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How to Create a Safer Retirement Plan

By Jane Bryant Quinn | Apr 29, 2011

What if pre-retirement savers have been doing things all wrong? Instead of focusing on stocks, to grow money for your later years, advisors are looking at increasing current income guarantees. They're asking how you're going to pay your bills when your paycheck stops.

Traditionally, you're supposed to keep 50 or 60 percent of your money in stocks (or stock mutual funds). That's because, at 65, healthy people are likely to live for another 20 or 30 years. Over that long period of time, stocks will almost certainly go up (we assume, based on U.S. history). You'll be well provided with assets for your later years.

But what about your earlier years? Twice in a decade now, savage bear markets have wrecked the retirement plans of aggressive stock owners in their 50s and 60s, and crushed the standard of living of those who had already left their jobs. They were positioned for higher market prices in the distant future, but not for income to pay their bills today.

One big reason for owning stocks at 50 and 60 is the hope of earning, in capital gains, the money you failed to save in your younger years. From the 1970s through the 1980s, that gamble worked, if you held for 20 years and then sold out.

For people still in stocks at the end of the 1990s, however, the casino closed. When it will open again, no one knows. Today, "a mutual fund manager can say, 'My fund recovered,'" says Craig Israelson, a professor of personal and family finance at Brigham Young University, "but did its investors recover? When you get bucked off a horse, the horse still makes it back to the barn, but you don't."

The alternative to a substantial bet on stocks at age 60 and up is a portfolio heavily in bonds or bond mutual funds, with only a modest amount of money in stocks. There's less prospect for growth. But you can be more certain of getting a check in the mail every month.

"Retirees face their maximum risk exposure the day they retire," writes Josh Cohen, defined contribution practice leader for Russell Investments, in a recent paper. ""Why would you take on a high level of market risk for your retirement years on that same day?"

Russell recommends a 32 percent allocation to stocks when you retire, with the rest in a mix of diversified bonds. You'd maintain that same division for life, rebalancing once a year to keep equities at 32 percent. Withdrawals should equal 4 percent of the total portfolio in the first year you retire, plus an increment for inflation in each subsequent year. That's the same amount you'd take from a traditional portfolio that's half in stocks, but with less risk. In a year like 2008, you're less likely to panic and sell.

Zvi Bodie, professor of management at Boston University and author of "Worry Free Investing," thinks you should invest a substantial amount of your money in Treasury Inflation-Protected Securities (TIPS). That's "the closest we can get to a risk-free portfolio, especially for retirees who need to retain the purchasing power of their assets," he says.

TIPS are safer than cash or Treasury bills, because their payout rises with the consumer price index. If you buy individual TIPS through Treasury Direct, your inflation-linked income is taxed annually but not paid until the bonds mature — so buy them in Individual Retirement Accounts. IRAs give you tax deferral. If you're living on your savings, buy TIPS mutual funds, which pay the income monthly. TIPS generally aren't yet available in 401(k) plans — corporate sponsors should wise up.

Bodie also advises that you put some of your money into annuities, which, combined with TIPS and Social Security, gives you a larger income guarantee. Only after these basics are in place would he add risky assets, such as U.S. and international stocks, commodities, and real estate stocks.

An Alternate Approach

Another idea comes from Financial Engines, a company that manages 401(k) accounts. FE calls its new program Income+. You can't buy it directly. It's available only through corporate sponsors, whose retirees keep their money in the plan. But you can adapt the approach yourself.

Income+ begins five years before you start taking payouts from your 401(k). Your money is gradually moved into more conservative accounts. At retirement, you wind up with three pots:

1. Short and medium-term bond mutual funds for 65 percent of your money. This pot is gradually depleted, to provide you with steady income for at least 20 years.

2. Diversified stock funds, for the next 20 percent of the money you've saved. In years when the market goes up, some of these shares are sold, with the proceeds moved into bonds. That gives you a higher annual payout, to help keep up with inflation.

3. More bond mutual funds for the remaining 15 percent of your 401(k). Dividends are reinvested. At the end of 20 years (or before), you can choose to turn this pot into an annuity paying an income for life. By Financial Engine's calculation, you'll continue to receive at least the income you started with and probably more.

Even in the unhappy years between 2000 and 2010, this strategy would have maintained your basic income with an annual increase of 0.4 percent, says Jeff Maggioncalda, president and CEO of Financial Engines. Over better periods, payouts would have been much higher. In any case, you'd have begun with a higher annual income than that typical "4 percent of assets" that most advisors suggest. One company, Aon Hewitt, currently runs Income+, with four more scheduled to start this year.

One warning: The Income+ program covers a single life. If you're married, it it assumes that each of you has a retirement account to work with, says Maggioncalda. If not, you'd need a larger reserve fund for the annuity, to guarantee income to the surving spouse.

There's a second benefit to investing for income first. It forces you to face facts. Many retirees draw down their accounts too fast, counting on stocks to make up the difference 10 or 15 years from now. They'll run out of money if their gamble fails. With a bonds-first strategy, you can calculate pretty closely how long that pool of money will last, if you draw down both principal and interest. That helps you trim your spending to the amount of money available. That, in itself, will make your money last for life.