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Drawing A Hard Line

How advisors can use critical path strategies to provide cash flow in retirement.

MANAGING A PORTFOLIO TO PROVIDE retirement income is complicated. But as advisors draw a map to help their clients negotiate the twists and turns, they might consider something called a "critical path."

This is the amount of capital, plotted over time, that clients will need to achieve a particular necessary objective. It divides retirees into those who can take risk and those who can't. A theoretical concept, true, but one with useful implications for those designing retirement portfolios. It's a convenient line in the sand between those who take on more conservative positions and those who take on more risk.

The way it works is that retirees on or below the critical path can take no risk. They must instead use investments such as guaranteed products that offer them the closest thing to riskless, bond-like returns. These allow the investor to pass that risk on to a third party.

If they are willing to change their objectives, however, and rise above the critical path, they can free themselves of these restraints. Those above the critical path can invest using traditional strategies that strive for higher returns than what third parties could guarantee them. These investors should design their strategies so that they never become controlled by the constraints of those who shun risk.

One of the more powerful benefits of the critical path is that advisors can use it to explain to clients why they need to modify what might be impossible plans (below the critical path) and instead increase savings, delay retirement or demand less income after they stop working. (See Figure 1.)

The critical path is based on "risk capacity"—the ability of an investor to take a loss and still achieve a stated objective, such as retiring on time. Most literature, on the other hand, focuses on risk tolerance, a psychological factor, that asks questions such as how much a portfolio can drop before an investor can no longer sleep at night. In 2008, many learned the importance of risk capacity when portfolio losses forced changes in many retirees' plans. The difference between capacity and tolerance is significant.

When an investor is below the critical path, he or she must use riskless investments. In those cases, the investor has said that there is no compromising and no risk can be taken. Some advisors argue that investments with risk have done better historically than riskless ones. But using them would be counter to the clients' guidance.

At the same time, some advisors might ask why those below the critical path must only use riskless investments when they might benefit from traditional investments that have historically offered higher returns. These investors are in effect being restricted to investment purgatory. The reason they are limited is that they have said their objective must be achieved, and traditional investments carry some risk. Rather than taking on risk that could destroy their plans, it might instead be that these investors need to relax their demands.

But it's important to remember that the critical path is a theoretical concept. Truly riskless investments do not exist. And a person's objectives are not likely to be absolute and uncompromising. People change their minds, particularly when given unpleasant choices. Nor should investors be thinking of nominal returns at the expense of real returns. Nonetheless, the critical path offers a useful foundation for building investment strategies in the real world.

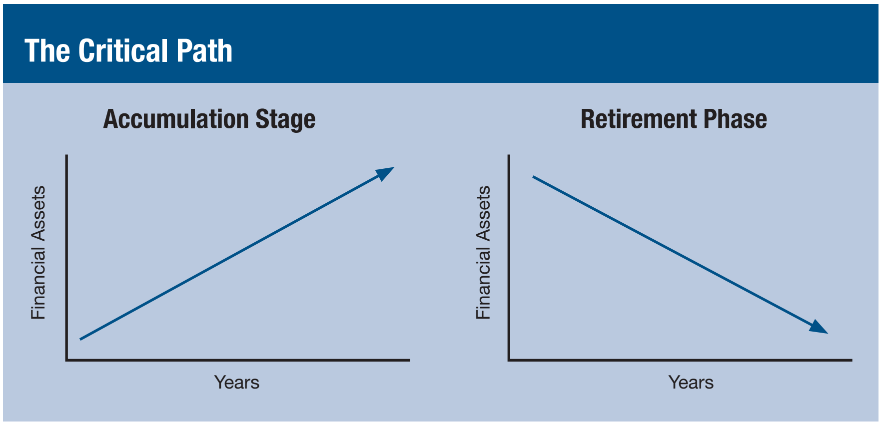
Individuals below the critical path face the unpleasant task of deciding how to cover the difference between the lifetime income they can generate and their expenses. To do this, they can either seek supplemental income from outside sources, now or in the future, or they can reduce their standard of living below what they currently call "acceptable."

A retiree on or below the critical path can also modify what she considers to be absolutely necessary objectives (such as living expenses that are non-negotiable). If, by making this change, she moves above the critical path, then she would be able to invest in nonguaranteed investment vehicles and seek the higher returns available in traditional investments (and also take on their inherent risks). This could have the benefit of increasing her retirement income.

Those who sit above the critical path can use no guaranteed investments and rely entirely on their portfolios to generate annual income, which they would gather from sources such as dividends, nonguaranteed interest and capital appreciation, as well as through their consumption of capital. They should design investment and withdrawal strategies that always keep them above the critical path. Should their investments underperform and their objectives be endangered, they would need to change their strategies to reflect those of somebody sitting on or below the critical path. They would need to purchase investment and insurance products to lock in their positions and receive guaranteed income to cover their essential expenses. They do not have the option of saying, "I will wait. The market will recover. It always has." The threat that they will need to convert to riskless or guaranteed investments should be a strong incentive to keep them on a more conservative path.

Even so, individuals above the critical path may still want to make a portion of their income guaranteed. They could develop a plan to cover all or a portion of their living costs from guaranteed sources and then supplement those with the income of dividends, interest, etc. In doing so, they have, in effect, lowered their critical path. With a portion of their income guaranteed, the rest of their portfolios can be more aggressive to seek higher returns.

FIGURE 1



The Risks Retirees Face

People in retirement face a number of threats:

- Higher-than-expected living expenses (typically inflation)
- Unexpected expenses to cover long-term health care
- Less-than-expected investment returns
- The possibility of living longer than expected and depleting resources

With these problems looming in front of them, guaranteed products offer retirees the closest thing to riskless returns. Of course, there are no riskless investments. Guarantees by high-quality third parties such as bond issuers or insurance companies promising future payouts are the closest thing. And there are big differences among these groups in the quality of their promises.

Laddered TIPS, immediate annuities with inflation riders and longevity insurance are all logical choices for retirees seeking guaranteed income. Deferred annuities with living benefits are another option, but they are hard to understand and have high expenses. Presumably, investors go to these third parties because they have little or no risk of defaulting on their promises. But at a time when even the creditworthiness of governments and insurance companies has been cast in doubt, clearly no organization is 100% safe.

Traditional open-end mutual funds that hold bonds do not qualify as a guaranteed investment vehicle, even though the bonds themselves may guarantee a future payment. The funds are actively managed for objectives such as current income or total return and do not offer guaranteed future payments for retirees.

The Conservative View Of Risk

In their book *Risk Less and Prosper: Your Guide to Safer Investing,* authors Zvi Bodie and Rachelle Taqqu argue that most individuals, including retirees, should invest most of their portfolios in conservative investments, particularly TIPS. After enough is put away to take care of basic needs, they write, the surplus can be invested in risky assets such as stocks.

This is a bold challenge to the investment practices used by the majority of advisors and supported by the majority of the investment community—the traditional approach of modern portfolio theory, which says that including some risky assets increases expected risk-adjusted returns. Advisors typically use these techniques for managing investors' portfolios regardless of whether they are above or below the critical path. Bodie and Taqqu say that most investors can't take this risk. In other words, they say most investors really sit below the critical path.

A practical way to locate retirees on the path is through a "decumulation benchmark."

This benchmark was proposed by authors Stephen Sexauer, Michael Peskin and Daniel Cassidy in the January/February 2012 issue of *Financial Analysts Journal.* (They call it a "defined contribution-decumulation benchmark.") It's a portfolio composed of laddered TIPS for the first 20 years of a person's retirement and a deferred life annuity (longevity insurance) to cover expenses after 20 years—for as long as the person lives. These products combined offer guaranteed lifetime income.

The benchmark is useful because investors can use it to calculate how much capital they would need for a particular level of guaranteed lifetime income. It is made up of nearly riskless investments, so it is a useful reference for comparing other strategies that don't offer guaranteed lifetime income. And what's more, plotting the results over time approximates the location of the critical path.

For the "decumulation" benchmark, the investor purchases both laddered TIPS and longevity insurance initially. The TIPS purchases are laddered to provide constant, inflation-adjusted returns for 20 years. The longevity insurance also purchased at the beginning offers lifetime income after 20 years. This product, however, is not available with an inflation rider, so after 20 years the income is not adjusted for inflation. Since the authors published their paper, the government has started to sell 30-year TIPS, which for some people may negate the need for longevity insurance.

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Sexauer, Peskin and Cassidy compare this strategy to purchasing an immediate annuity with an inflation rider. The laddered TIPS and longevity insurance offer very similar cash flows for the same invested dollars for the first 20 years. But after 20 years, the immediate annuity keeps offering increases to offset inflation, while the TIPS and insurance do not.

Still, say the authors, most retirees would prefer the laddered TIPS and insurance because they could still access the remaining investment in the TIPS during the first 20 years, whereas they could recover none of the original investment in the immediate annuity after it's purchased. On day one, the market value of the TIPS is 88% of the total investment, a desirable benefit for someone who might change his or her mind, while the cost of the deferred life annuity is 12%.

The critical path can be thought of as the dividing line between those who argue for conservative portfolios like these, and those who argue for the use of strategies entailing some risk, typically based on modern portfolio theory.

Not Always Applicable?

In some situations, the critical path may not apply.

Obviously, if you have college bills to pay in six months and you have no alternative options, the assets should be invested in a riskless manner. The individual would have no alternative options if the assets lost value.

During longer periods of time, investors may have additional flexibility to meet or even modify their objectives; for example, they could choose a college with lower costs, tap funds from other sources or even defer their college start date. In those cases, they would not need to use the critical path.

Nor does the path always apply to retirees. Those who have the option of delaying their retirement, going back to work or reducing their living expenses can modify their objectives. How about those people who can't find additional resources and need 30 years or more of income? Can they change their living expenses? Probably, but perhaps they don't want to, and it's critical for them to receive the income. If so, the restraints of the critical path should apply. Over long planning horizons, some retirees may want to hold on to some investment risk because third parties offer unfavorable guaranteed returns.

Some retirees would be better off keeping some risk to themselves. For very long-term planning horizons, they could turn to stocks, which, through the "equity premium," theoretically offer higher returns than bonds. But it must be a long term. After the stock market fluctuations and underperformance of the last decade and a 30-year bull market for bonds, investors have tended to forget the concept of the equity premium. They are asking, is it really certain that stocks will outperform current bond returns over the long haul? Should they take risks that institutions are not willing to take? Or will these stock returns be high enough to abandon a return that's guaranteed (albeit lower). Even after asking those questions, some retirees should consider saying yes to stocks.

Financial Repression

We are not in normal times. Many of the free-market functions of capitalism have been taken over by government. Monetary authorities around the world have driven interest rates close to zero, well below what they would normally be. Markets aren't serving their normal function of pricing and allocating resources. With interest rates so low, third parties can offer return guarantees based only on abnormally low interest rates. In the past, such periods of financial repression were temporary, and hopefully that will also be true this time.

How does financial repression affect the decisions retirees need to make for their lifetime income? For starters, they might want to avoid locking themselves into long-term commitments for now and stay flexible. That means the best approach might be to retain more investment risk. Later, when the economy is less dominated by government policies that keep interest rates artificially low, retirees can adopt strategies with the assurance that guaranteed rates are competitively priced.

Challenging Conventional Thinking

While the critical path is only theory, advisors can use it to help their clients challenge their basic assumptions. With it, clients can quickly grasp their limits and find the best way to free themselves from its constraints by changing their financial plans. This can mean increasing their savings, extending their planned retirement dates or curbing their retirement needs.

The critical path may also encourage advisors to challenge some of their own beliefs. The popular use of modern portfolio theory (even in an updated from) is based on the premise that all individuals can take risk. This may not be true for those on or below the critical path. If advisors accept the concept, it would mean a big shift in the foundation of their investment strategies. FA

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