How Does the Bucket Strategy Work in Practice?

Christine Benz, Director of Personal Finance

Morningstar, Inc.

Presentation Overview

Part I: The retirement income problem: Better, but not solved

Part II: Bucket strategy basics

Part III: Model bucket portfolios

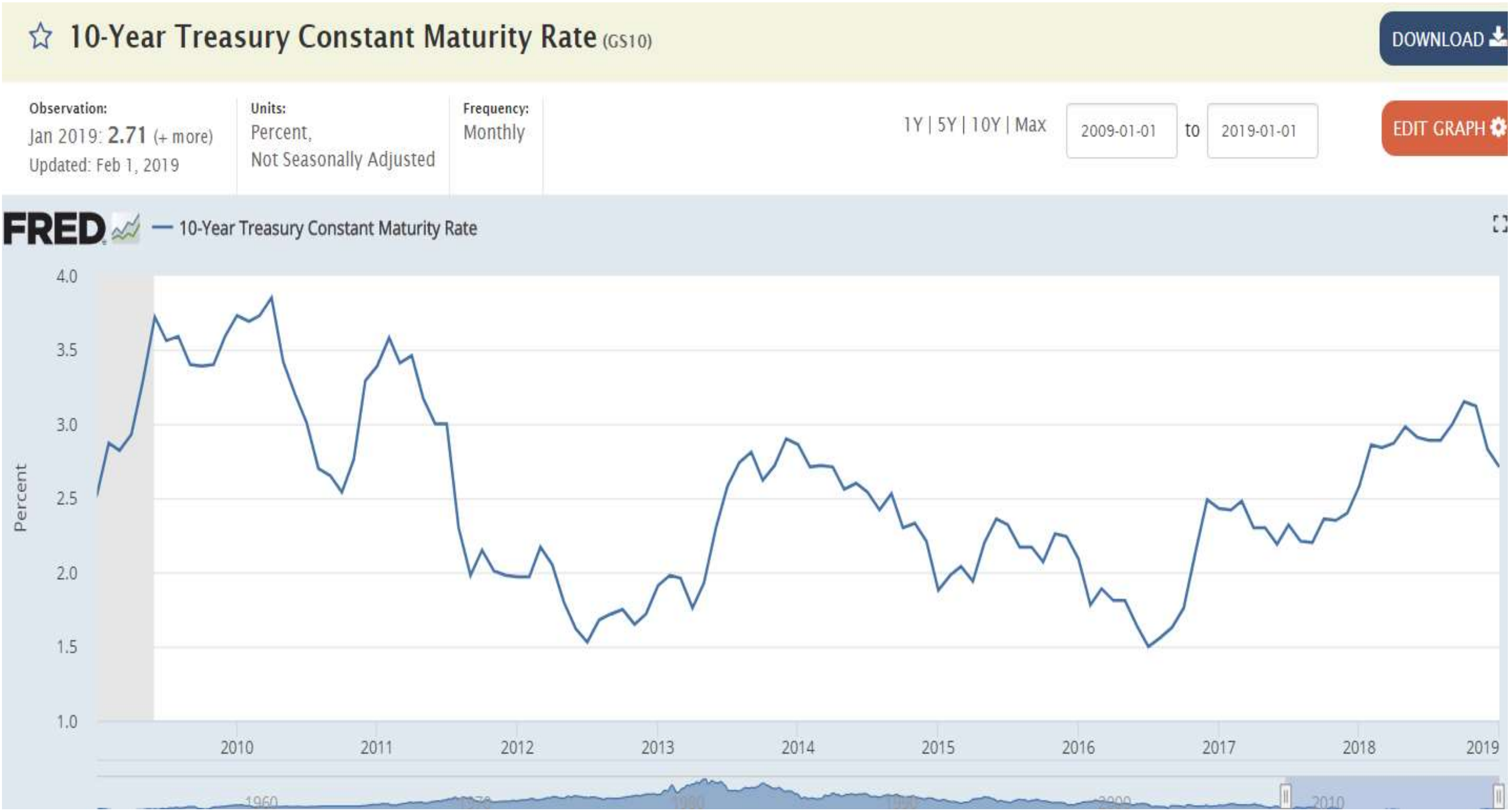
Part IV: Implementation challenges in real-life situations

Part V: Bucket 'stress tests'

Fed Policy More Favorable to Savers

Source: St. Louis Federal Reserve

Bond Yields Are Improving, But Still Pretty Low



Source: St. Louis Federal Reserve

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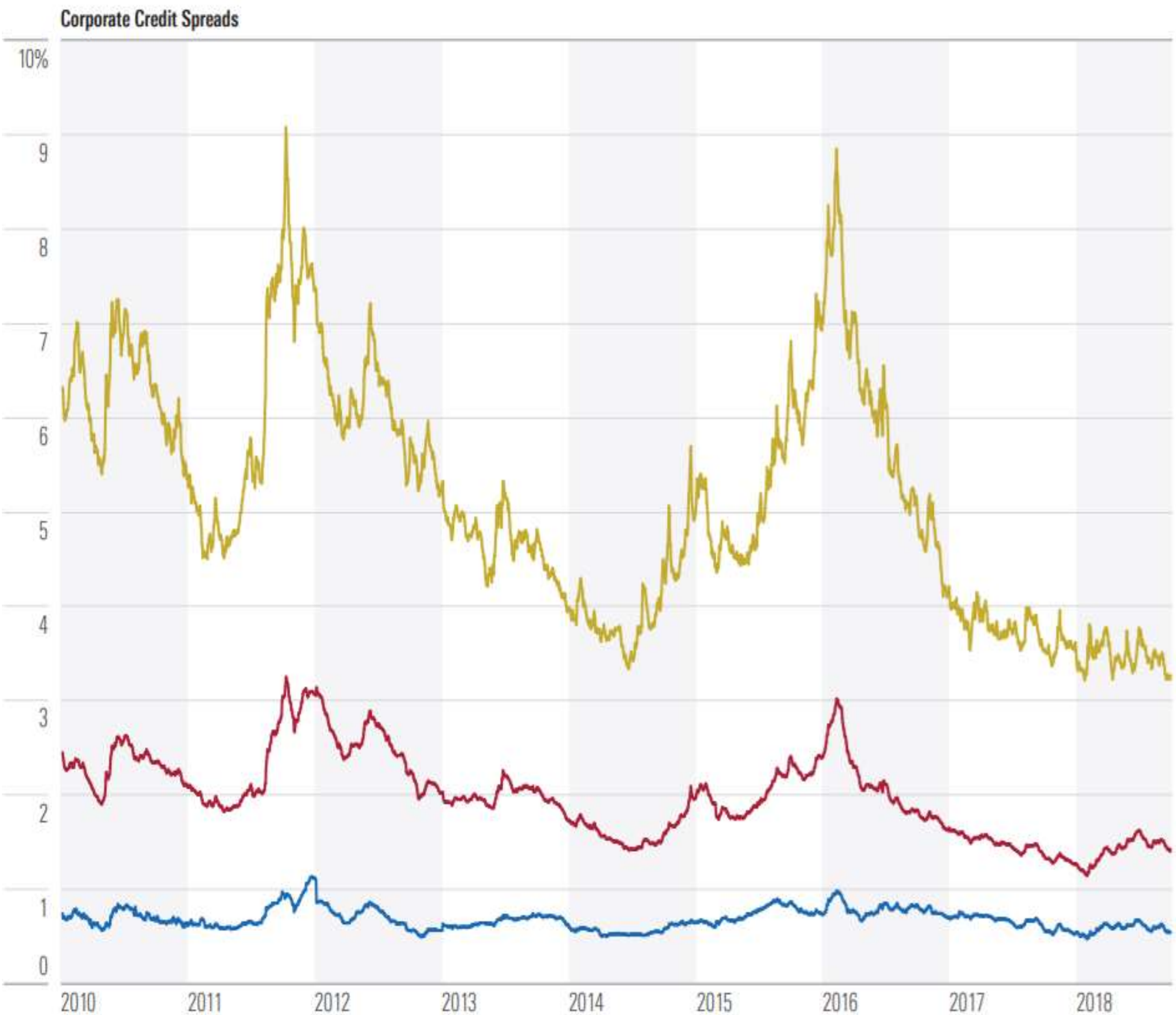
Every Rock Has Been Turned Over in Search of Higher Yields



	Current (%)	Avg (%)	Change Over Last Quarter
AAA	0.6	0.8	–0.1
BBB	1.4	2.0	–0.2
High Yield	3.2	5.6	–0.4

Source: Morningstar Markets Observer

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Bucket Approach Enables Retiree to Keep Ongoing Living Expenses on Hand, Refill with Income Distributions and Rebalancing Proceeds

Bucket 1

For: Years 1 and 2

Holds: Cash

Goal: Fund Living Expenses

Bucket 2

For: Years 3-10

Holds: Bonds, Balanced Funds

Goal: Income production, stability, inflation protection, modest growth

Bucket 3

For: Years 11 and beyond

Holds: Stock

Goal: Growth

Advantages of bucket approach

- Gets retirees off of the “income only” bandwagon; cash flows can come from income or rebalancing
- Psychological benefit: Cash provides a buffer in volatile markets
- Uses probability of earning a positive return over a given time horizon to drive allocations to asset classes
- Helps retirees “back into” a situation-appropriate asset allocation mix
- Discrete buckets make it easy to spot rebalancing opportunities
- Can be customized based on retirees’ own investment preferences
    - Individual stocks
    - Actively managed mutual funds
    - Index funds/ETFs

Disadvantages of bucket approach

- Won't ensure there won't be a shortfall
- Not "set it and forget it"; requires maintenance
- Relies on a well-thought-out system for refilling bucket 1/rebalancing
- Cash is a drag in upward-trending market environments
- Can get complicated across multiple accounts:
    - Taxable
    - Tax-deferred
    - Roth
    - Two spouses'

What the Bucket Approach *Doesn't* Entail

- Constantly moving money from bucket 3 to 2 and 2 to 1
  - It's not always a good time to move money from stocks
  - Plus, it's too much work!

- Spending "through" the buckets (cash, then bonds, then stocks)
  - Would leave retiree with a big bucket of stocks late in life; may not be an opportune time to tap

Sample In-Retirement Bucket Portfolios

Assumptions

- 65-year-old couple with $1.5 million portfolio
- 4% withdrawal rate with annual 3% inflation adjustment ($60,000 first-year withdrawal)
- Anticipated time horizon: 25 years
- Fairly aggressive/high risk tolerance (total portfolio is ~ 50% stock/50% bonds and cash)

Sample In-Retirement Bucket Portfolio: Mutual Fund

Bucket 1: Liquidity Portfolio for Years 1 and 2: $120,000

$120,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $480,000

$130,0000 in Fidelity Short-Term Bond FSHBX

$150,000 in Harbor Bond HABDX

$100,000 in Vanguard Short-Term Inflation-Protected Securities VTAPX

$100,000 in Vanguard Wellesley Income VWIAX

Sample In-Retirement Bucket Portfolio: Mutual Fund

Bucket 3: Growth Portfolio for Years 11 and Beyond: $900,000

$400,000 in Vanguard Dividend Appreciation VDADX

$250,000 in American Funds International Growth & Income IGIFX

$125,000 in Vanguard Total Stock Market Index VTSAX

$125,000 in Loomis Sayles Bond LSBRX

Sample In-Retirement Bucket Portfolio: ETF

Bucket 1: Liquidity Portfolio for Years 1 and 2: $120,000

$120,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $480,000

$100,000 in Vanguard Short-Term Bond ETF BSV

$150,000 in iShares Core US Bond Market IUSB

$150,000 in Vanguard Short-Term Inflation-Protected Securities VTIP

$80,000 in Vanguard Dividend Appreciation VIG

Sample In-Retirement Bucket Portfolios: ETF

Bucket 3: Growth Portfolio for Years 11 and Beyond: $900,000

$350,000 in Vanguard Dividend Appreciation VIG

$225,000 in Vanguard Total Stock Market Index VTI

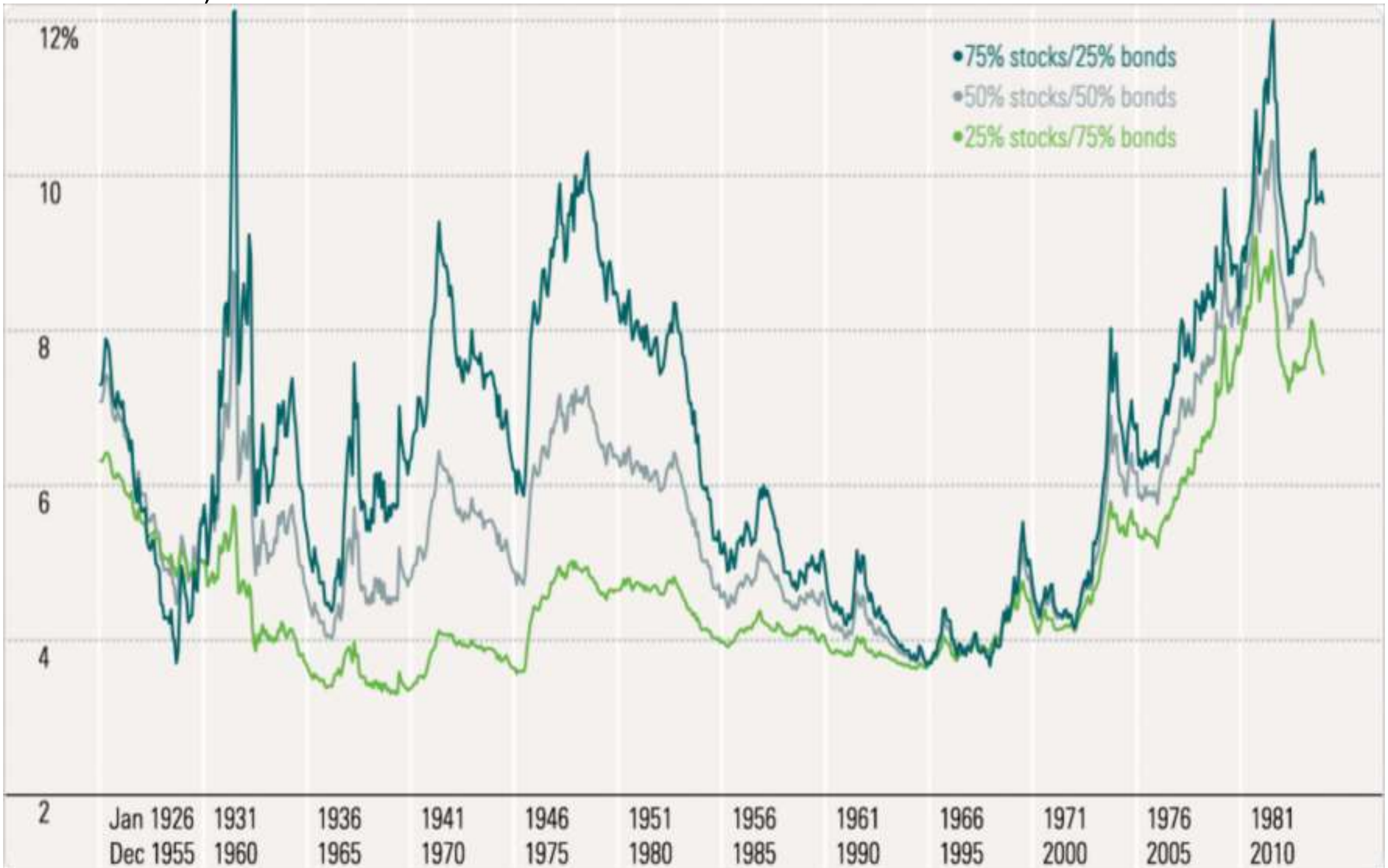
$250,000 in Vanguard FTSE All-World ex-US VEU

$75,000 in Vanguard High-Yield Corporate VWEHX

But Implementation Jobs Abound

- Job 1: Check sustainability
- Job 2: Identify spending method
- Job 3: Decide on portfolio "glidepath"
- Job 4: Articulate maintenance strategy
- Job 5: Implement across multiple account types/sequence withdrawals

Job 1: Check sustainability: Safe withdrawal rate depends on asset allocation, retirement time horizon



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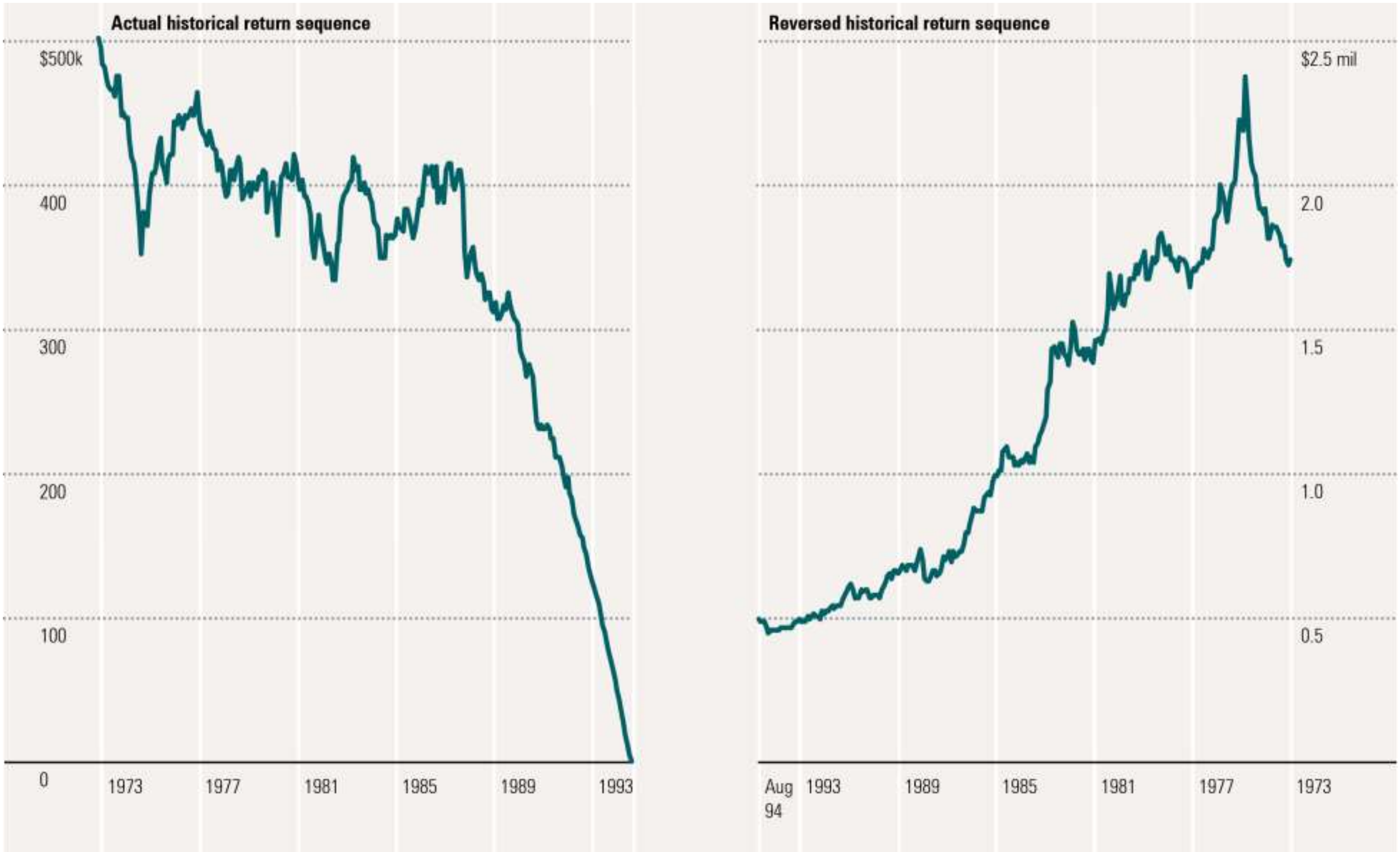
Job 1: Check sustainability: Entry point matters



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Job 2: Identify spending method

- Where will you go for cash to refill bucket 1 as it becomes depleted?
- Choose one of the following:
    - Option 1: Income-centric (“old school)
    - Option 2: Pure total return/rebalancing
    - Option 3: Hybrid income/total return

Spending Method 1: Income-Centric/Old School

Pros

- Intuitively appealing
- Low maintenance: "Paycheck" equivalent
- Enables retirees to maintain principal/bequest motive

Cons

- Retiree cash flows are buffeted around by prevailing yields
- In low-yield environments, retirees might take on extra risk in quest for yield

Spending Method 2: Pure Total Return/Rebalancing

Pros

- Portfolio can be optimized for risk/return w/o regard for current income
- Rebalancing to meet cash flow needs can help optimize portfolio on an ongoing basis

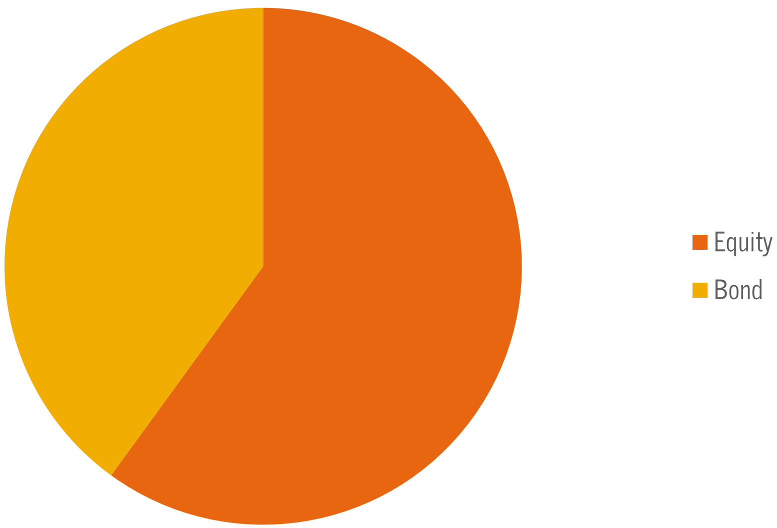
Cons

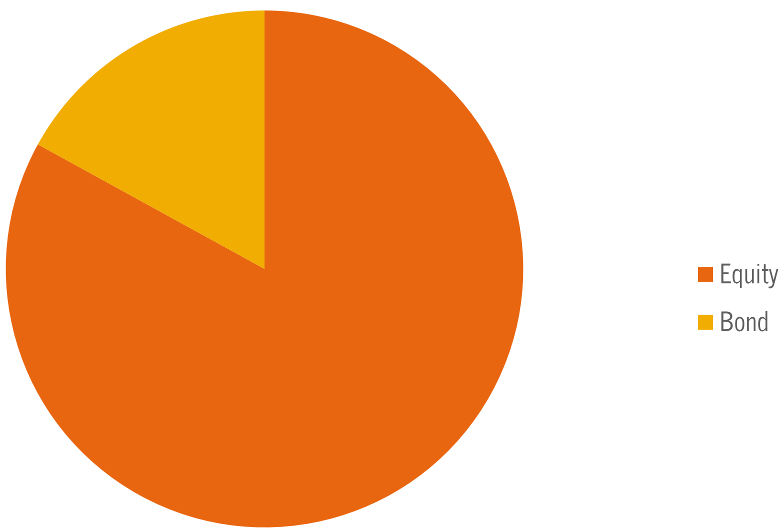
- Requires more maintenance than income-centric approach
- Doesn't ensure that retiree will never touch principal

Rebalancing Can Help Retirees Achieve Multiple Goals

- Reduce risk in their portfolios
- Tee up cash flows for the year ahead
- Meet required minimum distributions (RMDs)
- Make charitable contributions (donating appreciated securities from taxable accounts or make charitable contribution from IRA if post-age 70-1/2)

Rebalancing Opportunities Still Plentiful in Early 2019





A 60% equity/40% bond portfolio in March 2009….

…Would be 81% equity/19% bond today

Spending Method 3: Blended Income Plus Total Return

Pros

- Tapping income can provide a baseline of living expenses
- Rebalancing to supply additional living expenses ensures retiree doesn’t stretch for income
- Strategy enables retirees to be opportunistic: Rely on income when yields are higher; fall back on rebalancing when they’re lower

Cons

- Requires more maintenance than income-centric approach
- Doesn’t ensure that retiree will never touch principal

Job 3: Decide on Portfolio Glidepath→Rebalancing Regimen

Glidepath 1: Static

- Rebalance back to target glidepath on a regular basis
- Portfolio's asset allocation stays the same throughout retirement

Glidepath 2: Progressively more conservative (traditional)

- Regularly scale back appreciated positions
- Deploy rebalancing proceeds into cash and bonds
- Will tend to preserve purchasing power for retirees; won't maximize returns
- Appropriate for "last breath last dollar" retirees

Glidepath 3: Progressively more aggressive

- Portfolio conservatively positioned at retirement; equity exposure ramps up
- Best for retirees who are concerned about sequencing risk
- Not appropriate for retirees who don't have a bequest motive

Job 4: Articulate Maintenance Strategy

Key considerations for maintenance include:

- **How often?**
  - Annually, for rebalancing, refilling bucket 1, and meeting RMDs
  - More frequently for more rebalancing opportunities

- **How rebalancing will occur**
  - Asset-class level
  - Securities level

Job 4: Articulate Maintenance Strategy

Rebalance at the asset class level (classic rebalancing)

- Will tend to keep risk in check
- Will tend to yield fewer rebalancing opportunities→fewer opportunities to harvest cash flows

Rebalance at the securities level

- Can be done in conjunction with asset-class rebalancing
  - e.g., while you're trimming equities, trim large-growth equities
- Is a great option for people relying exclusively on rebalancing to maintain cash flows

Job 5: Implement across multiple account types/sequence withdrawals

Most retirees bring multiple accounts into retirement

- Traditional tax-deferred (401(k), IRA)
- Roth
- Taxable

Traditional sequence of returns to maximize tax savings can inform asset allocation within each account

- RMDs
- Taxable
- Tax-deferred
- Roth

Bucket Approach Meets Multiple Accounts

ACCOUNT: Taxable	**ACCOUNTS:** Taxable and Traditional IRA	**ACCOUNTS:** Traditional IRA and Roth IRA
STARTING BALANCE: $120,000	**STARTING BALANCE:** $480,000	**STARTING BALANCE:** $900,000
ASSETS: $120,000 in cash and cash equivalents	**ASSETS:** $380,000 of short- and intermediate-term bonds held in the taxable account + $100,000 of intermediate-term bonds held in the traditional IRA	**ASSETS:** $400,000 of equities/equity funds held in the traditional IRA + $500,000 of equities/equity funds and higher-risk high-yield bond funds held in the Roth IRA

Assumption: 65-year-old retiree has $1.5 million split equally across traditional, Roth, and taxable accounts.

Basic Bucket Stress Test: 2000-2017

Assumptions

- 4% withdrawal rate with 3% annual inflation adjustment
- Reinvest all dividends and capital gains from buckets 2 and 3
- Rebalance positions when they exceed 110% of original size; use rebalancing proceeds to meet living expenses but tap bucket 1 if more needed
- If rebalancing proceeds exceed living expenses, re-fill bucket 1
- If bucket 1 is full, redeploy into positions below starting values

Results

- Starting value (2000): $1,500,000
- Ending value: $1,894,195
- Cash flows (income): $1,464,766 ($60,000 initially inflation-adjusted annually)

Takeaways from the Stress Tests

- Rising tides lift all boats: Despite a rough first decade, stock and bond returns were very good between 2000-2018
- Cash was a drag but was the portfolio's best performer in 2018
- Cash carries a benefit that can't be counted: Peace of mind
- Discrete holdings for rebalancing beat all-in-one long-term fund
- Maintenance regimen matters: The one employed in my stress test led to ever-higher weightings in safe assets

Questions? Comments? Want a copy of my slides?

christine.benz@morningstar.com