The worst possible time to retire

Market performance in the first few years of retirement determines financial security throughout one's golden years. Here's why the outlook for people retiring today is concerning

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The outlook isn't good for clients on the verge of retirement today.

The probability of being financially secure throughout one's golden years — without severely compromising one's lifestyle or running out of money altogether — depends largely on what happens in the markets in the first few years of retirement.

Here's the bad news: Current market conditions bode horribly for near-term retirees. In fact, the U.S. is in uncharted waters, researchers say, because of the concurrent forces of stock valuations near record highs and bond yields that are historically low.

"We'd view this as an elevated-risk time for retiring," said Michael Kitces, partner and director of research at Pinnacle Advisory Group. "This is as close as you'll get to all-time [market] highs and dangerously high valuations that make it a risky time to retire."

The "worst" time to retire is when stocks have run for a while without an intervening bear market, which is a downturn of 20% or more from recent highs. This is when expected returns are low or negative, Mr. Kitces said. Conversely, he said the "best" time to retire is during a bear market, when client portfolios will benefit from good returns on the upswing.

In practice, this translates to a difference in the yearly spending levels that maintain a healthy portfolio balance. A client retiring immediately before a bear market will have a lower sustainable amount of spending throughout retirement than the same client retiring at the end of a bear market.

Of course, it's impossible for retirees to predict whether they will be retiring right before or after a bear market hits. But history tells us one is looming.

The last bear market in U.S. stocks ended in March 2009 — more than nine years ago — when stocks bottomed out during the financial crisis. Bear markets tend to occur every four years, said Jim McDonald, chief investment strategist at Northern Trust.

"It is highly likely we will have at least a 20% decline in the market over the next five years," he said.

The cycle of a bear market brings sequence-of-returns risk squarely into focus. This is the risk posed by a newly retired individual withdrawing from a stock portfolio that's declining in market value. When the market recovers, the portfolio doesn't have as much room to run because it's been depleted by ongoing withdrawals.

A bear market isn't likely to be too damaging for clients with diversified investment portfolios — at least, as long as the market recovers within a few years. There are other pots, like fixed income, from which retirees can draw during a downturn. And even if the client withdraws some money from equities, it wouldn't be a huge portion of the portfolio.

The much greater risk, research shows, is if a bear market leads to a prolonged period of negative or mediocre returns.

"Retirement withdrawals are more sensitive to bad decades than they are to bad years," Mr. Kitces said. "And bad decades could simply be a decade of 0%, not a catastrophic 50% decline or anything."

According to Mr. Kitces' research, 10 years is the "sweet spot" for sequence-of-return risk. There is a high correlation — 0.79 — between what are considered "safe" withdrawal rates and market returns during the first decade of retirement. (Basically, the higher the stock returns after accounting for inflation in the first decade of retirement, the higher the withdrawal rate that can be sustained in the portfolio.)

Safe withdrawal rate vs. 10-year annualized real returns

The link between stock market returns and a sustainable withdrawal rate

Created with Highcharts 6.0.3S&P 500 returnsSafe withdrawal rateRegression Line10 Years-5%-2.5%0%2.5%5%7.5%10%12.5%15%17.5%20%3%4%5%6%7%8%9%10%11%12%1919Real 10-year equity returns: 17.72%Safe withdrawal rate: 8.58%

Note: The chart shows what a retiree's safe withdrawal rate would be given stock market returns in the first decade of retirement. Market returns account for inflation. Assumes a 30-year retirement. Analysis of market data through 2014.

Source: Michael Kitces of Kitces.com

To frame this another way: A client's remaining wealth after the first 10 years of retirement can determine 80% of the variation in a retiree's safe withdrawal rate (over a 30-year retirement), Wade

Pfau, professor of retirement income at The American College of Financial Services, wrote in the paper "Can we predict the sustainable withdrawal rate for new retirees?" in the August 2011 issue of the Journal of Financial Planning.

Individuals who retired in 2000 are a recent example of this concept. The S&P 500 hovered around 1,400 points to start the new millennium and fell to 815 by September 2002. It rebounded to about 1,550 points in October 2007 before falling during the financial crisis, and it **didn't recover to a similar level** until about March 2013.

"Most people don't retire expecting 0% returns for the next 15 years," Mr. Kitces said, adding that there are "few places to hide" after such a prolonged period of poor returns.

Market measures

Fortunately, some market-valuation measures offer reliable hints as to when advisers should consider taking action for clients. Mr. Kitces finds the Shiller price-to-earnings ratio, also known as the cyclically adjusted P/E (CAPE) ratio, is a good predictor of real returns over a decade or more, when sequence-of-return risk matters most. The ratio is the current stock price divided by the average of the past 10 years of inflation-adjusted earnings.

The CAPE — which began this year with a value of roughly 33 — is **higher than it was** at the prelude to the bear markets in 2008 and 1929 and is approaching its value in 2000. In other words, many down markets have followed equally high valuations.

Market valuations are high by historical standards

High valuations traditionally precede a bear market

Created with Highcharts 6.0.32000-02bear market:Market dropped 49%1968-70bear market:Market dropped 36%1929-32bear market:Market dropped 86%1937-38bear market:Market dropped 48%2007-09bear market:Market dropped 57%1973-74bear market:Market dropped 55%190019101920193019401950196019701980199020002010010203040 50

Note: Market valuation data is based on the Shiller price-to-earnings ratio, which measures the price divided by the average, inflation-adjusted earnings from the previous 10 years. Data correspond with Jan. 1 of the listed year.

Source: http://www.multpl.com/shiller-pe

The flurry of volatility since the beginning of the year hasn't shaved much from the ratio, either; it's now around 31.

"There hasn't been a point in the last 140 years or so where the CAPE ratio has been this high and bond yields this low," said David Blanchett, head of retirement research at Morningstar Investment Management. This signals a "pretty good chance" returns will be lower for retirees in the near future, he said.

The 10-year Treasury yield was hovering around 3% at the end of April — **below the average** of 4.6% going back to 1870.

Lower yields mean retirees will get less of a return from their fixed-income assets, on a relative basis. And, because bond prices move inversely to interest rates, retirees looking to draw from bonds during a stock downturn may end up selling bonds at a loss due to rising interest rates.

10-year Treasury yield is low by historical standards

Low yields mean retirees get lower returns on fixed-income assets

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Note: Data correspond with Jan. 1 of the listed year.

Source: http://www.multpl.com/10-year-treasury-rate/table/by-year

There are things financial advisers can do to mitigate the sequence risk posed by a prolonged bear market. The most surefire approach is to counsel new retirees to start spending conservatively, said Mr. Pfau of the American College.

For advisers using the 4% rule (historically considered the "safe" percentage a retiree can pull from his or her portfolio in the first year of retirement, with that dollar amount adjusted each year thereafter by inflation) as a guide, Mr. Pfau said that 3% is "much more realistic" as a withdrawal rate under current market conditions.

Clients also can adopt a flexible spending strategy, Mr. Pfau said. Advisers have crafted several different approaches in this regard, but the basic strategy boils down to cutting spending after a market downturn.

Cornerstone Wealth Advisors Inc. has developed such a strategy. The firm recommends a certain maximum sustainable withdrawal rate based on market conditions; however, if that withdrawal rate rises 20% or more because of a market decline, Cornerstone recommends clients cut income from their portfolio by 10%, said financial planner Andrea Eaton. (The withdrawal rate rises in a downturn because the client would be pulling the money from a smaller portfolio.)

The firm's current maximum sustainable withdrawal rate is 5.25%; a 20% increase — which brings the max to 6.3% — would trigger a spending cut. If that withdrawal rate were to decrease enough in the future, clients could get the green light to increase income again, Ms. Eaton said. Clients also can take an inflation increase the year after a portfolio delivers positive returns.

"Our strategy really is: How do we maximize a person's safe sustainable income while taking into account people's real-life situation and the market?" Ms. Eaton said.

"What provides us some comfort is having been through it before with clients" in 2008-09, she said. "It wasn't really a fight with them. I can't think of one client situation where we recommended a pay cut and a client said, 'Thanks, but no thanks.'"

Mr. Pfau also recommends reducing exposure to volatility — not via bonds, but with instruments such as annuities so a client's lifestyle "is not exposed to a market downturn." Such instruments can fill part or all of any spending gap that may exist after accounting for a client's other guaranteed sources of income, like Social Security and pension payments.

Buffer assets

Clients also can draw temporarily from "buffer" assets — such as reverse mortgages or cash-value life insurance — after market downturns to avoid selling investments at a loss.

Mr. Kitces recommends that advisers who don't invest tactically or use strategies based on market momentum begin getting more defensive for clients who are about to enter retirement or who have just done so.

Advisers also can consider using a "bucket" strategy to help clients deal with the behavioral aspects of equity risk in a bear market.

Jim Saulnier, owner of an eponymous advisory firm, uses the strategy with clients to "battle overvalued markets." He explains it as a "dumbed-down" version of asset allocation that segments years of retirement spending into different pots of money so clients are more comfortable spending down assets.

The first two to five years of spending come from a cash or cash-like account. The second grouping includes intermediate-term instruments like bonds, certificates of deposit, laddered multiyear guaranteed annuities and other fixed annuities. The client should get eight to 12 years of retirement spending from these two buckets.

The third bucket includes equities, and the fourth includes guaranteed income sources (such as deferred income annuities) that provide a backstop to maintain lifestyle even if the other assets are depleted.

"If I call it 'asset allocation,' people have a hard time understanding what it means," Mr. Saulnier said. "But they have a very easy time visualizing buckets."