

## **A Strategy for a Lifetime of Income**

*Split your nest egg into separate buckets to generate income throughout your retirement.*

To win the battle for income that lasts a lifetime, a growing number of financial advisers and retirees have decided to divide and conquer. Their approach: Split portfolios into separate "buckets" designed to generate income for specific segments of retirement.

The buckets designated for the first few years of retirement will hold the most stable, secure investments, so retirees know their immediate income needs are covered. The buckets designed for later years, meanwhile, hold riskier fare meant to generate portfolio growth over the longer haul.

While some financial planners have used a basic bucket approach for decades, the strategy has gained popularity in recent years. That's partly due to the recent market swings. When retirees know their next five to ten years' worth of expenses are stashed away in conservative holdings, they gain confidence to remain invested in stocks through volatile times.

Norm Mindel, managing partner at Forum Financial Management in Lombard, Ill., says a bucket approach helped almost all of his clients stay in the market during the financial crisis. "They can sleep at night knowing they have money for the next ten years," he says.

The bucket strategy marks a significant departure from old retirement rules of thumb. By starting with an assessment of how much annual income the retiree needs, rather than how much can be "safely" withdrawn from the portfolio each year, it reverses the approach used in one of the most dominant, and hotly debated, draw-down strategies -- the "4% rule."

Here's how the 4% rule works: In the first year of retirement, the investor withdraws 4% of his total nest egg, or \$40,000 from, say, a \$1 million portfolio. Each year, that dollar amount is adjusted to keep up with inflation. Assuming 3% inflation, for example, this investor would withdraw \$41,200 in the second year of retirement, \$42,436 in year three, and so on.

While the 4% rule is simple to follow and gives a portfolio good odds of lasting a lifetime, many advisers object to its rigidity. Retirees withdraw a set amount each year, regardless of their actual income needs and the investment performance of their portfolio.

What's more, when making their inflation-adjusted withdrawals, retirees following the 4% rule tend to sell more shares when the stock market is down and fewer shares when it's up -- a reversal of the "dollar-cost averaging" approach, in which investors regularly buy a set dollar amount of stocks so that they'll buy more shares when prices are low. "Dollar-cost averaging out of the market is the worst thing to be doing during retirement," says Paul Grangaard, a St. Paul, Minn., adviser.

The drawbacks of the 4% strategy became clear during the economic downturn. By taking inflation-adjusted distributions from shrinking portfolios, retirees faced the prospect of outliving their nest eggs. They were advised to skip their inflation adjustments or to take less than 4% of the new, smaller balance.

A bucket strategy aims to address such concerns by taking withdrawals from more stable cash and fixed-income holdings, leaving riskier stock holdings plenty of time to recover from market downturns. And each bucket can be designed to deliver a different amount of income to respond to fluctuating needs, if, for example, the retiree plans to travel a lot in his first five years of retirement but expects spending to decline after that.

There are many versions of the bucket strategy, and some are so complex that they require the help of a financial adviser. But do-it-yourselfers can implement basic elements of the strategy in their own portfolios.

### *Filling the Buckets*

To start, consider the amount of money you'll likely spend annually in the first five years of retirement. Then, after factoring in Social Security, pensions and any other steady sources of income, decide on how much to draw from your portfolio each year to cover expenses.

Money to cover that five years' worth of spending should be invested in the safest holdings, so accept a 1% or 2% return and forget about going for growth, advisers say. You might *invest* in a money-market fund to deliver income for the first year, for example, and buy certificates of deposit that will mature in years two, three, four and five. Short-term, high-quality bond funds, a "ladder" of Treasury bonds maturing in each year, or a single-premium immediate annuity could also go in this bucket.

Although you can begin using a bucket strategy after you've entered retirement, it's best to start thinking about your first bucket roughly five years before you actually *retire*. While the bucket holds low-yielding investments, those who plan ahead may be able to time their purchases to coincide with higher interest rates that offer a more generous income stream.

With interest rates so low today, of course, it can be painful to put a full five years' worth of living expenses into holdings that yield next to nothing. Harold Evensky, president of Evensky & Katz Wealth Management in Coral Gables, Fla., addresses the issue by putting two years' worth of assets into money-market funds and short-term bond funds, and another three years' worth in short- to intermediate-term bond holdings. No one should invest in riskier holdings, he says, unless they have at least a five-year time horizon for that money. "The risk of investing is having to take your money out at the wrong time," he says.

Many advisers design the second bucket to cover another five years' worth of living expenses, and fill it with slightly riskier investments. Appropriate holdings might include high-quality intermediate-term bond funds, global bond funds and a small allocation (under 20%) to well-diversified stock funds. After your first five years of retirement, you can use the money in this second bucket to replenish your first bucket -- for example, buying another five-year ladder of CDs or Treasury bonds.

Francis Cartwright, a 69-year-old retired software engineer in Phoenix, started using the bucket approach about five years ago. In his first bucket, he invested in short-term bond funds and targeted a 2.5% annual return. Now he's ready to replenish that with his second bucket, where he aims for a 4% annual return and holds a range of conservative mutual funds. So far, Cartwright says, the plan is on track and he's pleased with the strategy "because you have money set aside for current needs."

To keep your plan relatively simple, you can design the third bucket to hold the remainder of your portfolio. In this segment, it's appropriate to go after some growth. Forum Financial's Mindel, for example, devotes 50% to 70% of this bucket to stocks.

### *Refilling the Buckets*

Advisers recommend a combination of strategies to help balance your portfolio, minimize costs and keep near-term expenses covered. The key point is to always draw spending money from your safest assets.

Let's say you have one bucket holding a five-year CD ladder, another bucket holding short- and intermediate-term government bond funds, and a third filled with broadly diversified stock and bond funds. While you're spending from your initial five-year bucket, you don't need to constantly refill it to maintain a five-year lifespan -- but don't ignore the other segments, either. Review the entire portfolio at least annually. If the third segment is performing much better than expected, take some profits and use them to extend your CD ladder, if needed, or to bolster your conservative-investment cushion in bucket two.

Mindel targets a 6% to 7% annual return for the bucket that holds 50% to 70% stocks. If a big market rally pushes this segment well ahead of the target, he'll sweep some of the profits into safer holdings.

If your riskier investments aren't performing as well as projected, avoid tapping them for the moment. Your ten-year cushion of conservative holdings gives you time to dial back spending while you wait for them to recover. Given the long time horizon, a 3% to 5% reduction in annual spending can help keep the plan on course.

You'll also need to periodically rebalance your growth-oriented segment, and that offers another opportunity to refill your safer buckets. Let's say your growth bucket has a targeted allocation of 50% stocks and 50% bonds. You should rebalance if market movements shift that mix by more than ten percentage points -- say, to 60% bonds and 40% stocks, Evensky says. When you sell some of those bonds to rebalance, you can use some cash to refill your safer buckets.

After the first five-year period, you should have sufficient assets in your second bucket to rebuild the five-year ladder of CDs. Even if there has been a slight decline in those bond holdings in the second segment, the combination of your periodic profit-taking, rebalancing adjustments and portfolio growth should be enough to cover expenses for another five years.

Keep costs in mind when employing a bucket strategy. Low-fee index-tracking funds can be important cost-saving tools. Investors should also weigh the total size of their portfolio against trading costs and tax consequences when determining whether a bucket strategy makes sense. Many advisers say the costs of the strategy are too burdensome for portfolios under \$250,000, and some say a bucket approach is best reserved for portfolios over \$1 million.

### *Adding Extra Buckets*

While a do-it-yourself bucket approach may use only three basic segments, some advisers slice and dice a client's retirement into six or more five-year buckets, each with its own investment mix and targeted return. But this approach may be too unwieldy for retirees to pursue on their own -- and if not managed properly, transaction costs and taxes can undermine the plan.

Philip Lubinski, founding partner of First Financial Strategies in Denver, builds a bucket for each five-year segment of a client's retirement. While an immediate annuity or laddered CDs might fill the first bucket, investments grow slightly more aggressive with each subsequent segment. The second bucket might have 20% stocks and 80% bonds, while the last bucket is 100% stocks. These later buckets are composed of exchange-traded funds, which offer broad diversification and help keep costs "as low as possible," Lubinski says.

Similarly, Grangaard often uses Treasury bonds in clients' first two segments, and then creates a series of five-year segments holding low-cost ETFs. When a client hits age 90 or so, the plan is to create a new segment by buying an immediate annuity to provide income for the rest of the retiree's life. While some clients ultimately opt not to purchase this final annuity, "at least when they're 65, we know we can put a plan together that will take care of them for the rest of their life, not just the first 30 years" of retirement, Grangaard says.

For do-it-yourselfers, online tools can help ensure that your spending level is appropriate and your plan stays on track. A new feature of the ESPlanner financial-planning software developed by Boston University economics professor Laurence Kotlikoff shows investors how much they can draw out of their safe assets and still maintain their living standard throughout retirement. Using this "Upside Investing" feature, available at <https://basic.esplanner.com>, riskier stock-market assets aren't touched until they've been converted to something safe, like Treasury inflation-protected securities. A version of ESPlanner that saves personal data and includes the Upside Investing feature costs \$60.

For retirees who need a helping hand, financial-services firms are launching new products that do some or all of the work of creating the buckets and making certain that they remain filled. These products are available through financial advisers.

RetireSense, launched by Nationwide Financial Services in 2007, helps advisers divvy up assets that clients will spend in various stages of retirement. It first suggests an annuity to cover essential expenses for life, and then creates buckets to cover discretionary spending in five-year increments. The buckets can include cash, laddered bonds, mutual funds and variable annuities that offer some stock-market exposure but also have a guaranteed floor in case of market declines. Investors should have at least a \$350,000 retirement portfolio to use the plan, says Kevin McGarry, director of retirement income strategies at Nationwide.

Another new product relies on much simpler holdings: individual bonds. The Defined Income separate account, launched last year by Mill Valley, Cal., money manager Asset Dedication, offers a highly personalized fixed-income portfolio that can cover near-term income needs in a bucket strategy. The firm creates a mix of CDs, Treasury inflation-protected securities and other high-quality bonds that will deliver the exact amount of income the retiree needs for a certain number of years. With that income locked in to cover expenses for, say, five or ten years, the retiree can then maximize his investments in higher-growth assets, such as stocks.

The Asset Dedication product is available through registered investment advisers and charges fees of 0.35% of assets. The minimum investment is \$100,000.

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