital gains) is used first. If this proves insufficient to meet spending needs, the investor then taps some of the principal. In other words, in situations when the total portfolio cash flow (interest, dividends, and capital gains) is more than the retiree needs, the total return approach is equivalent to the income approach. With the total return method, the investor does not base investment decisions on maximizing income, but instead focuses on establishing and maintaining the appropriate asset allocation, portfolio diversification, and balancing the need for current income with long term portfolio growth. This helps decrease the portfolio's risk and increase its longevity.

Much of the research conducted comparing the income and total return approaches suggest that unless the retiree's portfolio is substantial relative to their spending needs, the total return approach is more effective in reducing the likelihood they will run out of money.

The bottom line: the composition of the portfolio should be determined by sensible asset allocation and the need for balancing current income with long-term growth, rather than the desire to spend only certain portions of the portfolio.

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