
A Conservative Retirement Portfolio in 3 Buckets

By Christine Benz Thu, Sep 24, 2015

The Director of Personal Finance and senior columnist at Morningstar offers a three-bucket strategy for retirees who want to draw income from a diversified portfolio over a 15-year time horizon. The article was first published at Morningstar.com.

Many retired investors are comfortable embracing a healthy equity stake in their portfolios. That's a sensible tack for retirees with longer time horizons or those who know that they want to leave money behind for their children, other loved ones or charity.

This conservative bucket portfolio has a more modest goal: preserving purchasing power and delivering living expenses for the retiree who has an approximately 15-year time horizon (that is, life expectancy).

This portfolio does stake more than 30% in equities, but it also holds about 55% of its assets in bonds and another 12% in cash. The remainder of the portfolio is in commodities and other securities, such as convertibles and preferred stock.

Let time horizon lead the way

The main idea behind the bucket approach is to segment the portfolio by the spending time horizon: Assets that will be tapped sooner are parked in short-term holdings, and longer-term monies are stashed in higher-returning, higher-volatility asset types, mainly stocks.

To construct a bucket portfolio, the retiree starts with anticipated income needs for a given year, then subtracts certain sources of income such as Social Security and a pension. What's left over is the amount of cash flow that the portfolio will need to supply each year.

In the case of the conservative portfolio, one to two years' worth of living expenses (those not covered by Social Security, and so on) are housed in cash instruments (Bucket One), and another 10 years' worth of living expenses are housed in bonds (Bucket Two). The remainder of the portfolio is invested in stocks and other more volatile assets, such as commodities and a high-risk bond fund. Income and rebalancing proceeds from Buckets Two and Three are used to replenish Bucket One as it becomes depleted.

As noted earlier, the conservative portfolio's focus is on capital/purchasing power preservation and income production, so it stakes roughly 70% in bonds and cash. That will likely strike many retirees and pre-retirees as overly bond-heavy.

After all, starting yields are minuscule, and the next few decades are unlikely to be as kind to bonds as the previous three were. Yields will go up, but they'll hurt bond prices in the process. In recognition of that fact, I've generally aimed to steer the portfolio away from the most interest-rate-sensitive bonds.

Moreover, as with the Moderate and Aggressive portfolios, the specific parameters of the Conservative portfolio can be altered to suit a retiree's own goals and preferences. For example, a more risk-tolerant, growth-oriented retiree may choose to hold just one year's worth of cash in bucket one while also shrinking the number of years' worth of assets in bonds, thereby enlarging the equity stake as a percentage of assets.

And though I've supplied specific fund recommendations in my model portfolios, a retiree needn't reinvent the wheel to put the bucket approach to work: Many of the key ingredients likely already appear in well-diversified retiree and pre-retiree portfolios.

A total stock market index fund or a portfolio of individual dividend-paying equities could stand in for [Vanguard Dividend Growth \(VDIGX\)](#), for example. Meanwhile, a retiree in search of simplification could use an all-in-one-type investment such as [T. Rowe Price Spectrum Income \(RPSIX\)](#) to supplant the individual holdings that make up Bucket Two.

The portfolio includes three buckets, one each for short-, intermediate-, and longer-term spending needs.

Bucket One: Years 1-2

- 12%: Cash (certificates of deposit, money market accounts, and so on)

This portion of the portfolio is geared toward meeting near-term spending needs. Because of this role, it sticks with true cash instruments, as noncash alternatives like ultrashort bond funds have lower yields and more risk than CDs right now.

Bucket Two: Years 3-10

- 12%: [Fidelity Short-Term Bond \(FSHBX\)](#)
- 5%: [Fidelity Floating Rate High Income \(FFRHX\)](#)
- 20%: [Harbor Bond \(HABDX\)](#)
- 6%: Vanguard Short-Term Inflation-Protected Securities ([VTIPX](#))
- 5%: [Vanguard Wellesley Income \(VWINX\)](#)

Bucket Two is designed, in aggregate, to preserve purchasing power and deliver income

with a dash of capital appreciation. Fidelity Short-Term Bond serves as the portfolio's next-line reserves in case Bucket One were depleted and bond and dividend income and/or rebalancing proceeds were insufficient to refill it.

Fidelity Floating Rate High Income, one of the most conservative bank-loan vehicles, provides both a cushion against rising bond yields (bank-loan yields adjust upward along with lending rates) and a measure of inflation protection (yields are often heading up at the same time inflation is).

Harbor Bond is the portfolio's core fixed-income holding; the PIMCO-managed bond fund has a good deal of flexibility to adjust duration (a measure of interest-rate sensitivity), invest in foreign bonds, and range across bond-market sectors.

I also used Vanguard Short-Term Inflation-Protected Securities to provide a measure of inflation protection; it owns bonds whose principal values adjust upward to keep pace with the Consumer Price Index, but it's less sensitive to interest-rate-related volatility than intermediate- and long-term Treasury Inflation-Protected Securities vehicles.

Finally, bucket two includes the conservatively allocated Vanguard Wellesley Income, which is anchored in fixed-income investments but also holds roughly 40% in stocks, both U.S. and foreign.

Bucket 3: Years 11 and Beyond

- 23%: [Vanguard Dividend Growth \(VDIGX\)](#)
- 7%: [Harbor International \(HIINX\)](#)
- 5%: [Harbor Commodity Real Return \(HCMRX\)](#)
- 5%: [Loomis Sayles Bond \(LSBRX\)](#)

As the long-term portion of the portfolio, Bucket Three holds primarily stocks. Its anchor holding, as in the Aggressive and Moderate portfolios, is Vanguard Dividend Growth, an ultra-cheap equity fund that skews toward high-quality mega-cap stocks. I've also included a healthy stake in Harbor International. The equity portion of the portfolio includes limited exposure to small- and mid-cap stocks; investors who would like more exposure to that area might consider a fund such as [Vanguard Small Cap Index \(NAESX\)](#) or [Royce Special Equity \(RYSEX\)](#).

In addition to two equity holdings, the portfolio also includes a small stake in a commodities investment as well as a position in Loomis Sayles Bond. The former is in place to provide an

additional layer of inflation protection, whereas the latter supplies exposure to more aggressive bond types (and even stocks) that are not well represented in Bucket Two.

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