The Real Threat to Your Retirement Portfolio -- It's Not What You Think!

The first 10 years matter the most. Here's why.

November 11, 2015

FORECASTING THE FUTURE CAN BE STRESS INDUCING. THIS SHOULD HELP MAKE THE RETIREMENT-PLANNING PROCESS EASIER.

There are lots of reasons why people worry about having enough money in retirement. Pensions are disappearing, Social Security could get cut, and many haven't done an adequate job of saving for their Golden Years.

But even if you *have* done a good job, there are still threats that could deplete your nest egg while you're still alive. The culprit isn't ballooning healthcare costs or unforeseen changes in lifestyle, either. In fact, it's probably not what you think at all.

First, a little background

Two weeks ago, I published a piece encouraging readers to "Ignore the Retirement Alarmists." In it, I argued that withdrawing 4% of your nest egg in year one, and continuing to increase that amount to match inflation each year, was a very safe strategy to protect your principal and allow you to enjoy retirement.

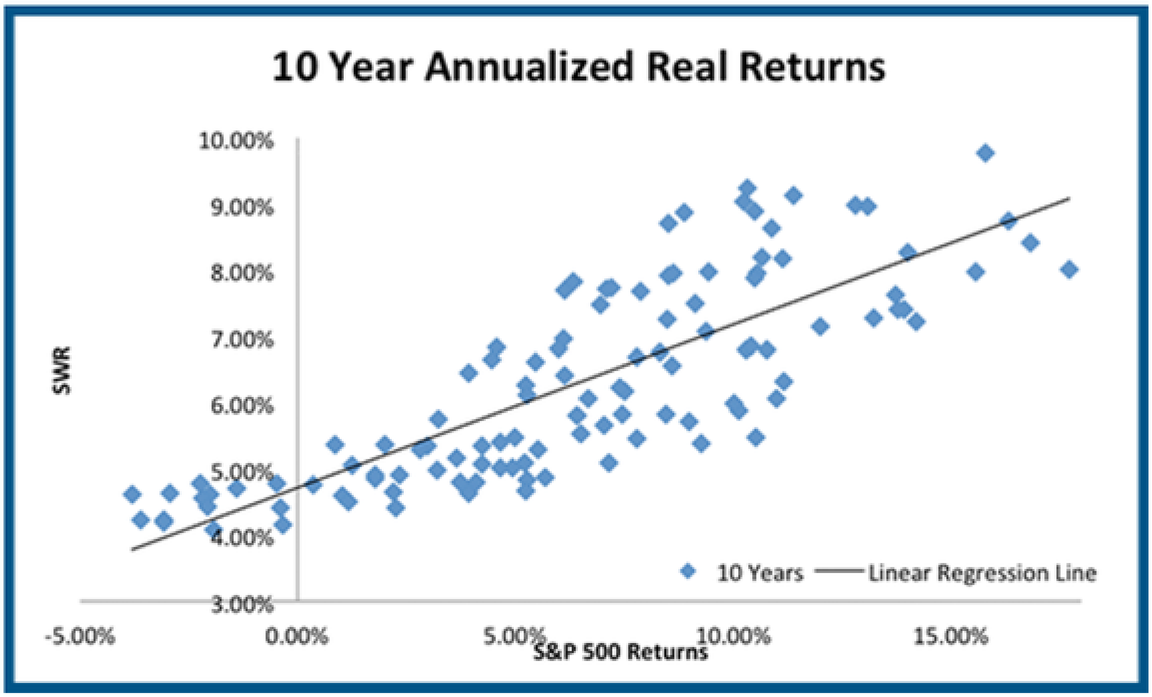
Some have recently argued that this "4% Rule" needs to be lowered to 3% -- which is actually a much bigger deal than you might think. But assuming that you'd have a 60/40 mix between stocks and bonds, retirement planning expert Michael Kitces has shown that using the 4% Rule is eminently safe. In fact, the median safe-withdrawal rate (SWR) for a retiree since 1871 -- and there weren't many back then -- has been 6.5%.

So what's the Big Threat?

When it comes to planning for retirement, the safest approach is to assume that you'll retire under the worst circumstances possible. If your nest egg can survive that, the thinking goes, then it can survive anything.

Kitces has shown (and thanks to the Madfientist blog for pointing it out) that the biggest threat to your nest egg being depleted is actually from something called "Sequence of Returns Risk." What the heck is that?

In essence, it means that the returns of your investments *during the first 10 years of retirement* will determine the health of your retirement portfolio. In fact, Kitces found that real returns (adjusted for inflation) during the first 10 years of retirement account for 79% of variation in nest-egg balances.



CREDIT: MICHAEL KITCES.

Why does this matter so much? It's here that we humans really stink at math; conceptualizing why this is important can be tough.

To demonstrate, let's assume that we have three retirees, and all three need their $1 million nest egg to last three decades. For perspective's sake, the average annualized gain of a 60/40 portfolio between 1976 and 2014 has been 10.4%. The worst-ever decade in this time frame (starting in 2000) had *annualized* returns of 2.4%.

Let's assume that all three investors have a decade where returns are 1% per year, 7% per year, and 11% per year -- but the order is different in each scenario.

	First Decade	Second Decade	Third Decade
Retiree A	Up 1%	Up 7%	Up 11%
Retiree B	Up 7%	Up 1%	Up 11%

	First Decade	Second Decade	Third Decade
Retiree C	Up 11%	Up 7%	Up 1%

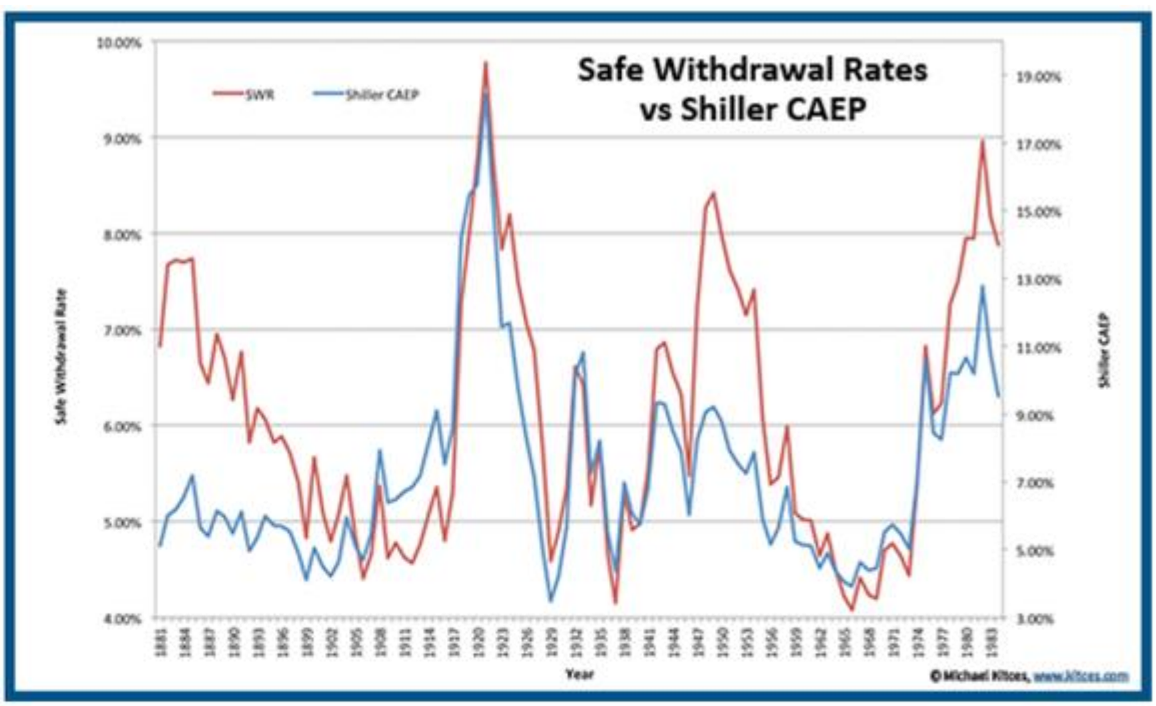
If we assume that all three of these retirees follow the 4% rule (take out $40,000 in year one), and that inflation is at 3.2% -- here's what would happen to those portfolios during the next 30 years.

Why is this the case? Because the more time your nest egg has to grow, the better off it is. When your nest egg is growing robustly in early retirement, setbacks later on aren't as big of a deal. But when your returns are minuscule early on -- as is the case with Retiree A -- the results can put you in an uncomfortable position.

How to deal with this

Is there any way to know what the next 10 years hold if you're looking to retire soon? While there's no *perfect* indicator, it turns out that there's one that's mighty close.

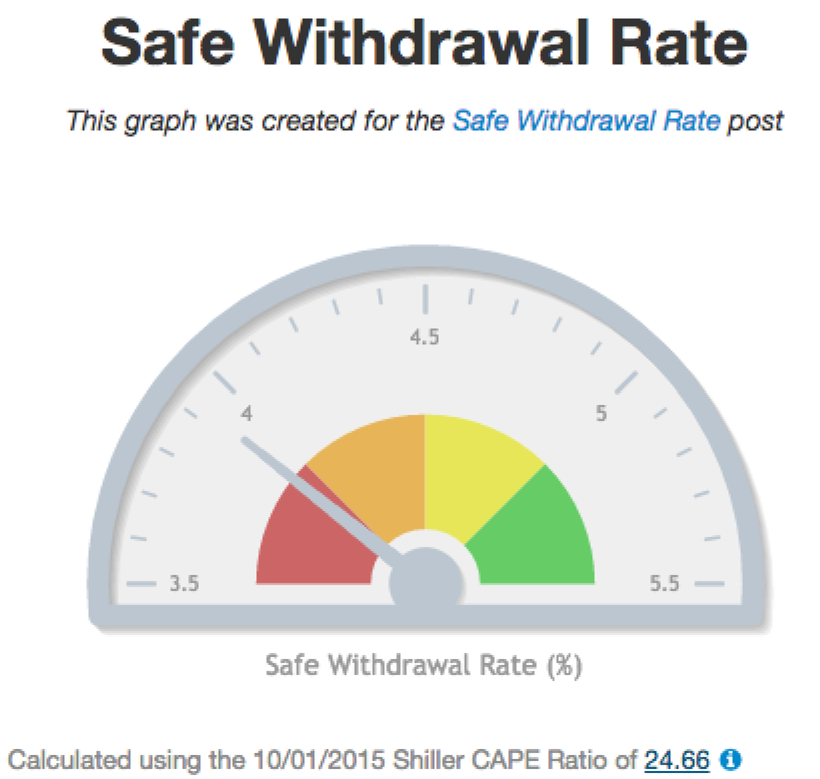
Kitces found that Nobel laureate and Yale economics professor Robert Shiller's Cyclically Adjusted Price-to-Earnings (CAPE) Ratio does a pretty good job of predicting normal market returns during the next 10 years.



CREDIT: MICHAEL KITCES.

"If we look at the earnings yield of stocks using Shiller methodology and compare it to the 30-year SWR, the correlation is a remarkable 0.77," states Kitces. "Market valuation and earnings yields at the start of retirement are remarkably predictive of 30-year safe withdrawal rates!"

What does that mean for today's retirees? Currently, the CAPE ratio stands at 24.66, well above its long-term average of 16.6. The good news is that the Madfientist blog has created a calculator to tell you what your SWR should be, given today's CAPE.



CREDIT: MADFIENTIST.

It hovers just below 4% right now. But knowing that almost every retiree's spending increases at a rate *below* inflation, I would still argue that the 4% Rule is eminently safe.

http://www.fool.com/retirement/general/2015/11/22/the-real-threat-to-your-retirement-portfolio-its-n.aspx?source=eogyholnk0000001&utm_source=yahoo&utm_medium=feed&utm_campaign=article