The Bucket Approach to Retirement Planning: The Devil Is in the Details

Christine Benz, Director of Personal Finance

Morningstar, Inc.

4 Key Reasons Why I'm Passionate about Simplifying Retirement Decumulation

1. People make investing more complicated than it ought to be. ("The Financial Complexity Complex.")

2. Retirement decumulation is inherently MUCH more complicated than retirement accumulation.

3. Behavioral issues further "complexify" retirement planning and lead to behavioral traps—e.g., investing for current income at the expense of total return.

4. Retirees are the ultimate "just-in-time" learners.

5. Cognitive decline is a major issue—simplifying is crucial

What I'll Cover in This Presentation

1. Defining a bucket approach

2. Advantages of a bucket strategy

3. Potential drawbacks (and pushbacks on the drawbacks!)

4. Practical considerations when implementing a bucket strategy

Defining a Bucket Approach

- Baseline idea: Buckets organized by anticipated time horizon to spending
- Harold Evensky's buckets: Cash "bucket" bolted onto long-term retirement portfolio to supply liquidity (2 buckets, tops)
- "Reverse glidepath" buckets: Spend through cash and bond buckets; leave stocks untouched to circumvent sequencing risk
- My interpretation:
  - Three buckets: Cash, bonds, and stocks
  - Retiree spends from cash on an ongoing basis
  - Cash bucket refilled opportunistically, with current income and/or rebalancing proceeds

A Basic 3-Bucket Framework

Bucket 1

For: Years 1 and 2

Holds: Cash

Goal: Fund Living Expenses

Bucket 2

For: Years 3-10

Holds: Bonds, Balanced Funds

Goal: Income production, stability, inflation protection, modest growth

Bucket 3

For: Years 11 and beyond

Holds: Stock

Goal: Growth

Advantages of bucket approach: Psychological/behavioral

- Cash provides a buffer in volatile markets
- Time-segmentation approach helps retirees understand asset allocation recommendations and exercise patience with underperforming asset classes
- Helps retirees move away from unhealthy “income-only” mindset

Advantages of bucket approach: Practical/logistical

- Uses probability of earning a positive return over a given time horizon to drive allocations to asset classes
- Discrete buckets for different asset classes make it easy to spot rebalancing opportunities
- Can be customized based on retirees'/advisors' own investment preferences
    - Index funds/ETFs
    - Individual stocks
    - Actively managed mutual funds
    - CDs and bond ladders for buckets 1 and 2
- Helps advisors illustrate their asset allocation recommendations to clients, which in turn can help them understand the program

Disadvantages of bucket approach

- Won’t ensure there won’t be a shortfall
- Not “set it and forget it”; requires maintenance
- Relies on a well-thought-out system for refilling bucket 1/rebalancing
- Can get complicated across multiple accounts:
    - Taxable
    - Tax-deferred
    - Roth
    - Two spouses’
- Cash is a drag in upward-trending market environments (see: 2009-2021)

Pushback on Last 2 Critiques

Critique 1: Bucket approach is too complicated

- Bucket approach can be simplified with simple index funds/ETFs plus cash

Critique 2: Cash a drag/Bucket strategy underperforms static strategy involving rebalancing ("The Bucket Approach for Retirement: A Suboptimal Behavioral Trick?" by Javier Estrada, October 2018)

- Bucket approach mainly a behavioral tool, not a portfolio-optimization tool
- We make many decisions/recommendations that reduce return in the name of managing behavior, reducing volatility

Sample In-Retirement Bucket Portfolios

Assumptions

- 65-year-old couple with $750,000 portfolio
- 4% withdrawal rate with annual 3% inflation adjustment ($30,000 first-year withdrawal)
- Anticipated time horizon: 25 years
- Fairly aggressive/high risk tolerance (total portfolio is ~ 50% stock/50% bonds and cash)

Sample In-Retirement Bucket Portfolio: Mutual Fund

Bucket 1: Liquidity Portfolio for Years 1 and 2: $60,000

Goal: Stable Cash Flows

$60,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $240,000

Goals: Stability, Income Production, Some Inflation Protection

$65,0000 in Fidelity Short-Term Bond FSHBX

$75,000 in Harbor Bond HABDX

$50,000 in Vanguard Short-Term Inflation-Protected Securities VTAPX

$50,000 in Vanguard Wellesley Income VWIAX

Sample In-Retirement Bucket Portfolio: Mutual Fund

Bucket 3: Growth Portfolio for Years 11 and Beyond: $450,000

Goals: Growth, Long-Term Inflation Protection

$200,000 in Vanguard Dividend Appreciation VDADX

$125,000 in American Funds International Growth & Income IGIFX

$65,000 in Vanguard Total Stock Market Index VTSAX

$60,000 in Loomis Sayles Bond LSBRX

Sample In-Retirement Bucket Portfolio: ETF

Bucket 1: Liquidity Portfolio for Years 1 and 2: $60,000
Goal: Stable Cash Flows

$60,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $240,000
Goals: Stability, Income Production, Some Inflation Protection

$50,000 in Vanguard Short-Term Bond ETF BSV

$75,000 in iShares Core US Bond Market IUSB

$75,000 in Vanguard Short-Term Inflation-Protected Securities VTIP

$40,000 in Vanguard Dividend Appreciation VIG

Sample In-Retirement Bucket Portfolios: ETF

Bucket 3: Growth Portfolio for Years 11 and Beyond: $450,000

Goals: Growth, Long-Term Inflation Protection

$175,000 in Vanguard Dividend Appreciation VIG

$110,000 in Vanguard Total Stock Market Index VTI

$125,000 in Vanguard FTSE All-World ex-US VXUS

$40,000 in Vanguard High-Yield Corporate VWEHX

Sample Minimalist Bucket Portfolio: $30K spending, $750,000 portfolio

$60,000 Cash

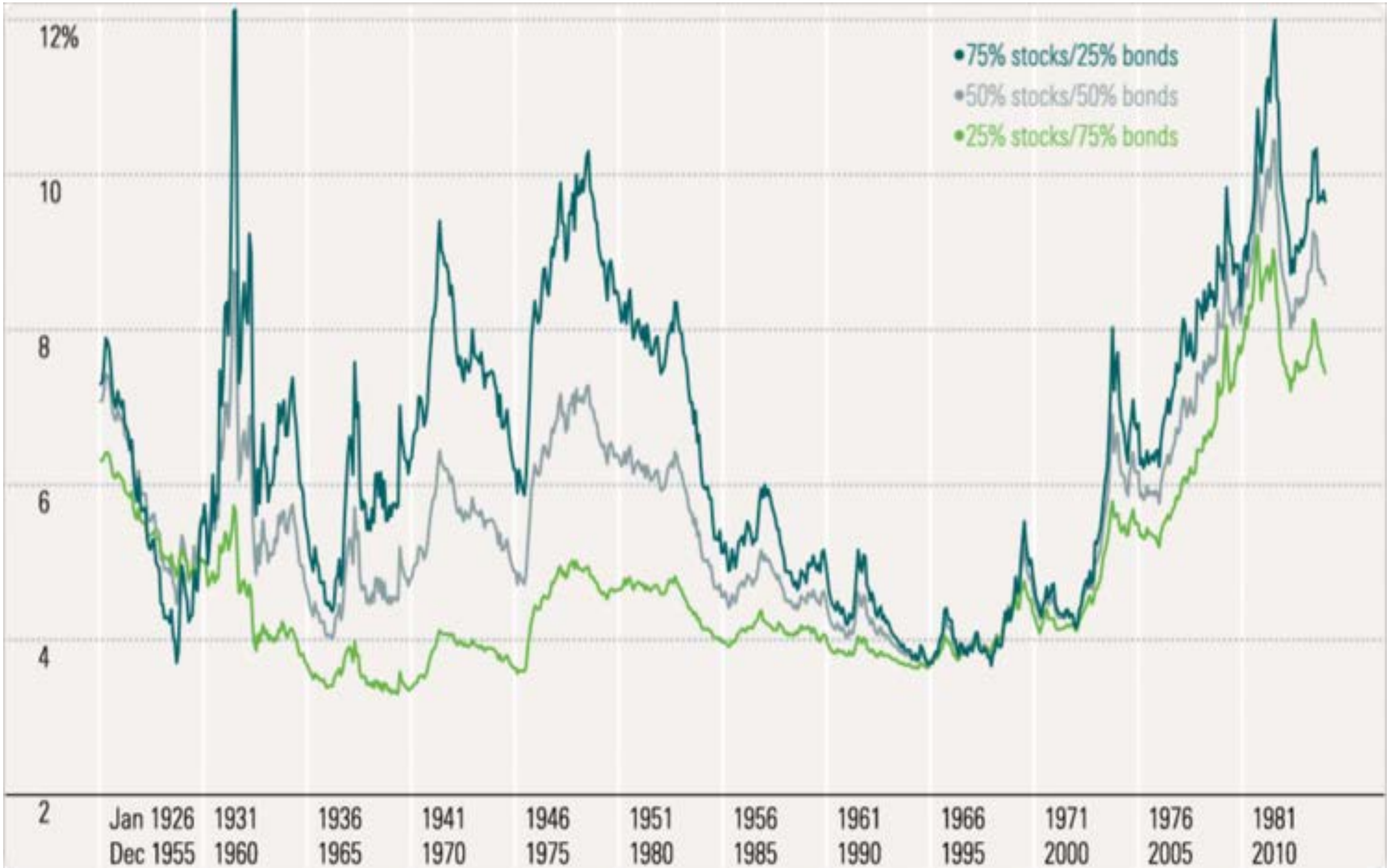
$240,000 Vanguard Total Bond Market Index BND

$450,000 Vanguard Total World Stock Market Index VT

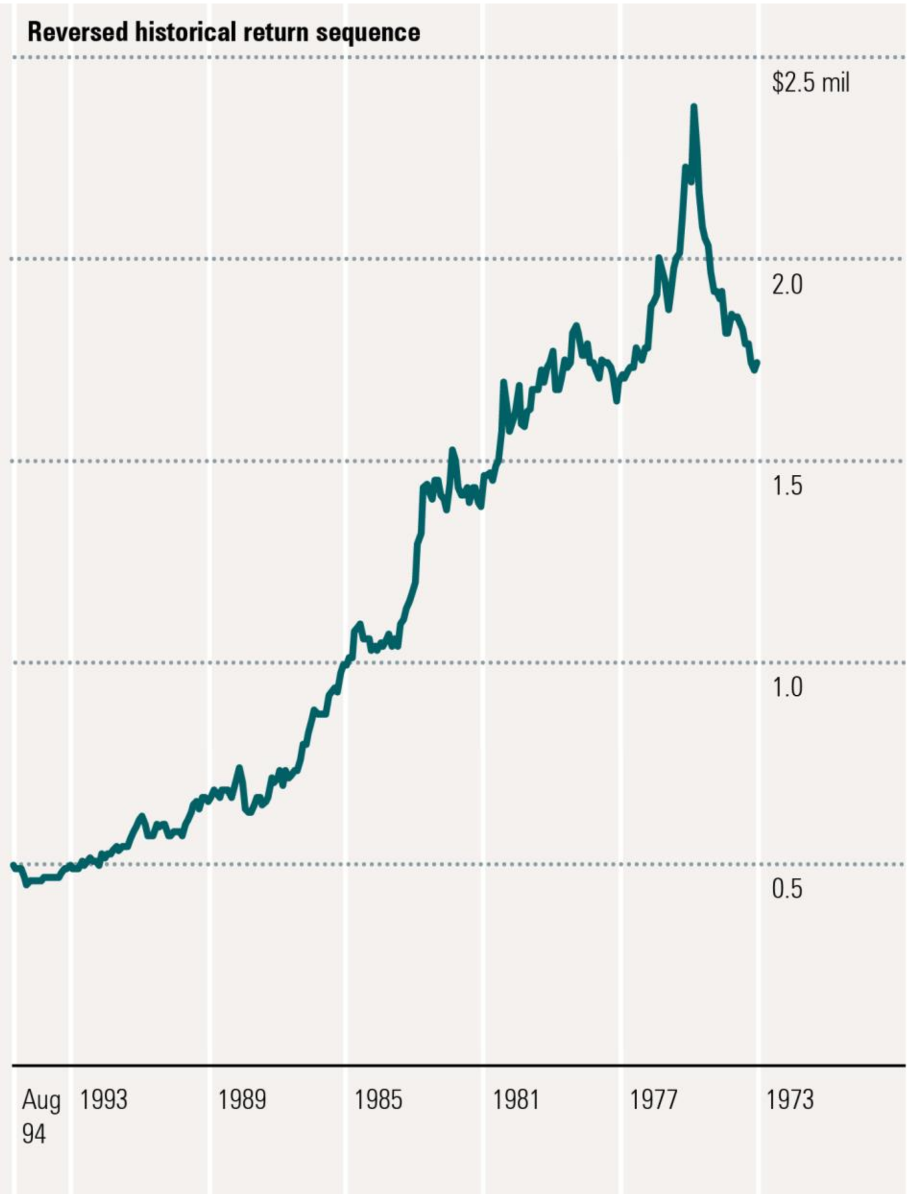
Looks Simple, But Implementation Jobs Abound

- Job 1: Check sustainability
- Job 2: Identify “refill” method
- Job 3: Decide on portfolio “glidepath”
- Job 4: Articulate maintenance strategy
- Job 5: Implement across multiple account types/sequence withdrawals

Job 1: Check sustainability: Safe withdrawal rate depends on asset allocation



Job 1: Check sustainability: Entry point matters, too



Job 2: Identify "refill" method

- How will bucket 1 become replenished as it becomes depleted?
    - Option 1: Income-centric (not recommended)
    - Option 2: Pure total return/rebalancing
    - Option 3: Hybrid income/total return

Refill Method 1: Income-Centric

Pros

- Intuitively appealing
- Low maintenance: “Paycheck” equivalent
- Enables retirees to maintain principal/bequest motive

Cons

- Retiree cash flows are buffeted around by prevailing yields
- In low-yield environments, retirees might take on extra risk in quest for yield
- Clashes with/obviates need for cash bucket

Refill Method 2: Pure Total Return/Rebalancing

Pros

- Portfolio can be optimized for risk/return w/o regard for current income
- Rebalancing to meet cash flow needs can help optimize portfolio on an ongoing basis

Cons

- Requires more maintenance than income-centric approach
- Doesn’t ensure that retiree will never touch principal
- There may be years when nothing has appreciated (hello 2022)

Refill Method 3: Blended Income Plus Total Return

Pros

- Tapping income can provide a baseline of living expenses
- Rebalancing to supply additional living expenses ensures retiree doesn't stretch for income
- Strategy enables retirees to be opportunistic: Rely on income when yields are higher; fall back on rebalancing when they're lower

Cons

- Requires more maintenance than income-centric approach
- Doesn't ensure that retiree will never touch principal

Rebalancing: The Swiss Army Knife of Retirement Planning

- Reduce risk in the portfolio
- Tee up cash flows for the year ahead
- Meet required minimum distributions (RMDs)
- Make charitable contributions (donate appreciated securities from taxable accounts or make charitable contribution from IRA if post-age 70-1/2)

How Retirees Can Source Needed 'Cash Flow' from Income *and* Rebalancing

- Retiree needs $40,000 in cash flow from $1 million portfolio to re-fill bucket 1 in 2017
- 60% S&P 500/40% bond portfolio yields $27,180 in 2019
- Portfolio also has capital return of $197,080 in 2019
- Retiree's $40,000 cash flow distribution comes from:
    - $27,180 in income
    - $12,820 from capital return
- Retiree reinvests remaining $184,260 of capital return into underweight holdings or steers it to cash to cover next year's living expenses

But Some Years Won’t Be That Good

- In 2018:
    - S&P 500 return: -4.38%
    - Bloomberg Barclays Aggregate Index return: 0.01%
- Holding two years’ worth of portfolio withdrawals in cash helps guard against years in which neither stocks nor bonds provide rebalancing opportunities
- Holding short-term bonds serves as next-line reserves in case cash is depleted and income insufficient/rebalancing opportunities aren’t there

Job 3: Decide on Portfolio Glidepath→Rebalancing Regimen

Glidepath 1: Static

- Rebalance back to target glidepath on a regular basis
- Portfolio's asset allocation stays the same throughout retirement

Glidepath 2: Progressively more conservative (traditional)

- Regularly scale back appreciated positions
- Deploy rebalancing proceeds into cash and bonds
- Will tend to preserve purchasing power for retirees; won't maximize returns
- Appropriate for "last breath last dollar" retirees

Glidepath 3: Progressively more aggressive

- Portfolio conservatively positioned at retirement; equity exposure ramps up
- Best for retirees who are concerned about sequencing risk
- Not appropriate for retirees who don't have a bequest motive

Job 4: Articulate Maintenance Strategy

Key considerations for maintenance include:

- **How often?**
  - Annually, for rebalancing, refilling bucket 1, and meeting RMDs
  - More frequently for more rebalancing opportunities

- **How rebalancing will occur**
  - Asset-class level
  - Securities level (powerful!)

Job 4: Articulate Maintenance Strategy

Rebalance at the asset class level (classic rebalancing)

- Will tend to keep risk in check
- Will tend to yield fewer rebalancing opportunities→fewer opportunities to harvest cash flows

Rebalance at the securities level

- Can be done in conjunction with asset-class rebalancing
  - e.g., while you’re trimming equities, trim large-growth equities
- Is a great option for people relying exclusively on rebalancing to maintain cash flows

Job 5: Implement across multiple account types/sequence withdrawals

Most retirees bring multiple accounts into retirement

- Traditional tax-deferred (401(k), IRA)
- Roth
- Taxable

Traditional sequence of returns to maximize tax savings can inform asset allocation within each account

- RMDs
- Taxable
- Tax-deferred
- Roth

Bucket Approach Meets Multiple Accounts

ACCOUNT: Taxable	**ACCOUNTS:** Taxable and Traditional IRA	**ACCOUNTS:** Traditional IRA and Roth IRA
STARTING BALANCE: $120,000	**STARTING BALANCE:** $480,000	**STARTING BALANCE:** $900,000
ASSETS: $120,000 in cash and cash equivalents	**ASSETS:** $380,000 of short- and intermediate-term bonds held in the taxable account + $100,000 of intermediate-term bonds held in the traditional IRA	**ASSETS:** $400,000 of equities/equity funds held in the traditional IRA + $500,000 of equities/equity funds and higher-risk high-yield bond funds held in the Roth IRA

Assumption: 65-year-old retiree has $1.5 million split equally across traditional, Roth, and taxable accounts.

Questions? Comments? Want a copy of my slides?

christine.benz@morningstar.com