How Does the Bucket Strategy Work in Practice?

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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

Effective Federal Funds Rate (FEDFUNDS)

Observation: Jan 2019: 2.40 (+ more)
Updated: Feb 1, 2019

Source: St. Louis Federal Reserve

Source: Morningstar
Bond Yields Are Improving, But Still Pretty Low
Every Rock Has Been Turned Over in Search of Higher Yields

Source: Morningstar Markets Observer
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 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**
$130,000 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 VWIAAX
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
Job 1: Check sustainability: Entry point matters
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
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
Rebalance at the asset class level (classic rebalancing)

- Will tend to keep risk in check
- Will tend to yield fewer rebalancing opportunities

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

1. **ACCOUNT:** Taxable
   **STARTING BALANCE:** $120,000
   **ASSETS:** $120,000 in cash and cash equivalents

2. **ACCOUNTS:** Taxable and Traditional IRA
   **STARTING BALANCE:** $480,000
   **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

3. **ACCOUNTS:** Traditional IRA and Roth IRA
   **STARTING BALANCE:** $900,000
   **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?

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