An Old Paradigm with a New Reality

Rethinking traditional asset allocation in preparation for and during retirement

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TWO OAKS

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EXECUTIVE SUMMARY

This white paper focuses on asset allocation leading up to and during the retirement years when that investment paycheck kicks in. It addresses the new realities of retirement… better health, more active lifestyles, longer life expectancies, and the need for investment dollars to last far more than just a few years. It explains how perceived riskless fixed income investments may actually prove quite risky in the current low interest rate environment. It offers a different model for asset allocation – one that remains conservative and focuses on crucial cash flow to meet ongoing expenses, but includes investments with greater growth potential than traditional fixed income securities.

So once an investor has the ability to retire, just how should his or her assets be allocated to ensure that the new cash flow from investments can replace the old paychecks throughout retirement?

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10k a Day: Welcome to the Rest of your Lives

According to the Social Security Administration and the Pew Research Center,10,000 baby boomers (those born between 1946 and 1964) are retiring every day. That's 10,000 people who:

- are smacking snooze on their alarm clocks each morning and realizing they have nowhere to go – or at least not to work.
- are suddenly realizing payday is just another day of the week and that their regularly anticipated work paycheck is a thing of the past.
- qualify for entitlements like Social Security and Medicare after years of paying into the system, and may soon realize that such government benefits do not go as far as they once did or they thought they would.
- are now counting on their investment and retirement accounts and hoping their careful financial planning will allow them to continue to live how they have grown accustomed. Once individuals have achieved a certain quality of life, they generally do not want to jeopardize their ability to maintain that (or even improve on it) after their working days and the associated paychecks have ended.

Many baby boomers have been planning their entire adult lives for retirement day. They spent their working years trying to ensure financial independence during retirement. They saved a good portion of their paychecks and bonuses, and prioritized spending between necessities of life and the luxuries they longed to enjoy.

Some retirees achieved their retirement financial goals sooner than anticipated, while others worked longer than desired. Some had to adjust their plans for retirement to account for new financial realities. Hopefully, they also came up with a new plan, a new purpose, and a new adventure. After all, retirement no longer means sitting around watching flowers grow (unless horticulture is a hobby!) and waiting for life to end. Rather, people are now retiring TO something instead of FROM something. While individual journeys to retirement may differ, most retirees are striving to be able to do what they want to do in life, not what they have to do. So now what?

Modern Portfolio Theory: Diversifying to Reduce Risk

In the 1950s, Harry Markowitz devised a mathematical formulation that has become the "Bible" or "gospel" of investment management among many financial professionals. Ultimately, his work earned him a Nobel Prize. Modern Portfolio Theory (MPT) focuses on the key concepts of diversification and correlation, and explains how allocating investment dollars among different asset classes may lower the risk of the overall portfolio.

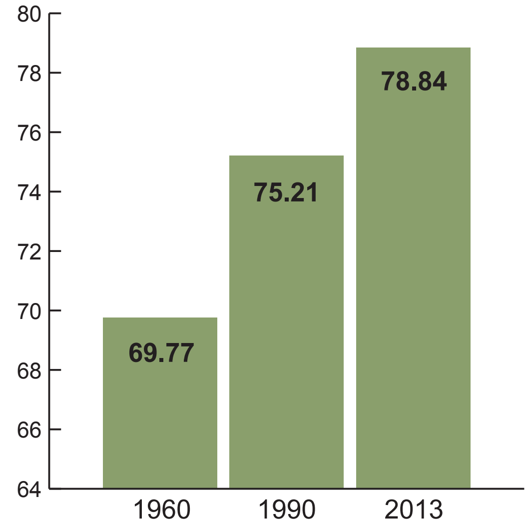
According to Markowitz, since various investment classes perform differently during changing economic and market conditions, investors should be able to reduce their risk by including a diversified mix of assets in their portfolios.

An Age-Based Approach

While investors often incorporate Modern Portfolio Theory throughout their investment lives, many have simplified the concepts for their retirement planning and have adapted an "age-based" asset allocation model. In its simplest terms, the age-based approach suggests that investors allocate a percentage of their portfolios equal to their current age to fixed income securities (bonds) and a percentage equal to "100 minus their current age" to equity securities (stocks). Therefore, a 25-year old should allocate 25% to bonds and 75% to stocks, while a 65-year old should allocate 65% to bonds and only 35% to stocks.

Life Expectancy at Birth in the U.S. (Years)

Source: The World Bank



For years, many financial planners have advocated this asset allocation model under the assumption that fixed income is far safer than equities, but that equities offer greater growth potential. In fact, within the mathematical formula of MPT, government securities (Treasuries) are shown to earn a "risk-free" return. Therefore, some investors view bonds as a safety net for their portfolios and choose to allocate more to this asset class as they move into retirement.

Many believe the age-based approach allows younger investors greater opportunity for growth from the equity portion of the portfolio. These investors have time to recoup losses from market downturns. Conversely, older investors – especially those already retired – cannot easily replace the principal lost in those down years. According to MPT, these investors should allocate more to fixed income so they can rely on the steady interest income stream these types of investments produce. They can budget for the future with the certainty that these securities will mature on a set date and their entire principal will be returned.

For many investors and financial professionals, the basics behind the age-based approach to asset allocation seem quite logical. However, times have changed since Markowitz first introduced his theory. Once upon a time (or at least in the 1950s), individuals lived relatively quiet lifestyles in retirement. Their expenses were greatly reduced once the working years ended, and a steady stream of interest income could go a long way toward covering their daily activities. However, today's retirees are healthier, more active, and more able to continue to enjoy their life's passions. They are living longer and, in some cases, their expenses actually grow in retirement to accommodate travel and more expensive hobbies. More individuals are living to 100 and beyond and remain active well into their 80s and 90s.

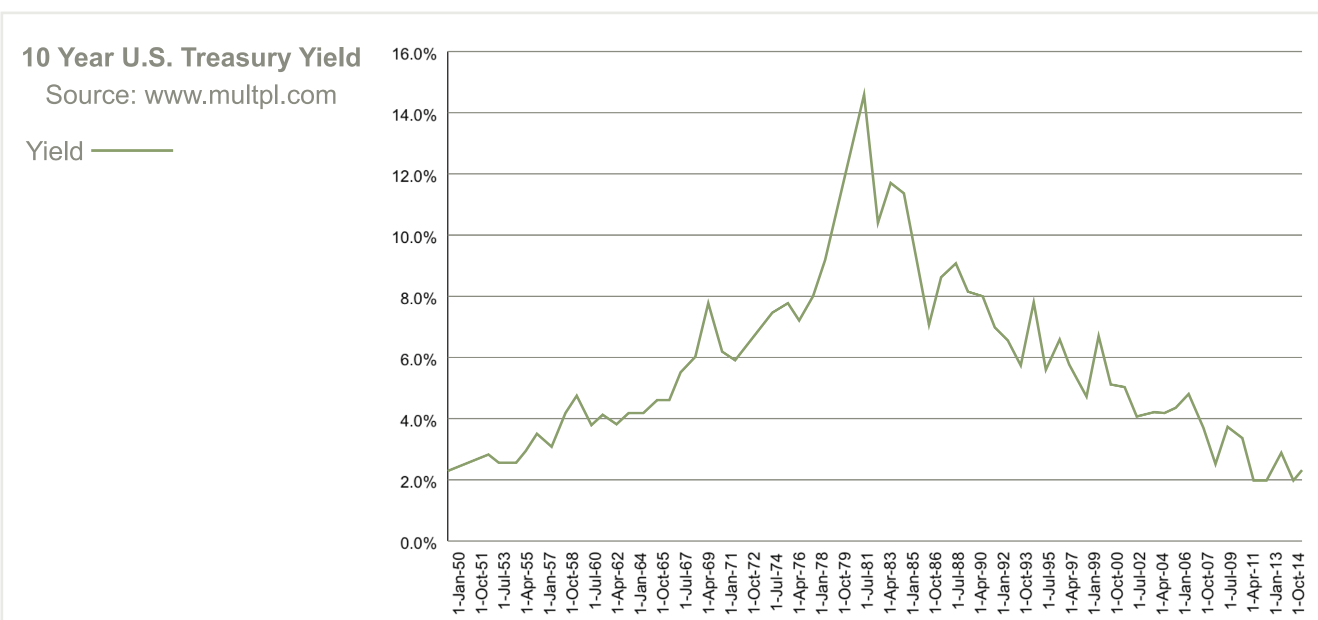
Interestingly, many retirees may now be accepting *greater* portfolio risk by investing such a large portion of their retirement assets into the perceived safety of fixed income. Suddenly, this riskless asset as defined by Modern Portfolio Theory is not riskless at all…

Rethinking Fixed Income

A Little History of Fixed Income

Many investors (and financial professionals, for that matter) have never experienced a time when interest rates were rising for an extended period. Rates have been declining since the early 80s so, perhaps by happy accident, many investors have earned competitive returns on this seemingly safe part of their portfolios. These investors sought out fixed income investments for the regular, periodic cash flow from the associated coupons, but have also enjoyed the benefit of the principal value of these bonds increasing as rates have fallen. (Bond math 101 shows that interest rates and bond prices move inversely to each other – as rates decline, prices rise, and vice versa.) In fact, investors who follow MPT and, more specifically, the age-based allocation model, have done far better in their fixed income portfolios than they may have expected. But that friendly trend most certainly cannot last forever. Although rates have drifted to historically low levels since 2008, many analysts expect the Federal Reserve to begin lifting rates by late 2015.

In this scenario, a little gray hair isn't such a bad thing, as investors and advisors who were monitoring the markets in the 1970s can remember the negative impact of rising interest rates on bond prices and performance. For much of the three decades prior to 1981, interest rates climbed in the U.S., and investors suffered through the oil crisis and the inflationary periods of the 1970s. Conversely, today's interest rates are not high enough to generate meaningful income for investors. Moreover, if rates begin to rise from their historically low levels, principal values will decline, as will the overall value of the portfolio. Investors who continue to favor an age-based asset allocation may be accepting additional risk in their portfolios, even though they are investing in a perceived "risk-free" asset class. And remember, those retirement dollars need to last longer than they did in the 1980s, 1990s, and even 2000s when rates were falling.



The Risks of Fixed Income

The old paradigm of investors allocating significant assets to fixed income when they are entering retirement is no longer rational. Demographics have changed, and the income earned from fixed income is not worth the investment or the risk of declining principal value if (rather, when) rates begin to rise. Even if rates by chance do not rise, fixed income interest today will most likely not replace the income investors earned while working. Looking forward, we don't believe retirees should allocate a sizable percentage of their portfolio to fixed income. Following are some specific risks of investing in this asset class:

Credit Risk

The U.S. has experienced an easy money environment since the economic downturn beginning in 2007. The prevailing extremely low interest rate environment has prompted companies and public entities to carry higher debt loads. Defaults currently stand at historically low levels. The Federal Reserve has enacted stimulus measures that have expanded the money supply and the level of outstanding debt relative to the nation's GDP. As rates rise, investors face the potential for credit downgrades and even bond bubbles in both corporate and government/ municipal securities. Already, high profile municipal bankruptcies have dramatically risen, exceeding numbers not seen in decades. Stockton, CA, and Detroit, MI, are prime examples.

Inflation Risk

Currently, analysts and global investors seem more worried about the possibility of deflation than inflation. Inflation remains far from the radar screen. However, as interest rates rise, inflation may again rear its ugly head as the monetary printing presses open up even more and purchasing power diminishes. If so, individuals living on a fixed income in retirement could see their quality of lives severely impacted at a time when they cannot add more capital to the equation (through work paychecks) to balance out the impact of higher prices and the contracting purchasing power of their dollars.

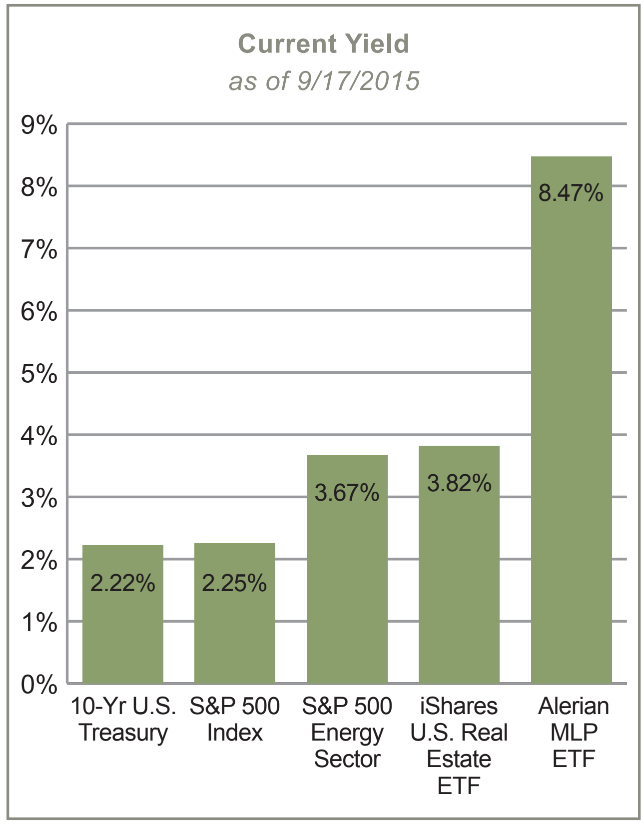
Price (Interest Rate) Risk

As mentioned, as interest rates go up, the value of the associated bond principal goes down. Retirees whose fixed income allocation is sizable (as in through an age-based approach) will find the overall values of their portfolios declining over time. Even if they plan to hold these securities to maturity and not realize any losses on their bond portfolios, they will suffer a decline in overall net worth. And, if they need to raise cash for some reason and sell bonds from their portfolio prior to maturity, they will lock in those losses. In today's low interest rate environment, investors are not earning enough interest on their fixed income investments to compensate for the increased risk of negative principal volatility. While owning some fixed income products makes sense for the portion of the portfolio seeking liquidity and safety (see the next section for more information), we believe investors should utilize a bond laddering strategy so they can reinvest at higher rates as their bond investments mature.

While investors can look in the rearview mirror and see favorable rates of returns with limited volatility for fixed income products over the past few decades, they cannot expect similar results moving forward, given the current economic and interest rate environments. Therefore, investors should consider a more sensible approach than the age-based allocation method.

So, if Not Fixed Income…?

Once retirement begins and work paychecks end, retirees will need investment income to replace the money they used to receive every payday. Our case against fixed income should not be perceived as a case against cash flow. To the contrary, cash flow should be a prime consideration and play a significant role in any investment program, regardless of investor age. But the products used to generate this cash don't need to be traditional fixed income.



Instead, retirees should consider investing in a mix of quality non-traditional assets with the potential for (and a history of) producing steady and/or increasing income. The market is rife with public and private companies that have survived and thrived through various market cycles and know how to generate and distribute cash. Many corporations increase their dividends each year as excess cash becomes available or engage in share buyback programs that often increase stock prices.

These days, investors have far more options to generate cash flow than traditional fixed income. In addition to high quality and dividend-paying stocks, investors may want to consider Real Estate Investment Trusts (REITs), Master Limited Partnerships, and other asset-based securities. Investors should allocate the largest percentages of their capital to asset classes with the potential to increase their quality of life by providing the highest annual cash flow. In many cases, these investments also provide significant potential for higher market valuations and increased capital.

Steps to Retirement Success

STEP 1

Determine Cash Flow Needs (*Honestly!*)

The first step to creating the optimal retirement portfolio does not involve analyzing various investment options at all. In fact, individuals nearing retirement should take a step backward and first candidly assess their financial situation. It's critical for these investors to have a solid, honest understanding of how much money they are spending each month and each year. What do utility and cable bills look like? How often does the fridge get restocked or do they eat out? What's the mortgage or rent payment? Are there still children (or perhaps even parents) to support? Do they want extra money for gifts or a luxurious vacation once or twice a year? Where does charity fit in?

Retirees should also differentiate between basic survival and quality of life – i.e. the "needs" vs. the "wants." Once survival needs are met, these investors can begin taking steps to improve their quality of life. For some, a second career may beckon (Colonel Sanders started Kentucky Fried Chicken as a retirement gig to supplement social security). However, since that "secret blend of 11 herbs and spices" has already been discovered, many investors must instead devise and stick to a quality investment plan that makes the most of what they accumulated during the working years.

Bear in mind – once retirement hits, expenses may change. The retiree may no longer need a work wardrobe or have daily commuting and parking expenses, but those costs may be replaced with golf course green fees or yoga studio memberships. Most people dread budgeting and put off balancing their checkbooks as long as possible (if ever). Unfortunately, this means most investors have no idea about their true cash flow needs, so this initial step requires an honest evaluation of current and expected annual expenses.

STEP 2

Don't Forget Taxes!

For some investors, taxes during the working years are a mere paycheck line item and not something they consider when devising budgets and calculating expenses. Others make estimated payments a few times a year or save up for April 15 when the tax man cometh. However, one can't make an honest assessment of cash flow needs without a careful consideration of taxes, as actual expenses require after-tax dollars. Many investors' tax situation may change once the traditional paycheck ends and retirement begins. A trusted Certified

Public Accountant or financial advisor can help determine true after-tax cash flow needs.

STEP 3

Establish a Cash Reserve

Some call it a rainy day fund; others, an emergency fund. Preferred phrasing aside, we believe all retirees should invest one year's worth of expenses in a short-term money market account and/or in CDs or Treasury bills maturing over the course of the next 12 months. The securities should be allocated as a quarterly ladder and used to cover monthly expenses and other periodic costs like vacations, charity contributions, home improvements, etc. Each quarter, some of the securities will mature into the money market account to cover cash flow needs. The CDs and Treasuries will produce some interest – not much in a low interest rate environment, but the goal with these really is to establish a solid cash reserve to pay bills. The investor is essentially taking no risk in this liquidity portion of the portfolio.

Retirees should already be familiar with this concept from their working years. Financial planners have long advised a safety net equating to three- to six-month's worth of expenses in case of a job loss, illness, or major unexpected expenditure. Additionally, the work paycheck enhanced the liquidity portfolio as it enabled individuals to cover short-term cash flow needs. Hopefully, investors were also able to invest a portion of their paychecks in growth and income securities within their retirement accounts throughout their working years. Once retirement begins, those assets must take over entirely. The 12-month cash reserve is a starting point to provide liquidity and cover unexpected needs.

STEP 4

Purchase One Year's Worth of Expenses in Fixed Income Annually to Weather Unexpected Market Volatility

What goes up must come down. Markets correct – always have; always will. Dotcom investors in the late 90s thought those Internet stocks would be "sure things" forever. They were wrong. Few people saw the housing bubble coming in 2007 and many got caught with excess risk in their overall portfolios.

Fortunately, for younger investors during these difficult times, ***what goes down eventually comes back up*** (hopefully). They enjoyed the luxury of time (and a work paycheck to cover short-term cash flow needs) and watched many of the losses in their portfolios disappear as valuations increased in the years following those painful downturns. Those who did not panic and whose portfolios were prepared to weather the storms have reaped the rewards of patience and persistence (and perhaps some luck).

Unfortunately, many retirees do not have the luxury of time. Without a work paycheck to make up for a dwindling portfolio balance, they may have difficulty covering expenses. While they may realize the downturns are temporary, a few-year period of declining valuations can put a huge damper on their quality of life and cost them quite a few sleepless nights. This is why fixed income fits nicely into an investment portfolio.

Despite all the aforementioned reasons for disavowing fixed income as a significant portion of their main portfolio, retirees should strongly consider creating a second “safety” portfolio to protect against an unexpected downturn in riskier markets (like equities). Once again, the portfolio should consist of a few years’ worth of expenses invested in traditional fixed income securities. An appropriate strategy is to use a laddered one in which the investor purchases multiple bonds, each with different maturity dates, in accordance with the amount of time he or she believes is needed to weather any unexpected market volatility and provide much-needed insurance. As years pass, the shortest Treasuries mature into the cash reserves and the proceeds are used to buy CDs (money markets). Additionally, cash from longer-term allocations in the total return portfolio (see Step 5) amasses annually to buy bonds at the end of the maturity schedule to keep the ladder intact.

Because no two investors are the same, the duration and size of these portfolios will differ based on individual tolerance for risk and annual budget needs. Some investors will require a five-year timeframe (four years beyond the cash reserves) and will buy Treasuries with one-, two-, three, and four-year maturities. Those who are able to accept more risk may only need a shorter-term laddered portfolio of perhaps two additional years beyond the cash reserves. Investors should be aware that they might give up significant portfolio growth by allocating funds equal to a few years’ expenses to traditional fixed income. Then again, the risk of suffering through sizable losses at a time when no work paychecks or other capital infusions are making up for those portfolio declines is likely more sizable.

STEP 5

Invest Excess Capital in "Income and Growth" (Total Return)

A retiree's primary goal should be to build a portfolio that covers liquidity needs, provides insurance for unexpected downturns, and effectively removes market risk from the equation for the next few years. Once that has been accomplished, investors can utilize a total return approach for the remainder of their assets, which will better equip them to meet their long-term quality of life objectives. The goal of this portfolio is to generate an increasing stream of income that, when added to interest payments from the fixed income portfolio, will meet (and even exceed) annual cash flow needs.

The total return portfolio can include dividend-paying stocks, REITs, Master Limited Partnerships, and other asset-based securities that offer both growth and income opportunities. Interest, dividends, and other distributions from this portfolio will be combined with the interest from the traditional fixed income securities to keep the ladder intact in the "safety" portfolio as the years pass. In other words, cash from the various investments (CDs, fixed income, and total return portfolio) should equate to at least one year's worth of expenses and will be used to purchase bonds of the longest maturity in the laddered portfolio.

Because cash earned from the investments covers living expenses, the principal value of the total return portfolio is not touched and is expected to grow each year and pay out even greater distributions over time. Distributions beyond annual cash flow needs will serve to increase the prior budget and add to the retiree's quality of life.

(Optional) STEP 6

Invest in Higher Risk, Higher Growth Seeking Investments

(for investors with higher tolerance for principal volatility)

Once basic cash flow needs are covered, and perhaps the annual budget has been increased to enhance the retiree's quality of life, the less risk-averse investor may choose to allocate excess distributions to more speculative, higher growth investments. Investors who meet the financial qualifications for hedge funds, private equity, etc., may have the opportunity to earn even higher returns by investing in these investment vehicles.

Of course, investors should not invest in anything that could impact their current lifestyle. Most advisors would recommend limiting the allocation within this high growth portfolio to 5% to 10% of overall assets. For some, a small allocation to high growth can assure ongoing financial independence and perhaps even create opportunities to leave wealth to children, grandchildren, and/or charities.

Retirement Portfolio Example

Annual Expenses	**$100,000**
Overall Portfolio Assets	**$2,000,000**

Portfolio	Rate of Return	Principal	Interest / Distribution
Cash Reserves (CDs)	0.25%	$100,000	$250
Laddered Portfolio (Fixed Income)			
Year 2	0.40%	$100,000	$400
Year 3	0.75%	$100,000	$750
Year 4	1.00%	$100,000	$1,000
Total Return Portfolio	6.10%	$1,600,000	$97,600
Total Interest / Distribution			**$100,000**

Portfolio Breakdown

- Assets at retirement: $2,000,000; annual expenses: $100,000.
- One year's worth of expenses placed into a cash reserves / liquidity portfolio of CDs and money market funds that earn a nominal rate.
- A laddered fixed income portfolio for the next three years provides insurance against a downturn in the market.
- The remainder (majority) of the assets are allocated to a "growth and income" total return portfolio with 6.1% annual distributions.
- Combined interest (from CDs and fixed income) and distribution (total return portfolio) will cover annual expenses so principal is not touched and will grow under favorable market conditions.
- Combined distribution will be used to purchase securities for the last year of the fixed income ladder annually.
- If rates increase, distributions exceeding $100,000 can be used to increase annual cash flow and quality of life.
- As assets continue to accumulate, a small percentage may be invested in higher growth investments.

The Psychology Cycle of Most Investors

Often, the mindset of the investor is exactly the opposite of what it should be, and many financial professionals end up playing the role of therapist as much as advisor. When markets are soaring with no end in sight, few choose to take profits, rebalance assets, or worry about corrections. Instead, they become giddy, greedy, and eager to seek out the latest surefire “tip of the day” from that “brilliant” colleague in the next cubicle. Conversely, when markets are on the decline and naysaying financial bloggers, TV pundits, and pessimistic colleagues are scaring them with “doom and gloom” scenarios and worse case prognostications, investors often grow fearful, panic, and sell at market lows.

Advisors constantly warn clients to take their emotions out of the equation and stick to a disciplined asset allocation approach to meet their short- and long-term objectives. But in this era of 24-hour news with excessive (and often mis-) information, day trading, and do-it-yourself analysis, investors often find themselves on the wrong end of the market cycle (and their advisor must be there to pick up the pieces).

Similarly, a retiree’s mindset can also lead to some poor allocation decisions for their twilight years. The old allocation formulas are simply no longer rational, as today’s low interest rates and subsequent returns on traditional fixed income will not support the lifestyles of many healthy, active, and longer-living retirees. Instead, fixed income today should be used for liquidity and a safety net that gives investors time to weather unexpected storms in the markets. Once that portion of the portfolio has been established, retirees should have peace of mind that comes with knowing they can survive short-term bumps along the road. Potentially higher yielding investments should provide the distributions to meet (and hopefully exceed) annual cash flow requirements throughout the long term.

This recommended retirement allocation is not a changeable trading strategy executed by some sort of robo advisor. Instead it is an all-weather strategy that allows investors to build customized portfolios based on their individual cash flow needs and risk tolerance. At some point as rates rise, fixed income may become a more prominent allocation within the retirement portfolio. But in today’s environment, the higher distributions and growth potential from dividend paying stocks, REITs, and other non-traditional income-producing investments could prove very beneficial for those 10,000 baby boomers retiring every day.

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