What We Can Learn About Retirement Investing from Our Grandparents

By Andrew Dodds

Andrew Dodds advocates a retirement planning strategy based on limiting spending in retirement to the yield on investment.

I met a financial advisor who had recently established his practice and was already questioning the timing of his career choice. He was suffering defections among his retiree clients as a result of the recent market plunge. While no one can ignore client base erosion, his embryonic practice could not withstand many more desertions. I wondered how many other advisors were facing their first acid test in today's roiling markets. The difficulty in providing acceptable yields for retirees no longer in a position to generate additional principal is a challenge for every advisor. Given the age difference between youthful advisors and clients nearing retirement, I wonder if a "communications gap" might exist in many of these relationships? Given they had not experienced many economic cycles, I wondered also how much emphasis younger advisors had placed on the planning process versus investment performance? The problem is not limited to neophyte advisors. It appears to me that many experienced advisors tend to downplay the importance of the planning process. The best plans are often those easiest to understand. Our parents and grandparents used a simple plan and it worked pretty well for them. A look to the past may provide a blueprint for the future.

Grandpa Had the Right Idea

Today's retirees probably had parents (and grandparents) whose strategy for retirement may have been unsophisticated, but it was fiscally sound. They bought an apartment building and lived off the rental income. Or they bought stocks or CDs but only spent the dividends. It was an approach originally spawned by living through the depression or hearing about the experience from senior family members. It is the concept of living on the fruit produced by the tree. It was a sound strategy that served people well in the past, and it may be worth emulating today.

One reason investor retirement expectations became skewed was the introduction of the total return concept, born of the bull markets of the 80s and 90s. For the ensuing decades, many advisors and clients came to believe it was perfectly logical and indeed, their God-given right, to earn 20-percent annual return on their retirement portfolio. Worse, investors presumed they could commence spending 10 percent of their portfolio value each year once they reached retirement. Until the recent credit crunch and stock losses, many actually regarded that misguided notion as a conservative retirement approach!

As John Burr Williams said in his classic book, THE THEORY OF INVESTMENT VALUE: "Earnings are only a means to an end, and the means should not be mistaken for the end. Therefore we must say that a stock derives its value from its dividends, not its earnings. In short, a stock is worth only what you can get out of it."

In my opinion, a combination of old-school investment wisdom combined with a realistic spending plan can be the foundation for a sound and secure retirement. This assumes an income model where the payout rate on the stocks and the spending of income received from dividends is analogous to spending no

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more than what you receive from your apartment building rent. It may be a simplistic approach, but it can work as well for today's long-lived retirees as it did in our grandparent's day. It certainly helps prevent clients from outspending their portfolio and jeopardizing retirement. Our grandparents did not refinance the apartment building and pull out the cash. They controlled their spending.

The Conversation Nobody Wants to Have

You may agree that relying exclusively on portfolio income is a great concept, but how do you prevent dipping into principal in flat or down markets when the equity portion of the portfolio is contributing little or nothing towards annual distribution needs? One approach would be to suggest that retirees lower their investment expectations or spend less. They certainly need to gain a better understanding of finance and the markets; it might help them accept that double digit annual returns will not return anytime soon. If their retirement projections are currently based on 10-percent returns, they stand a good chance of having to someday go back to work.

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Another lesson for retirees is that stocks sometimes drop precipitously and simply do not generate any real return for five to 10 years at a time such as occurred during the recent decade. How do clients lacking substantial assets remain retired, particularly if that occurs during the early years of their retirement? Many retiree portfolios were overly allocated to equities in order to generate the total returns needed to meet their retirement wishes. A bear market occurring early in their retirement decimated income projections. The issue is not that there is a 60 percent probability their strategy will succeed: it is that there is a 40 percent probability it will not and what do they do if it does not? Monte Carlo simulations may be useful instructional tools, but they can be difficult to communicate effectively.

Granted, these are not conversations most advisors are eager to have with their new or existing clients, but our obligation to them requires we have a plan in place to deal with these possibilities. I have had conversations with advisors whose clients told them they could handle risk only to bail at the very bottom of a market slide. Many retirees can only deal with risk when the market is going up.

Case Study

A former client of mine retired in 2000. I advised him to work one or two more years because I believed he needed to accumulate more assets to support his retirement spending, but he decided to retire anyway.

In his first year of retirement, he purchased a new 3,000-sqare-foot home, a $60,000 luxury car, and he joined a golf club. He insisted we invest 100 percent of his portfolio in equities, despite our warnings. We refused his request and finally got him to sign off on a mix of 80 percent equities with the balance in bonds and cash equivalents.

We told him how much he could safely spend but he ignored our warnings and spent double that. His profligate lifestyle and excessive overhead caused him to spend the cash and fixed income portion of his portfolio in the first year! We were then forced to consistently sell off investments to fund his depleted cash account, often at less than advantageous prices. The combination of too much spending and too much risk were disastrous. A year or so after leaving us, he became penniless.

There are only two elements of retirement planning that can be absolutely controlled, risk and spending. The client refused to control either. He was the catalyst that prompted me to decide not to supervise another meltdown. Today, I refuse to work with anyone who ignores the laws of finance or will not abide by reasonable spending limits and reasonable and appropriate portfolio risk.

What Is Our Role?

As advisors, we are as much in the business of behavioral finance as we are in investment management. Getting clients to stay the course and do the right thing for themselves can be our greatest responsibility. Our role goes beyond seeking optimal investment returns for our retiree clients. We must also try to protect them from their own misconceptions regarding risk tolerances. Most retirees lack a

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realistic perspective regarding risk. Unfortunately, that disconnect does not become evident until they see an account statement showing they have less money as the result of a market slump or an inappropriate asset allocation.

We also must help retirees better understand returns. Most think in terms of annual returns but fail to consider how much of the return is in the form of income and how much is from capital gains. Theoretically, if the stock market is flat for a decade and dividends generate two percent, their annual return equation and possibly their lifestyle can change drastically, the result of spending down capital.

If we can help clients avoid overreactions to market movements and confusion regarding risk and returns, we have a much better chance of keeping retirement portfolios in an asset allocation that provides a reasonable measure of capital preservation during difficult periods. This can be as much a psychological exercise as an investment management directive.

How do we tie this into planning? Is there a connection between today's optimal planning and our grandparent's ability to stick to a spending regimen and do without when necessary? Obviously, no strategy can guarantee success, but a strategy that has resonated well with our clients is the control they feel by targeting a "yield" that equals their spending rate. Dividends from stocks plus interest of tax-free bonds or other yield investments help the client to feel more in control. Because the client is only spending the yield, it helps him deal with volatility and reduces the temptation to sell out if the portfolio drops.

It is ironic that despite Monte Carlo simulations, portfolio optimization software and other technology advances, the most reliable investment strategies may be the simple plans employed by our grandparents. This uncomplicated approach exemplified the saving, spending and lifestyle mindset that I believe will be back in vogue during the next decade. Turning back the clock may provide some clarity for the future.

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