My New Baseball Cap

By Editor Test *Mon, Jun 25, 2012*

Jeremy Grantham and William Bernstein spoke at the Morningstar Investment Conference, and Morningstar handed out a recent study in which its analysts compared five different retirement withdrawal strategies--and chose the most efficient.

Just as my supply of baseball caps with fund company logos happened to be running low, I was fortunate enough to find myself at the Morningstar Investment Conference, where last week dozens of fund company reps were giving away blue or grey or red caps—along with pens, stress balls, mints, fund performance reports and white papers.

Except by the standards of the Schwab or ICI conferences, the annual Morningstar conference and trade show is immense. So is the venue: Even after accommodating hundreds of booths representing all of the major asset managers—from Aberdeen to Wintergreen—and an adjacent auditorium with seating for about 1,800 financial advisors, Chicago's vast McCormick Center could probably have also tucked in a couple of 737s.

I don't usually write about mutual funds per se, but the Morningstar show included one or two decumulation-oriented sessions, including one on "Tackling the Retirement Income Challenge." The meeting also offered chances to see and hear icons like William Bernstein and Jeremy Grantham. And, in the media room, the Morningstar folks distributed copies of a recent research paper, "Optimal Withdrawal Strategy for Retirement Income Portfolios." There was ample grist for the *RIJ* mill.

The ideal withdrawal rate

The Morningstar paper evaluated and compared five systematic withdrawal methods to see which one was most likely to provide the highest, safest annual payout percentage. The five methods included:

- A constant dollar withdrawal (adjusted for inflation).
- A constant withdrawal percentage.
- A percentage rate that fluctuates with the probability of portfolio failure.
- A percentage rate calculated by dividing the portfolio value by the remaining number of years life expectancy.
- A percentage rate based on maintaining a constant probability of failure over the remaining life expectancy.

This question has been visited before, but Morningstar's addition to the field was a new yardstick it calls the "Withdrawal Efficiency Rate." The WER equation reveals "how well, on average, a given withdrawal strategy compares with what the retiree(s) could have withdrawn if they possessed perfect information on both the market returns, including their sequences, and the precise time of death."

The preferred method, consequently, would be the one that "on average captures a higher percentage of what was feasible in a perfect foresight world." The methods were tested for hypothetical portfolios with assumed equity allocations of zero, 20%, 40% and 60%, as well as for portfolios owned by single retirees or couples at ages 60, 65, 70, 75 and 80.

The winner, according to Morningstar's calculations, was the last one, the Mortality Updating Failure Percentage method. "The results make intuitive sense," the Morningstar authors wrote. "Since market returns and mortality are stochastic variables, a probabilistic approach that incorporates the distribution of both into the withdrawal strategy… should be expected to produce results that dominate strategies that focus on one or none."

The paper offered a chart, whose data is replicated below, suggesting payout rates at different ages for men, women and couples.

"Mortality Updating Withdrawal Percentage" A systematic withdrawal rate adjusted for mortality and portfolio failure risk			
Age at time of withdrawal from portfolio	Optimal withdrawal percentage for men (M), women (F) and couples (J) for a 40% equity portfolio		
	M	F	J
60	5.2%	4.8%	4.7%
65	5.7	5.1	4.9
70	6.4	6.1	5.3
75	7.2	6.8	6.4
80	8.6	8.2	7.2
Source: "Optimal Withdrawal Strategy for Retirement Income Portfolios," by David Blanchett, Maciej Kowara, and Peng Chen. Morningstar Investment Management, May 22, 2012.			

The traditional flat 4% rule, which some observers have characterized as too generous and risky for the slow growth era that appears to lie ahead, is unnecessarily stingy and inflexible, the paper seems to say. The Morningstar numbers also appear to add fodder to the debate over whether a careful systematic withdrawal plan can eliminate the need for a guaranteed income product.

It looks like this paper would give ammunition to advisors who are inclined to deal with longevity risk simply by reducing equity exposure and not bothering with annuities. At the same time, the results seem to conflict with the opinion, held by some, that retirees need more income at the beginning of retirement, when they're more likely to travel, for instance.

The authors suggest that if you don't want to bother with a lot of complicated calculations, just use the RMD method—the portfolio value divided by the number of years of life expectancy remaining—as a drawdown rule of thumb. They prefer the RMD method to the commonly-used "constant dollar" and "constant percentage" drawdown methods.

Of bonds and bond funds

At the breakout session entitled, "Tackling the Retirement Income Challenge," panel members John Ameriks of Vanguard's Investment Counseling & Research group, Sue Stevens, CEO of Stevens Wealth Management (and formerly of both Vanguard and Morningstar), and William Bernstein, a neurologist better known as co-founder of Efficient Frontier Advisors and author of "The Four Pillars of Investing," engaged in a wide-ranging conversation about stocks bonds, and annuities.

Sue Stevens said she's preparing her clients for average annual returns of about 4.5% a year for the foreseeable future, with "equity returns in the 5% to 7% range and bond returns in the 2% to 4% range." She said she would probably become more interested in income annuities as interest rates rise. As an advisor, she said her biggest job right now is "getting clients to lower their expectations for portfolio returns."

Bernstein joked that the bonds he holds have the average maturity of "green bananas." For retirement income, he recommended a ladder of individual TIPS. Ameriks, a Ph.D., defended the use of TIPS mutual funds—like Vanguard's—over individual TIPS. "It costs money to manage those ladders," he said. On the other hand, he conceded that Vanguard "always gets calls [from shareholders] when TIPS funds have negative returns."

Vanguard phone reps try to calm clients down by explaining the concept of duration, and the inherent ability of bond funds to benefit from the same higher coupons (on new bonds) that drove prices (of existing bonds) down. "We don't need to stampede people out of bonds," he cautioned. Regarding annuities, Ameriks suggested that retirees allocate money to bonds rather than buy variable annuities with lifetime withdrawal benefits. (Vanguard sells VAs, but it has a much bigger stake in bond funds.)

Grantham, ever bearish

Keynote speaker Jeremy Grantham attracted a standing room-only crowd on the final day of the conference. The British-born investment guru, whose bearish quarterly reports are widely read and discussed, held the audience rapt while sharing his market predictions. But he seemed to lose the advisors' attention as he digressed into bleak descriptions of the Malthusian dystopia that he believes may loom ahead.

"We live on a finite planet, we have finite resources, and we can't grow indefinitely," Grantham told an audience that would probably rather have heard expansive, bullish predictions. Glumly, he expressed little faith in humankind's ability to respond wisely to the challenges ahead. Instead of acting rationally, he said, "We will behave casually and in a spendthrift manner with lots of waste."

In an increasingly urbanized world where governments in developing countries are struggling to feed their citizens, Grantham regards rising demand for food as an investment opportunity. He is tracking the remaining sources of indispensible agricultural inputs, like potassium and phosphorous. "I spent time with the Moroccan phosphate people," he said. "Eighty-five percent of the world's phosphorous is in Morocco. But we don't like to talk about problems [like rising population and food shortages]. They're inconvenient and threaten the progress of the system."

You're probably wondering whose baseball cap I took home. Thank you, Motley Fool Funds.