What is a Retiree's Time Horizon?

By Gil Hanoch, February, 2010

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Have you ever heard about the principle of shifting the portfolio allocation from stocks to bonds as you approach retirement? This article presents an alternative to the principle above that may be more in line with a retiree's needs.

Before continuing, you are encouraged to read the article "What is your Time Horizon?" (Hanoch, Apr. 2006). It demonstrates several cases in which the principle above does not work.

When was the principle above appropriate? The idea of having most of your portfolio in bonds as you near retirement worked in the days when people retired at age 65 and typically lived for another 5 to 10 years. Under those conditions, and assuming limited resources, it was very important to protect the income for the upcoming few years, even at the expense of long-term depletion of assets.

Can you do better? The article mentioned above presents a more accurate approach to evaluating the time horizon of any person regardless of their age:

> Your time horizon is the time until you will need to use your money. Each person may have several time horizons for different parts of their savings.

If you are about to retire, and have a very short life expectancy and limited resources (the case described above), your time horizon is short, and most of your money should be invested in bonds, as suggested before.

In any other case the principle above fails, and the more accurate definition of time horizon, provides a better guideline for investment. Let's review several cases:

Case 1: Your income needs are very small compared to your portfolio size. If you withdraw a small enough percentage of your portfolio every year, even a high (as high as 100%) allocation to diversified stocks can be the most conservative plan. Depending on the portfolio, once the withdrawal rate becomes as low as 2%-4%, the stock portfolio can handle severe declines without depleting over time. In such a case, given your high short-term security in retirement, it is better to keep a very high allocation to stocks, to retain and increase your financial security over time, for as long as you live.

Case 2: Your income needs are fairly high compared to the portfolio size. If you expect to need, say 10% of your portfolio each year, you cannot afford having all of your money in stocks, because a big decline early in your retirement can deplete your whole portfolio in the first decade of your retirement. In such a case, the rule above should be applied as follows: leave enough money in bonds and cash to cover a number of years of living expenses, depending on how diversified your stock portfolio is. To maximize your financial security, the bond allocation should be used whenever the portfolio experiences a severe decline, and at no other time. As your portfolio grows, resulting in a lower annual withdrawal rate, you can reduce your allocation to bonds and shift into stocks, despite (actually, regardless of) your growing age. This is because your short-term security increases with your portfolio size, and you better address the now bigger risk – outliving your money.

Case 3: Guaranteed income that covers all expenses. If you are expecting guaranteed retirement income to provide for all your needs, your portfolio time horizon is infinite. You will not depend on any of the money while you are alive, and your heirs cannot depend on your money at any specific point, since they don't know how long you will live. In this case a high allocation to stocks (up to 100%) may be the most appropriate, providing the highest potential future extra cash for any desire or unexpected need.

Lifelong Security in Retirement

When people talk about retirement, the immediate thought is that the time horizon is short and emphasis should be given to providing money for short-term needs. Given the growing longevity of humans, this proposition has become incorrect and even dangerous. The average life expectancy of an individual retiring at age 65 is currently around 20 years, and this number keeps growing over time.

Say you spend 8% of your money per year, and you put most of it in bonds at age 65, with a growing allocation to bonds over time, you have a risk of going broke. Based on my analysis above, an allocation of more than 50% to stocks is likely to be appropriate, and should provide short-term security throughout extreme declines, as well as much higher security for as long as you may live.

Just as you don't count on your portfolio to grow every year by its average growth rate, you shouldn't plan on dying according to your life expectancy. The portfolio Long-Term Component has average returns greater than 15%, yet any conservative plan should not count on withdrawals much greater than 4%. Similarly, I would not recommend on planning to die (or alternatively go broke) anytime before age 100. As explained in the article "Preparing for a Long Life" (Hanoch, Dec. 2006), the difference between the withdrawal rate that will deplete your money in 30-40 years and the withdrawal rate that will never deplete your money, is relatively small. This leads me to construct retiree investment portfolios to last forever, in nearly all cases.

If this seems extreme to you, think about the hundreds of thousands of 100+ year-old people alive today, and imagine the millions that could reach this age group in upcoming decades, if you project the historic longevity growth. Preparing for life at this age, is no less important than preparing for a big crash in your stock portfolio starting precisely as you retire.

Assumptions

The ideas in this article depend on several important assumptions:

1. Your stock portfolio is globally diversified, and you do not individually select stocks or try to time the market.
2. You are highly disciplined, with nerves of steel, or your Investment Advisor has such nerves and you listen to him/her at all times. Specifically, you use stocks for living expenses when the stock portfolio is growing, and bonds when the stock portfolio is at a decline. Only if you depleted all your bonds at an extended decline, and there is no other source of money, you go back to selling stocks, and replenish your bond reserves when, and only when, the portfolio is recovered.

If these two are not true for you, please disregard this article.