HBKS® Wealth Advisors

Taking a Bucket Approach to Asset Allocation in Retirement

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MANAGING INVESTMENTS IN RETIREMENT is challenging enough, but steering them through volatile and uncertain times, in particular in a post-COVID world, can be harrowing. Yet it is an unavoidable task for the four to five million Americans who retire every year.

As a Certified Financial Planner, I regularly encounter the concerns of clients who are in or considering retirement. Their questions about how they should be invested vary widely, from whether they should adhere to the age-old idea of owning the percentage of bonds equal to your age — if you're 65 you should have 65 percent of your invested dollars in bonds — to whether someone with enough money to live comfortably for the rest of their life and no desire to leave a legacy should take no risk at all (even though no one knows just how long they will live and what their expenses will be).

As I'm having more and more of these conversations with clients, I decided to take a look at a more quantitative approach to investing in retirement. You might have heard of a "bucket approach" to retirement income planning. What if we use a similar approach to asset allocation?

STRATEGY

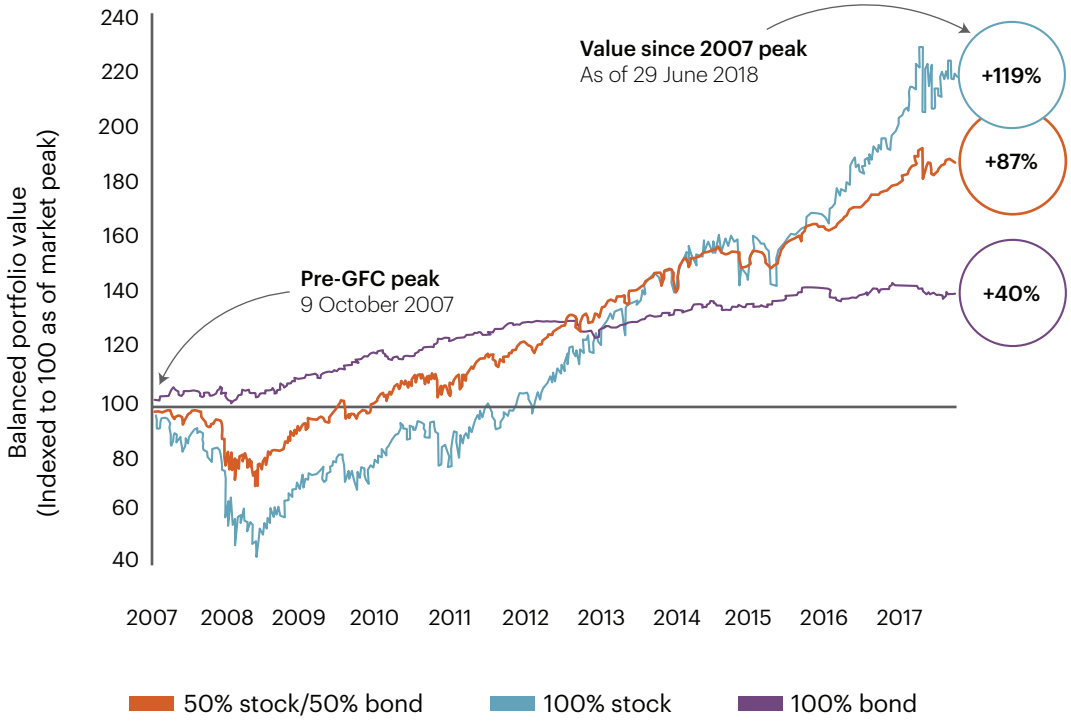
The idea involves using your needs in terms of retirement income to create a series of buckets that combined will supply that income. The strategy is completely customizable to each individual based on risk tolerance, personal goals and variables like inflation. For illustration purposes, let's use a broadly applicable, if oversimplified, approach:

- Bucket #1 consists of two years of needed income invested conservatively in cash and fixed income securities. Putting the required dollars in these types of investments will spare the retiree from a market correction.
- Bucket #2 consists of eight years of needed income, providing in combination with Bucket #1 a total of 10 years of needed income. This bucket will be invested in a more balanced portfolio of stocks and bonds, allowing the appreciation in value during re-balancing to be used to replenish Bucket #1.

Consider using a "bucket approach" to allocating your retirement assets.

The diversified, balanced portfolio historically has fully recovered within two years as demonstrated in the chart below:

The markets ultimately rewarded investors who remained disciplined.



Notes: Stocks are represented by the Standard & Poor's 500 Index. Bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. The 50% stock/505 bond portfolio was rebalanced monthly. Data are provided by FactSet and cover the period from 9 October 2007 through 29 June 2018. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Vanguard calculations using data provided by FactSet as of 29 June 2018.

- Bucket #3 will contain any assets remaining after the first two buckets are allocated. They will be invested via a more growth-oriented allocation in accordance with the individual's risk tolerance and financial needs or goals. The portfolio could range from 100 percent in stocks to a more moderate growth allocation with a blend of stocks and bonds, a combination of investments that will allow for replenishing Bucket #2 through different market cycles.

EXECUTION

Let's put our approach to work with a hypothetical example. Mr. and Mrs. Smith are about to retire. They have a combined Social Security income of $50,000 annually, and have accumulated a nest egg of $1.5 million. They estimate that they will need $100,000 a year to live on. We'll divide their funds into three buckets and invest each bucket as follows:

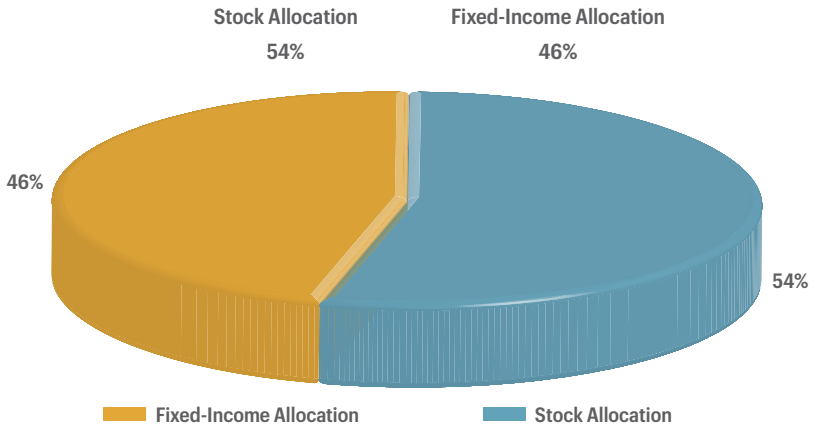
- **The Buckets:**
  - **Bucket #1:** $100,000 (two years of $50,000 each year required to supplement their Social Security income)
  - **Bucket#2:** $400,000 (eight years of $50,000 each year required to supplement their Social Security income)
  - **Bucket#3:** $1,000,000 (The remaining assets)

- **The investment allocations:**
  - **Bucket #1:** 50 percent cash/cash equivalents; 50 percent short-term fixed income
  - **Bucket #2:** 40 percent stock; 60 percent fixed income
  - **Bucket #3:** 70 percent stock; 30 percent fixed income

The following table illustrates the bucket distributions and the overall allocation resulting from the blending of the three: 54 percent in stocks; 46 percent in cash and fixed income:

Bucket Allocation
Total Investable Assets
$1,500,000

	Bucket #1	Bucket #2	Bucket #3
Goal Allocation	**50% Cash, 50% Short-Term Bond**	**40% Stock, 60% Bond**	**70% Stock, 30% Bond**
Goal Amount	$100,000	$560,000	$840,000
Cash	50%	0%	0%
Bonds	50%	60%	30%
Stocks	0%	40%	70%
Total Allocation	100%	100%	100%



In the above example, the Smiths have invested their savings into one, overall allocation that includes multiple approaches. It does not take into account inflation or any of the many other variables we would include in an actual plan. Nor does the example consider the wide variety of investment options available to the Smiths.

Take your risk tolerance into account to ensure you can weather the ups and downs in the market and stick with a long-term plan.

In past economic cycles, prior to the current, which is characterized by record low fixed-income rates, advisors would blend different types of insurance products into the buckets. They could, for example, use a single premium immediate annuity (SPIA) to fund the initial years of the income need, then use a defined period fixed annuity maturing at the same time as the SPIA to purchase the replacement SPIA. Insurance can also provide more opportunities for creative tax planning strategies with tax deferral and exclusion ratios.

There are many ways to determine how to invest at retirement to meet your ongoing needs and goals. The bucket approach may not be the right approach for every retiree, but this is one way to help you visualize why your investments are positioned the way they are and the reasons for and methodology of re-balancing. It is important to begin planning by taking your risk tolerance into account to ensure you can weather the ups and downs in the market and stick with a long-term plan. Your plan should also consider your time horizons, such as investing for a near-term goal.

We're here to help. Contact an HBKS advisor for customized retirement income planning.

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