FINANCIAL insight

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DAVIDSON COMPANIES

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Accumulation of Wealth
vs. Decumulation

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Investors typically have focused their attention toward accumulating assets to be used for specific goals such as a major purchase, education, or creating a retirement nest egg. Although not necessarily easy, the accumulation investment process is rather simplistic. Save and invest as much as you can, for as long as you can, adding periodically to a well-designed investment portfolio.

While markets are always volatile, and good years are intermixed with bad periods, systematically saving and investing smoothes out much of the volatility. When you add to your portfolio during bad years, you buy more assets inexpensively. Conversely, in periods of great investment performance, your regular investments buy fewer high-priced assets. This systematic investing, whether done on a monthly, quarterly, or annual basis, has similar characteristics to stocking up on toothpaste when it's on sale and buying less when the price is higher.

The discipline to save and grow your assets is not to be taken lightly. However, one can argue that the risks that must be managed are not as myriad as those facing "decumulators."

WHAT IS DECUMULATION?

This is a phrase to describe when a finite pool of assets is going to be used over a protracted period of time to fund a spending goal. An obvious example is retirement spending. It is this example we will use to illustrate the issues of decumulation.

Consider a married couple: Herman and Mabel. They have enjoyed a fruitful life together and, as early "baby boomers," they are contemplating their long-sought goal of an enjoyable retirement.

What do they face? First, they must consider what retirement means to them in terms of consumption or spending. The beginning point is creating a spending budget or goal. While not an overwhelming task, it is extremely important. Do Herman and Mabel need $5,000 each month, $7,000, or $10,000? Only they can answer this, based on their current and expected future lifestyle and circumstances. Some people will use a rule of thumb of 75% of their previous earnings just prior to retirement. I believe that is a lazy way out. A few hours of work and discussion can lead to a far more realistic identification of what retirement means to Herman and Mabel in terms of spending goals.

TWO COMMON EXPENDITURE RISKS

Having completed the retirement budgeting process to derive the monthly desired spending, two questions arise.

First, how long will this spending go on? This is the **longevity issue**. A 65-year-old male has a life expectancy of 85 years of age, or 20 years. A current 65-year-old female has a 23-year life expectancy, or until age 88. The expectancy of at least one of the pair surviving extends to age 91, or 26 years.

The problem is that these figures are actuarial averages, meaning that 50% of the group dies before that age and 50% lives longer. When addressing the longevity issue, the risk is not dying young; it is living long. Dying young isn't a great plan. Many retirees' greatest concern is outliving their money. This is a way to describe, in part, the longevity risk.

A married couple has a 25% probability of at least one spouse living until age 96. Of course, family history and current health can give you guidance. But to be conservative in your assumptions, you should plan for the possibility of a long retirement.

The second factor to be considered is that of **inflation**. Inflation, or the rise in cost of goods and services, is highly important. A 3% inflation rate (near historical norms) causes a doubling of costs in about 24 years. Said another way, if it takes $100,000 to support your lifestyle at age 65, it would take $200,000 to support the same consumption at age 89.

Inflation is stated relative to the CPI or Consumer Price Index. Interestingly, an elderly Consumer Price Index, or CPI-E, is also calculated. The CPI-E has historically run about 1% **higher** than the more widely quoted CPI. Ignoring the effects of inflation can lead to very erroneous expectations of retirement needs and spending.

WHAT ASSETS DO YOU HAVE TO MEET YOUR SPENDING GOALS?

I like to break these down into two basic elements of income stream and nest egg. Income stream is comprised of regular payments such as those derived from Social Security, a pension, and other items such as income received from ongoing rental income.

Herman and Mabel have identified their spending goals as $7,000 per month, or $84,000 annually, pre-tax. (Ignore taxes at your peril!) If they have identified Social Security income (which adjusts for inflation) of $2,400 monthly for Herman and $1,200 for Mabel, their nest egg need only support $3,400 per month in current dollars. Pensions and Social Security do not have longevity risk since they continue until death. In fact, if Herman predeceases Mabel, her benefit would move up to Herman's benefit of $2,400 per month.

RISKS SURROUNDING THE NEST EGG

Herman and Mabel's nest egg must support $3,400 monthly or $40,800 per year, adjusted for inflation. How large a nest egg is required? That depends on the investment **portfolio's returns** and the **pattern of returns**.

Rational return expectations (not guaranteed results) can be estimated by historical returns. A portfolio consisting of 60% common stocks and 40% high-quality bonds might be expected to return about 7½% annually. However, even if such a portfolio did just that over time, it is unlikely to do so each and every year. This recognizes that while over 30 years such a portfolio may average a time-weighted 7½% return, it is critical to recognize the scary part of decumulation: the pattern of returns. This is called volatility risk.

The worst situation encountered during decumulation is a period of poor returns early in the withdrawal period. The poor returns, coupled with withdrawals, diminishes the portfolio. When the markets recover, the assets affected by the recovery are fewer because of the withdrawals, so the dollar amount of the recovery is less.

Here is a basic example:

Year 1	$1,000,000	portfolio
	- $300,000	return (-30%)
	$100,000	withdrawal
	$600,000	end of year value

Year 2	$600,000	beginning value
	+ $300,000	return (+50%)
	$100,000	withdrawal
	$800,000	ending balance

Even though the average annual return was positive for the two years, the portfolio declined by $200,000.

Another illustration of the impact of the pattern of returns follows.

Results for Herman and Mabel Using Average Returns
Nest Egg Value

	Return Sequence A	Return Sequence B	Return Sequence C
Withdrawal amount	**$62,000**	$62,000	**$62,000**
Return year 1	**-10%**	+7.56%	**+29%**
Returns years 2-29	**+7.56%**	+7.56%	**+7.56%**
Return year 30	**+29%**	+7.56%	**-10%**
Average return for 30 years	**+7.56%**	+7.56%	**+7.56%**
Results: how long money lasted	**22 years**	**30 years**	**30 years**
Results: value at end	**$0**	$98,000	**$1,543,000**

This shows three scenarios, all of which had annual time-weighted returns of 7.56%. The only thing that varied was the negative first year in portfolio A, versus the positive first year in portfolio C. The last year, year 30, flip-flopped the image. Look at the difference in years the portfolios survived and the ending values. Patterns matter!

HOW BIG A NEST EGG DO WE NEED?

Fairly typical portfolio recommendations for retirees early in their decumulation period suggest between 50% to 60% equities and 40% to 50% in cash equivalents and fixed income investments. The equity portion is highly important because of expected higher returns and the ability to overcome the ravages of inflation. The cash and fixed income investments give stability to the portfolio and create a consistent and predictable income stream. For more information on this idea, you might refer to the last "Financial Insight" regarding a rational approach to the fixed income component and several previous issues discussing broadly diversified equity portfolios.

Testing such a portfolio suggests that a 4% withdrawal rate early in the decumulation period has a high probability to be sustainable. Withdrawals in excess of 4%, coupled with an adverse pattern of investment returns, will result in the probability of success being greatly diminished.

With Herman and Mabel needing just over $40,000 to augment their Social Security income, they will need a nest egg of slightly over $1 million. The nest egg could then fund a portfolio of roughly $600,000 in equities and $400,000 in cash and fixed income.

If Herman and Mabel have not accumulated a $1 million nest egg, they must modify their goals. First, they might delay retirement if possible. An additional year or two in the workforce does several things. It obviously eliminates the need for withdrawals. Their existing nest egg can be added to by continued savings. Also, delaying Social Security adds about 5% to the benefit for each year it is delayed. These factors add up quickly.

If it is not possible to delay retirement, Herman and Mabel must make some sacrifices on the lifestyle and consumption side of the ledger. It is neither prudent nor wise to try to stretch for excess portfolio returns, thus creating a more aggressive or risky portfolio.

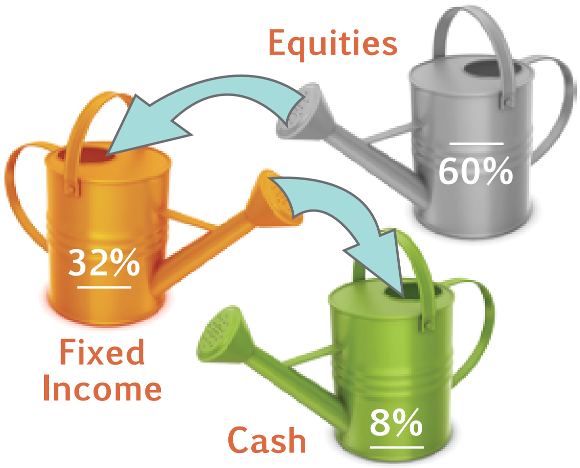
If Herman or Mabel happens to be in the fortunate position of having a larger nest egg, their choices are enviable. Of course, they could choose to upgrade their lifestyle in retirement or they could dedicate these excess investable assets toward fulfilling family or charitable legacy goals.

AN INVESTMENT STRATEGY FOR DECUMULATION

Decumulation requires a great deal of discipline. The discipline to control spending is certainly critical. It is equally important to maintain investment discipline. Either periods of strong market returns or, conversely, periods of negative returns, can lead one to becoming overly optimistic or pessimistic, resulting in poor portfolio decisions. It cannot be over-emphasized that our emotions must be kept in check. Perhaps easier said than done.

I might suggest an approach that addresses some of these issues. I call it the "fill and spill" approach. Referring to Mabel and Herman's $1 million nest egg, it might be deployed in this manner.

- **Cash**. Reserve two years of spending needs in a liquid interest-bearing account — in this case, about $80,000. Having this reserved means that even if we initially face a bad market, we have no need to make radical changes. This peace of mind can remove some of the negative emotional response.
- **Fixed Income**. $320,000 invested in a well-designed fixed income portfolio. The income stream from the fixed income will spill over to replace or fill the cash portion that Herman and Mabel spend. As bonds mature, the principal paid back also spills over to the cash component as necessary.
- **Equities**. The $600,000 invested in equities is allowed to grow but is rebalanced annually to maintain a 60% weighting of the overall nest egg. Amounts greater than 60% spill over into the fixed income bowl. In a bad market, no spillover is created. You stay the course, buffered by the security of your cash and fixed income component.



PROFESSIONAL ADVICE

The decumulation event entails every aspect of **investment risk** coupled with **longevity risk**, purchasing power or **inflation risk** and **pattern of return risk**.

D.A. Davidson & Co.'s Financial Consultants have powerful computer models to help guide you into and through retirement or any decumulation event. These models have the ability to stress test your investment return and expenditure situation to create and understand your likelihood for success. They can create numerous "what if" scenarios surrounding your individual situation.

Your Financial Consultant can help you design, monitor, and modify an investment portfolio appropriate for your needs. Importantly, your Financial Consultant helps guide you throughout your retirement. His or her professional advice is one of your greatest allies in a successful decumulation event.

Enjoy the grandkids!