How to Build an ‘Income-Oriented’ Portfolio

By Editorial Staff *Wed, Aug 5, 2015*

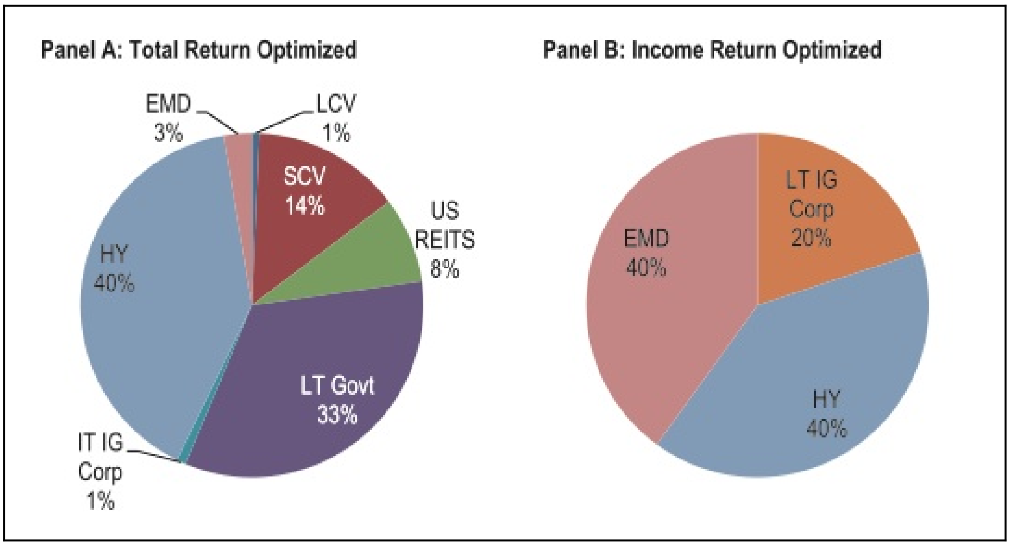
In this research roundup, we summarize six important new research papers, including analyses of retirement income strategies by experts from Morningstar and The American College. Story includes links to research.

Before the financial crisis, many affluent retirees relied on a “total return” approach to income generation. A diversified, age-adjusted and risk-adjusted stock-bond portfolio, they figured, could generate enough interest, dividends and/or capital gains to meet their needs.

But the income stream from a total return portfolio can be uneven, forcing retirees to tighten or loosen their belts unexpectedly. In the jittery post-crisis world, more risk-averse retirees are said to be looking for a portfolio that will give them income that’s both robust and predictable.

Writing in the Spring 2015 issue *Journal of Portfolio Management*, David Blanchett and Hal Ratner of Morningstar Inc. propose a framework for building what they call “income-oriented portfolios” to meet that demand. On paper, at least, they were able to create the desired portfolios by tapping the riskier regions of the bond universe.

To see how total-return and income-oriented portfolios differ at the extremes, check out the pie charts below, reprinted from the research **paper** (“Building Efficient Income Portfolios”). At left is the total-return portfolio. At right is the income-oriented portfolio. Both hypothetical portfolios are built to deliver a 7.5% expected average annual return (based on historical returns for the selected asset classes from 1997 to 2014). Both also use a fair amount of high-yield bonds to achieve it.



But in reaching for an ambitious overall return, the two portfolios use the rest of their risk budgets differently. The total return portfolio opts for small-cap value stocks and U.S. real estate, while the income-oriented portfolio looks for similar levels of risk and return in emerging market debt and long-term investment grade corporate bonds.

The payoff from using that particular all-bond asset allocation is a higher, more predictable income. "The income return for the total-return portfolio is 140 basis points below that of the income portfolio," write Blanchett (head of retirement research at Morningstar) and Ratner (head of global research).

"When looked at from traditional efficiency metrics, such as Sharpe ratio or total return-to-CVaR ratio, the total-return portfolio is more attractive," they write. "But in this case, the income investor is indifferent to total-return efficiency and more concerned with income predictability."

What are the trade-offs? Less chance for capital gains, for one. Within limits, the income-oriented investor can ignore fluctuations in the prices of his bonds. The total return investor relies on opportunistic asset sales for part of his income. Taxes are another trade-off. The income-oriented investor faces a larger tax bill, mainly because interest is taxed as ordinary income at up to 35%.

Taxes being a bigger problem for wealthy retirees and income sufficiency being a relatively bigger problem for the middle class, Blanchett and Ratner's conclusion that "less-wealthy investors in comparatively low income brackets with relatively little risk capacity will derive the greatest utility from an income-oriented strategy" comes as little surprise.

Annuities where annuitants share longevity risk

The prospect of longevity gains creates a significant financial risk to insurance companies that issue annuities. Here's a suggested alternative for issuers: deferred life annuities that adjust to rising longevity by delaying the start of payments, according to an index of longevity gains in the larger population.

This is proposed in an **article** by European finance professors M. Denuit, S. Haberman and A.E. Renshaw, "Longevity-Contingent Deferred Life Annuities," in *The Journal of Pension Economics and Finance*, 14 (3) 2015.

The article, heavy on equations, is aimed more at economists and actuaries than annuity product developers. But this concept for annuity redesign, which offers clients the benefit of lower premiums to compensate for uncertainty about the income start date, is already past the development stage. Some countries with aging populations, like Germany, have already applied it to their social security systems. "Considering the difficulties that have been experienced in issuing longevity-based financial instruments, this might well be an efficient alternative to help insurers to write annuity business," the authors venture.

Comparisons of withdrawal strategies, from Wade Pfau

Retirement expert Wade Pfau of The American College, whose work we cite regularly in *Retirement Income Journal*, has three more articles that will interest advisers:

- "**Making Sense Out of Variable Spending Strategies for Retirees**" (March 2015) compares 10 drawdown alternatives for spending wealth over the 30 remaining years of life, based on client's preferences. He looks at everything from the Required Minimum Distribution schedule to an annuitized floor with aggressive discretionary spending to his own and other prominent decision rules.
- "**Reduce Retirement Costs with Deferred Income Annuities Purchased before Retirement**" (*Journal of Financial Planning,* July 2015) examines annuities with a short-term deferral to hedge against bear markets and longevity risk. A short-term deferral, if the annuity is purchased prior to retirement, can be used to fund retirement spending at a lower cost.
- "**The Cost of Retirement with Different Income Tools**" (*Journal of Financial Planning*, April 2015) compares sustainable spending rates under various portfolio designs.

Stepping stones to bigger Social Security checks

It's smart to delay claiming Social Security benefits until age 70. The monthly payout, after all, is 75% higher than at age 62. And if you want to retire before age 70, use your investment portfolio to bridge the income gap.

In his paper, "**Bridges to Social Security**" (*Journal of Financial Planning*, April 2015), Jonathan Guyton shows how to fund this gap at the beginning of retirement without increasing longevity risk at the other end of retirement.

The client, he says, should take a lump sum from savings that's equal to the cumulative amount she would have received from Social Security during the delay period (from age 66 to age 70 in this example). That money should be invested conservatively, and then liquidated in a manner that replaces the foregone income from Social Security (including cost of living adjustments).

Over those four years, she can supplement that income by withdrawing from her remaining savings at the rate of 4.5% per year. Then, when she reaches age 70, she can live on the higher payments from Social Security and 4.5% a year from savings. This segmentation strategy works better, on an after-tax basis, than simply spending 6.5% a year from savings starting at age 66 (to meet 100% of income needs) and reducing that rate (to make room for full benefits from Social Security) at age 70. Guyton describes all this in a brief, not a full journal article, so not all of his assumptions are visible.

Aging aside, retirement can be good for your health

Is retirement good for your health or bad for your health? Of course, it depends on a lot of variables. In studying unhealthy retirees, researchers have had difficulty determining if they're unhealthy because they retired or if they retired because they weren't healthy enough to work.

Aspen and Devon Gorry of Utah State University and Sita Slavov of George Mason University tackle that question in a new **study**, "Does Retirement Improve Health and Life Satisfaction?"

Their answer: Retirement doesn't make you unhealthy. On the contrary. The researchers use data from a survey of Americans over age 50 that asks people questions about their health and daily activities (Sample question: Do you agree or disagree with the statement, "In most ways my life is close to ideal"). They conclude that retirement does improve life satisfaction. Over time, it even improves health, they posit, which can help reduce health care expenditures.

How much does America spend on medical care for those age 65 and over?

Not long ago, the Employee Benefit Research Institute and Fidelity Investments released estimates that Americans should be saving at least $250,000 just for expected medical expenses in retirement.

Fear over the possibility of high medical bills, especially the expense of long-term residential care, is known to drive a lot of saving behavior, especially by those too wealthy to qualify for coverage by Medicaid.

Given the natural infirmities of old age, older Americans use much more health care than younger people. In 2010, medical bills for those aged 65 or older were 2.6 times the national average, according to government data, and accounted for over one third of all U.S. medical spending.

A new report, “**Medical Spending of the U.S. Elderly**,” takes a closer look at these costs. Written by Mariacristina De Nardi of the Federal Reserve Bank of Chicago, Eric French and Jeremy McCauley of University College London and John Bailey Jones of the University of Albany, it’s based on an analysis of government data for the period from 1995 to 2010.

Among their findings:

- Medical expenses more than double for those between ages 70 and 90, with most of the increase coming from nursing home spending.
- The top 10% of all spenders are responsible for 52% of medical spending in a given year.
- Those currently experiencing either very low or very high medical expenses are likely to find themselves in the same position in the future.
- The government pays for 65% of the elderly’s medical expenses; the expenses that remain after government transfers are even more concentrated among a small group of people.
- The poor on average consume more medical goods and services than the rich, but are responsible for a much smaller share of their costs.
- While medical expenses before death can be large, on average they constitute only a small fraction of total spending, both in the aggregate and over the life cycle.
- Medicare covers well over half of the elderly’s medical expenditures. Private health insurance, Medicaid, and out-of-pocket expenditures each cover between 11 and 13% of the total.
- In 2013 personal health care expenditures in the U.S. amounted to $2.5 trillion in 2014 dollars, representing 14.7% of GDP.
- Low-income people consume more medical resources per year. The higher spending on

> the poor consists mostly of greater expenditure on nursing homes. When nursing home care is excluded, the income gradient is much less pronounced.