



Timothy Middleton

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Mutual Funds

New rules for a new retirement

Conventional wisdom of mixing bonds, pensions and Social Security simply doesn't apply anymore. Improve your odds by staying in the market until the day you get your gold watch.

By [Timothy Middleton](#)

My father will celebrate his 87th birthday this summer. His sister turns 89 this month. Their brother was 95 when he died last year. They belong to the fastest-growing age group in the developed world, those over 85, called the "oldest old" by the government.

My Depression-era relatives have traditional pensions and Social Security. I have a rollover IRA and what used to be called a Keogh plan. Like the baby boomers just behind me (I'm 59), I don't expect Social Security to count for much. It wouldn't pay my mortgage, which I just refinanced and has 19 years remaining on it.

So the old rules about retirement are wasted on today's workers. The conventional notion that I'll only need to make up for 40% of my pre-retirement income, with my pension and Social Security making up the balance, is nonsense. I'll be responsible for 75% or more, and my children will likely have to come up with more still.

They're likely to live longer than me, and we pre-seniors are apt to live longer than our parents. Someone who's 65 today should be planning for financial security for at least 26 years, the life expectancy used by the Internal Revenue Service to guide IRA withdrawals.

The old rules about planning your retirement portfolio are as out of date as the used Hudson in which my dad drove my sister and me to grammar school. Bonds? Use them sparingly. Bonds blossom in deflation. We have the contrary worry.

Don't fall for the 'rule of dumb'

"The only way to hedge against inflation in the long run is with stocks," says Ken

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Weingarten, a financial adviser in Lawrenceville, N.J. Purchasing power is what you have to protect.

So the rule-of-thumb approach to retirement planning, the so-called life-cycle mutual funds, which become increasingly bond-heavy as they mature, is the rule of dumb. They're poor investments, and I mean literally poor. You can double the 3%-or-so returns they offer with little additional risk, which can make the difference between comfort and want when you're really old.

Mutual Funds

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For those in retirement, as well as those planning for it, successful investing is a three-step process. First, you establish realistic long-range goals consistent with your own circumstances. Second, you establish a portfolio that can be expected to generate the returns you require over that lengthy period. Finally, you construct a portion of that portfolio that will reliably provide sufficient current income.

The most difficult task you face is an intellectual one: Having confidence in this total return, rather than income return, and in the orientation of your planning. "We employ the total return approach, but have found some difficulties recently in convincing clients that they are not spending principal," says D. Scott Neal, an adviser in Lexington, Ky.

They're not; they're growing principal. Here's how.

Mind the odds

By 2030, about 70 million Americans, or one in five, will be over the age of 65, according to the Health and Human Services Department. That's a doubling from 1996. Some 8.5 million of them will be 85 or older.

The Social Security system will be in tatters if it's not reformed first.

This is where Monte Carlo analysis comes in. As that casino-sounding name suggests, the approach is based on evaluating odds. The Monte Carlo theory doesn't tell you how much your \$500,000 nest egg will be worth in 25 years, but it tells you what the odds are that it will meet your needs.

[A useful study](#) of such odds was recently published by the American Association of Individual Investors. It says that, to sustain an inflation-adjusted current income of 6% from your investments, the odds are heavily on your side with an all-stock portfolio.

Seventy percent of the time that asset allocation will deliver the necessary income over any 25-year period. If you are 25% stocks and 75% bonds, which is where life-cycle funds tend to be when they mature, those odds are a dismal 24%.

A 6% return is \$30,000 annually on a \$500,000 portfolio. If you need \$60,000, save hard; you'll have to start with \$1 million. The reality is that expecting too much from your portfolio will condemn you to failure. If you want to take out 12% every year, the odds plunge to 20% that you will succeed over a 25-year period, even with an all-stock allocation, which delivers the highest returns you can predict.

A couple of options

Up until just before you retire, therefore, I recommend your portfolio be substantially all in equities. My own is. And until you actually begin making withdrawals, usually no later than at the age of 70½, it can remain in the stock market.

Last year, **Vanguard 500 Index Fund** ([VFINX](#)) shot up 28.5%, nearly twice the 15.6% return of **Wells Fargo Outlook 2010** ([STNRX](#)), which was one of the best performers among life-cycle funds.

On that day when your 6% withdrawals begin, you can opt to simply sell 6% of your holdings. If the market happens to be in the tank at the moment, however, this approach backfires.

Another strategy suggested by John Heinlein, a portfolio manager with Horan & Associates Financial Advisors in Towson, Md., provides a planning cushion.

Using the example of the \$500,000 portfolio and 6% withdrawals, Heinlein takes \$120,000 of the total one year before retirement and buys a ladder of government bonds or certificates of deposit maturing annually for the next four

years. It delivers the required \$30,000, plus interest, no matter what happens in the market.

Four years later, assuming the stock market's historical average return of 10.5%, the \$380,000 remaining in the stock portfolio has grown to more than \$566,000. He then takes 24% of that, as before, and puts it into another ladder. Income goes up with inflation.

Take the right amount of risk for you

Actually, Heinlein's model isn't quite as mechanical as this, because markets move up in fits and spurts, not straight lines. In the late 1990s, when stocks returned between 21% and 37% for five consecutive years, the four-year rebalancing would have drawn down far less than a quarter of the principal to re-fund the bond ladder.

Many investors aren't comfortable with having their entire investment stake committed to stocks. Rebecca Crossman, an Air Force sergeant stationed in Italy, is 35 and is investing in stocks. But she plans to start putting some fresh money two years from now in **Vanguard Target Retirement 2025** ([VTTVX](#)), which will be heavily invested in bonds when she's in her 50s.

Together with her government Thrift Savings Plan and Roth IRAs, both of which she's maxing out, she expects the balance to meet her goals. "I have no illusions of becoming 'rich,'" she says, "but I want to ensure enough diversification to retire by age 60-65 and travel occasionally."

Sounds like a plan to me. Investing for retirement has to be adjusted to your personal comfort level. Just keep the odds in mind.

At the time of publication, Timothy Middleton didn't own any securities mentioned in this article.

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