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RETIREMENT INVESTMENT GROUP, LLC

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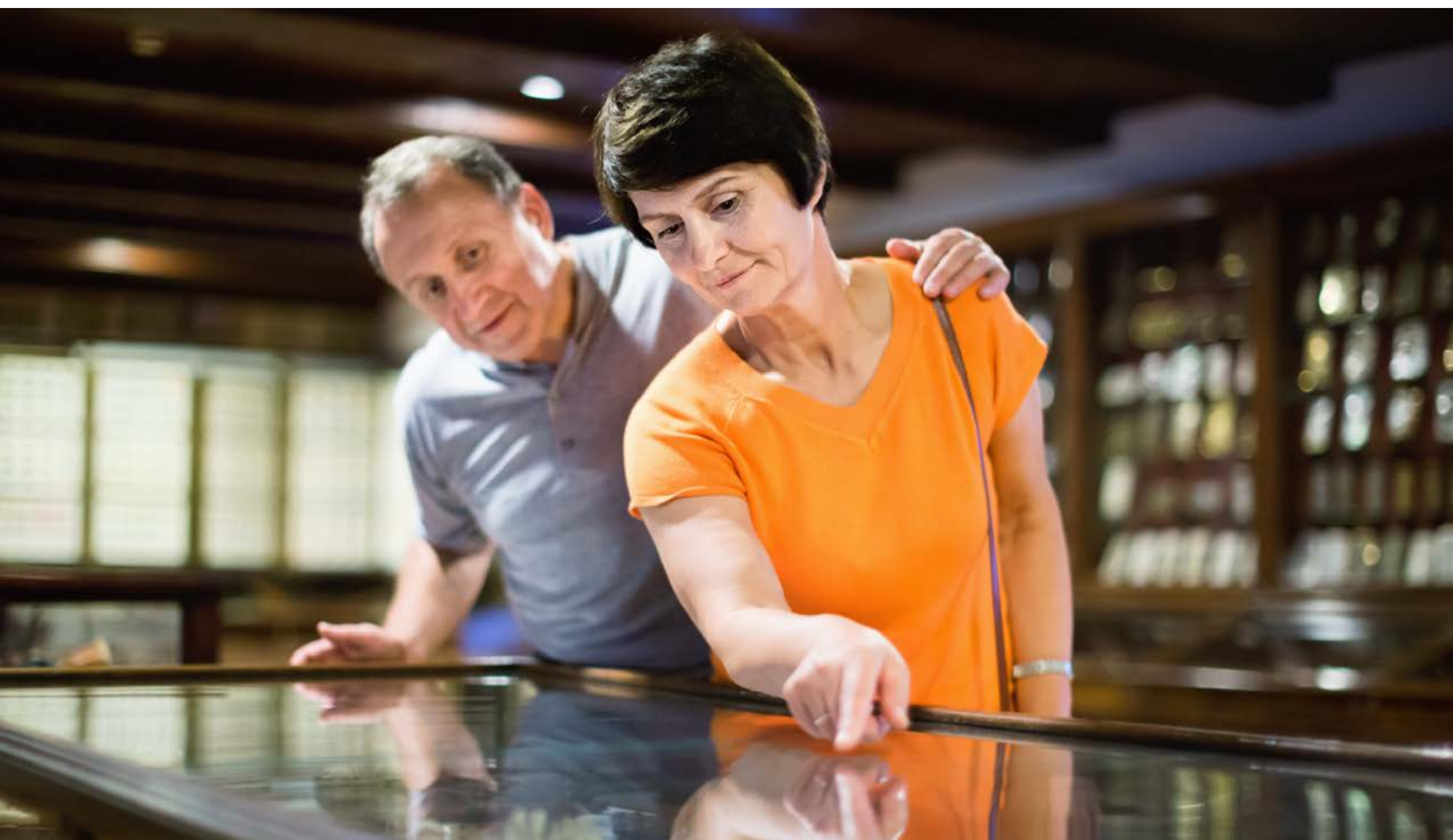
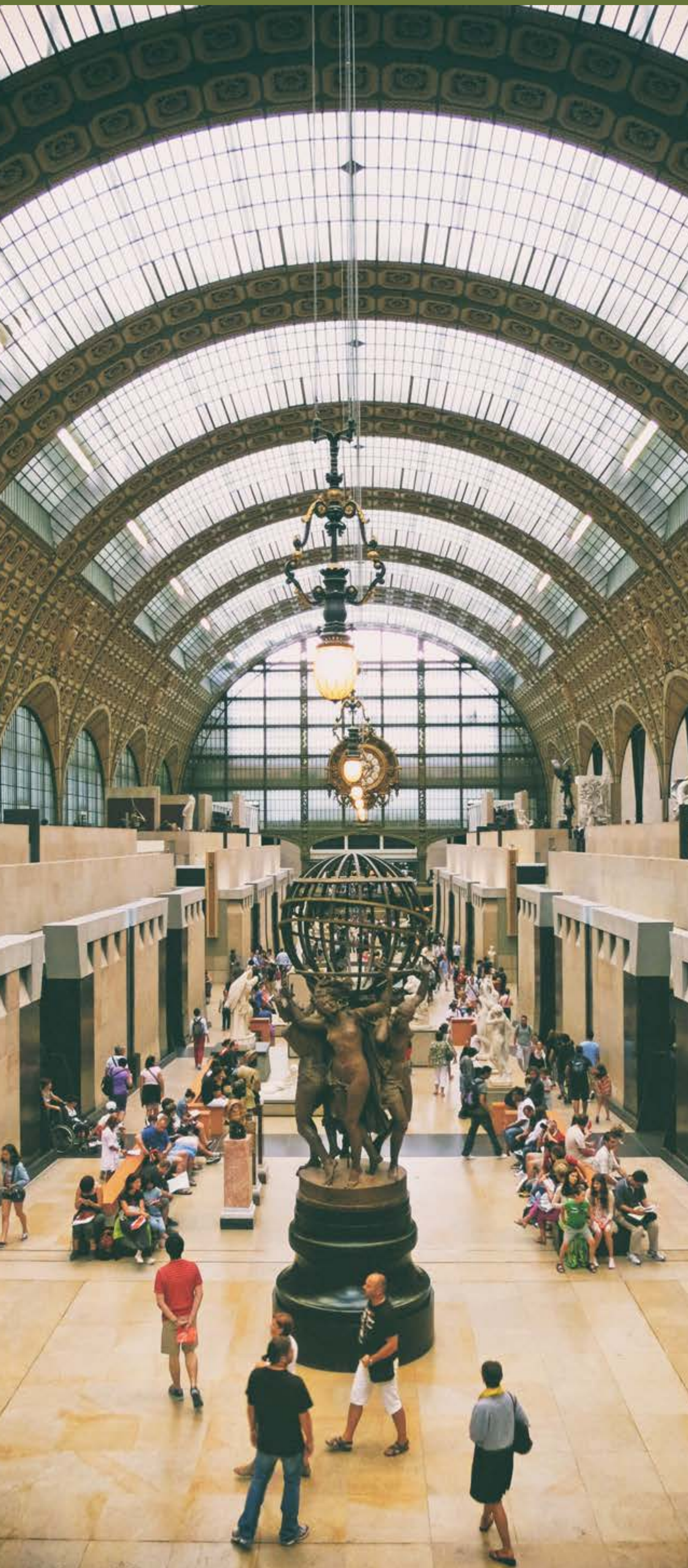
Introduction

When most people challenge deeply ingrained wisdom about finances, they're greeted with eye rolls. When one of the world's most successful financial gurus is the contrarian, people listen.

Such was the case with Warren Buffett's 2013 letter to Berkshire Hathaway investors, which seemed to challenge one of the long-standing axioms about retirement planning. Buffett noted that, upon his passing, the trustee of his wife's inheritance was instructed to put 90% of her money into a very low-fee stock index fund and 10% into short-term government bonds.

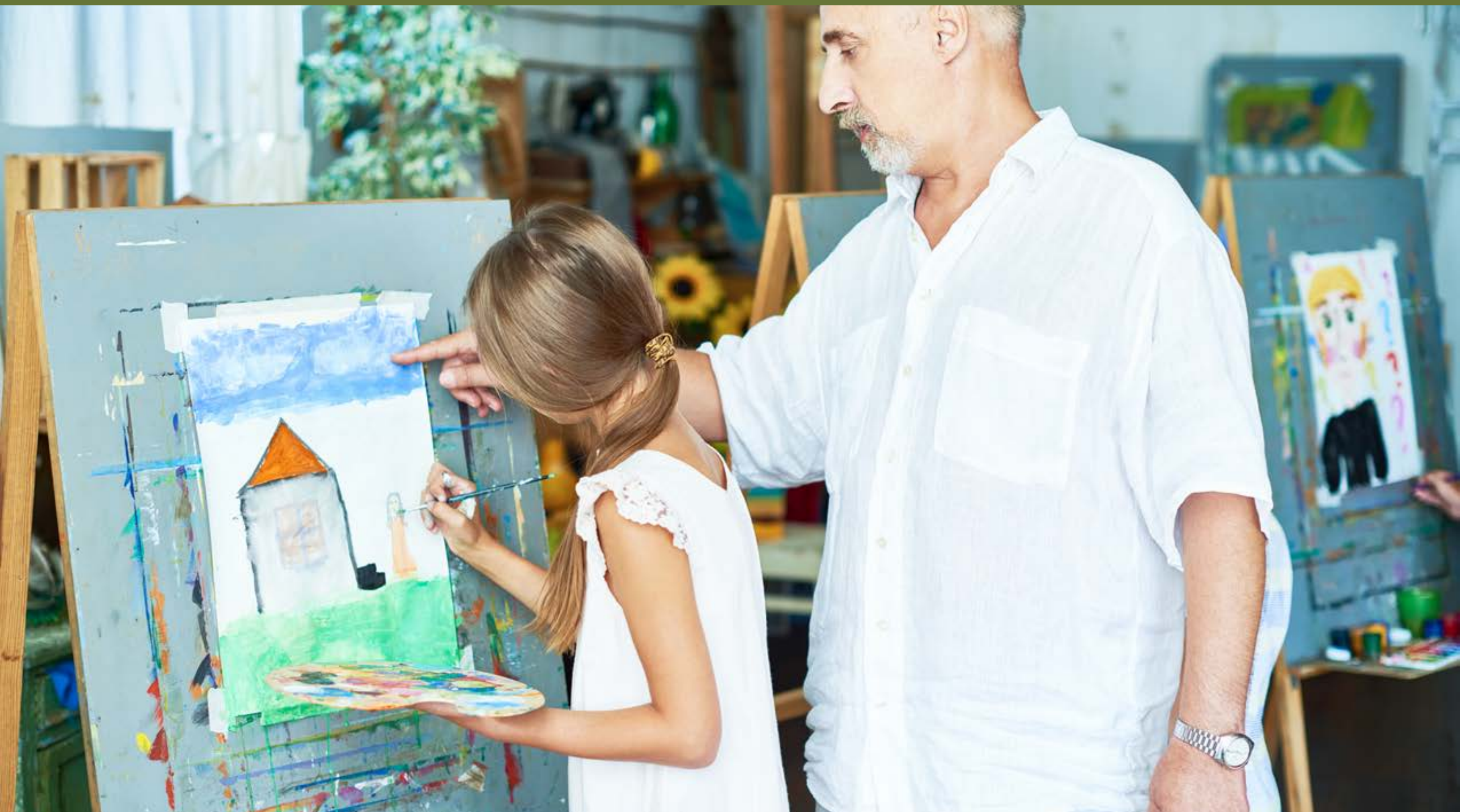




For investors regularly told to steer away from stocks as they age, this was pretty shocking stuff. A well-worn adage is to maintain a percentage of stocks equal to 100 minus one's age – at least as a rule of thumb. So when you hit the age of, say, 70, most of your investment assets would be high-quality bonds that generally don't take as big a hit during market downturns.

Because people are generally living longer and need to stretch their nest egg, some experts have suggested being a little more aggressive. Now, it's more common to hear about 110 minus your age – or even 120 minus your age – as an appropriate portion of stocks. But 90% in equities, at any age? Even for someone with Buffett's bona fides, that seems like a risky proposition.

Will it Work For Every Investor?



Now, it's important to point out that the Oracle of Omaha didn't say that the 90/10 split makes sense for every investor. The larger point he was trying to make was about the makeup of portfolios, not the precise allocation. His main contention was that most investors will get better returns through low-cost, low-turnover index funds – an interesting admission for someone who's made a fortune picking individual stocks.

Obviously, there is a distinction between Mrs. Buffett and most investors. While we don't know the exact amount of her bequest, one can assume she'll get a cushy nest egg. She can likely afford to take on a little more risk and still live comfortably. Even so, this 90/10 allocation drew considerable attention in the investing community. But just how well would such a mix of stocks and bonds hold up in the real world?

Putting 90/10 to the Test

One Spanish finance professor went to work finding the answer. In a published research paper, Javier Estrada of IESE Business School took a hypothetical $1,000 investment comprised of 90% stocks and 10% short-term Treasuries. Using historical returns, he tracked how the $1,000 would do over a series of overlapping 30-year time intervals. Beginning with the 1900–1929 period and ending with 1985–2014, he collected data on 86 intervals in all.

To maintain a more-or-less constant 90/10 split, the funds were re-balanced once a year. In addition, he assumed an initial 4% withdrawal each year, which was increased over time to account for inflation. One of the key metrics Estrada looked for was the failure rate, defined as the percentage of time periods in which the money ran out before 30 years – the length of time some financial planners suggest retirees plan for. As it turned out, Buffett's aggressive asset mix was surprisingly resilient, "failing" in only 2.3% of the intervals tested, as displayed in Figure 1 on the next page.

What's equally surprising is how this portfolio of 90% stocks fared during the five worst time periods since 1900. Estrada found that the nest egg was only slightly more depleted than a much more risk-averse 60% stock and 40% bond allocation.

Putting 90/10 to the Test

Estrada tested the failure rate of various asset mixes over 86 different historical periods. An asset allocation failed when the funds ran out before 30 years, assuming a fairly typical amount of withdrawals.

Figures indicated that strategies with equity holdings between 100% and 40% have similar failure rates, but when the allocation of stocks decreases to 30% failure rates increase considerably; to above 10% in most cases. Although there are varied opinions regarding what is an acceptable failure rate, most practitioners seem to agree that failure rates below 5% should be viewed as acceptable by most retirees. The author concluded his test with the observation that:

"...as far as static strategies is concerned, Buffett's suggested allocation has a very low (although not the lowest) failure rate; a very high (although not the highest) upside potential; and provides very good (but not the best) downside protection when tail risks strike. Put differently, Buffett's suggested allocation seems to provide a middle ground between the best performing strategy (100/0) in terms of upside potential and the best performing strategies (60/40 and 70/30) in terms of downside protection."

Javier Estrada goes on to look at two different dynamic asset allocation strategies, which are based on the static strategy recommended by Buffett, but with a few changes.

The first change [T1] relates the annual withdrawal to the behavior of the stock market in the previous year. If stocks have gone up, the retiree takes the annual withdrawal from stocks and then re-balances the portfolio back to the 90/10 allocation. Conversely, if stocks have gone down, the retiree takes the annual withdrawal from bonds and does not re-balance the portfolio.

The second change [T2] relates the annual withdrawal to the relative behavior of the stock and bond markets in the previous year. Just like the adoption above, if stocks have gone up in the previous year, (more so than bonds) this change calls for the retiree to take the annual withdrawal from stocks and then re-balance. However, if the returns from bonds have exceeded those from stocks over the previous twelve months, the retiree takes the annual withdrawal from bonds but does not rebalance. (Chart is on the next page)

Exhibit 2: Tweaking the 90/10 Allocation

This exhibit shows summary statistics for four strategies evaluated over 86 rolling 30-year retirement periods, beginning with 1900-1929 and ending with 1985-2014. All strategies consider a starting capital of $1,000, annual withdrawals of $40 in real terms, and annual rebalancing. The two dynamic strategies consider the behavior of stocks (T1) and the relative behavior of stocks and bonds (T2) in the way stated in the text. The failure rate (Failure) is the proportion of the 86 retirement periods in which the portfolio was depleted before 30 years. The statistics that describe the distribution of terminal wealth across the 86 retirement periods include the mean; median; standard deviation (SD); average bequest in the lower 1% (P1), 5% (P5), and 10% (P10) tail; and average bequest in the upper 1% (P99), 5% (P95), and 10% (P90) tail. Returns over the 1900-2014 period are annual, real, and account for capital gains/losses and cash flows. All figures in dollars except for failure rates (in %).

	90/10	T1	T2	60/40
Failure	2.3	2.3	2.3	0.0
Mean	2,638	2,726	2,711	1,267
Median	2,485	2,605	2,534	1,129
P99	8,625	8,683	8,770	3,208
P95	7,820	7,919	7,881	2,837
P90	6,695	6,817	6,751	2,647
SD	2,022	2,037	2,011	786
P1	0	0	0	2
P5	42	110	110	93
P10	219	284	300	204

As the author observes, results of the two twists considered are very similar. T1 has a slightly higher overall upside potential, and T2 provides a slightly better overall downside protection. Both T1 and T2 outperform the 90/10 allocation. Although, the three strategies have the same failure rate (2.3%), T1 and T2 provide retirees with both a higher upside potential (as measured by the mean, median, P90, P95, and P99) and better downside protection (as measured by both P5 and P10) than the 90/10 allocation.

Conclusion

Overall, Buffett's asset allocation advice is sound and simple. However, for those retirees that are concerned about holding such an aggressive portfolio, the two alternative strategies (T1 and T2) may be preferable. The author of the paper concludes:

"...the two simple twists considered here improve both the upside potential and the downside protection of the 90/10 allocation. These two twists require retirees neither to collect vast amounts of information nor to make any valuation judgments but only to observe the performance of the stock market, or the relative performance of the stock and bond markets."

"Either way, retirees can, with little effort, improve upon the results of the 90/10 allocation. In fact, because the performance of the two twists considered is so similar, retirees may want to lean towards the first one (T1) and simply adjust their asset allocation according to the observed performance of stocks."

"...those retirees that find a 90/10 portfolio acceptable are likely to find that with an insignificant additional effort, observing the performance of stocks and implementing the first twist discussed, they are likely to improve the performance of their portfolios."

Recent research suggests that retirees might be able to lean heavily on stocks without putting their nest egg in grave danger. But if a 90% stock allocation gives you the jitters, pulling back a little might not be such a bad idea.

Investing involves risk including the possible loss of principal. Past performance is not a guarantee of future results. Your actual investing experiences will vary.

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About Lynch Retirement Investment Group

The Lynch Retirement Investment Group was established by John M. Lynch in 1987, and John has served as managing director of the group since its inception. With offices in Fulton (MD) and Fairfax (VA) the Lynch Retirement Investment Group became a separate and independent office and began offering securities through Raymond James Financial Services in 2012. The team consists of ten full-time advisory and client services professionals with over 150 years of experience in the financial services industry, and manages over $500 million in client assets.

The Lynch Retirement Investment Group advises clients on the proper methods of planning for and managing their retirement distributions as they transition into retirement. Since 1987, our advisors have been assisting corporate employees of Fortune 500 companies to adequately prepare for the financial eventualities of their retirement years.

The majority of our clients are retirees who have opted for lump sum distributions at retirement. Over the years, while we are fully independent from the companies, we have worked with clients from Northrop Grumman, Verizon, Exxon Mobil, and Chevron among others. Our clients count on us to provide the full breadth of their retirement planning, asset management and insurance needs. Our specialties include the following:

- Navigating the tax laws surrounding Lump Sum distributions and IRAs
- Strategies for avoiding the 10% Early Withdrawal Penalty prior to age 59 ½
- Strategies for properly handling your company stock at retirement
- Strategies for taking In-service 401(k) withdrawals while you are still working, and
- Strategies for maximizing your Social Security benefits.

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