Risk Control along the Glide Path

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Timing matters, and it matters before and after retirement.

The growth of a lump sum investment is independent of the sequence of returns in an investment portfolio. However, when money is being invested annually the sequence of returns does matter. For example, a $2,000 annual investment in a 60% equity/40% fixed income portfolio grew to about $800,000 over the 39-year period from 1970 to 2008. If the returns are reversed (meaning we start with 2008 and end with 1970) the final account balance is about $1.2 million. The $400,000 difference is a result of encountering the meltdown of 2008 at the start of the 39-year period (when the account value was very small) versus at the end of the period (when the account value was very large).

Even more dramatic is the impact of the return sequence in a retirement distribution portfolio when money is being withdrawn annually. Let's assume a starting balance of $500,000 at retirement and a withdrawal of 5% (or $25,000), adjusted annually based on cost-of-living increases of 4%. The portfolio allocation is 40% equity/60% fixed income. Using actual returns from 1970 to 2008, the ending balance of the distribution portfolio was over $4 million (as shown in the first graph). But, what if a really bad event happened in the first year of the withdrawal period? Reverse the returns – assume 2008 happened first – and, as seen in the second graph, the portfolio was depleted after 32 years, leaving the hypothetical retiree broke for their final seven years.

Most target date funds are currently designed to serve participants through both accumulation and distribution. Accordingly, they really should be renamed target "death" funds because the implied target year is not the year of retirement, but the investor's death date. We believe extending the "auto-pilot" glide path beyond the stated target date is a mistake. Doing so overlooks the critically important transition phase from "accumulation" to "distribution" that occurs from five years before retirement to five years after retirement. The year 2008 is the only proof we need.

Bottom line: controlling risk in retirement portfolios is the highest priority. For guidelines on building target date funds that implement prudent risk control visit us at www.TDBench.com.

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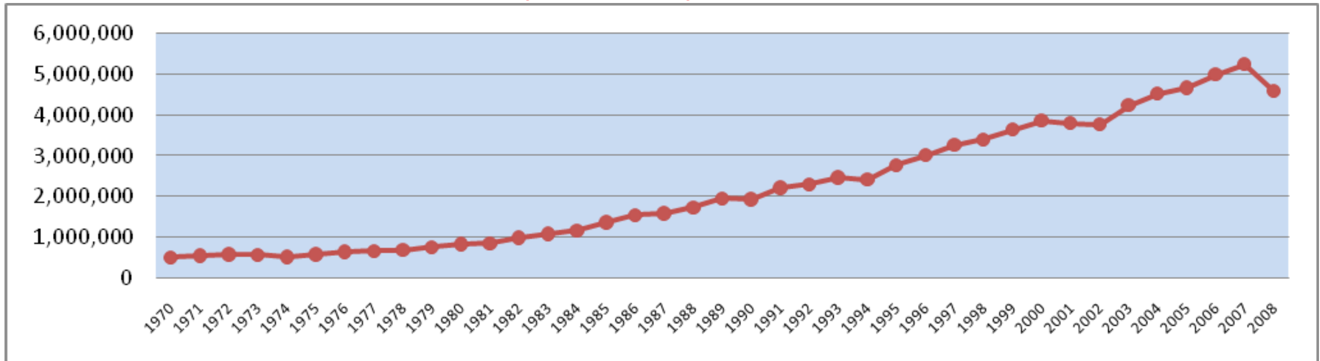
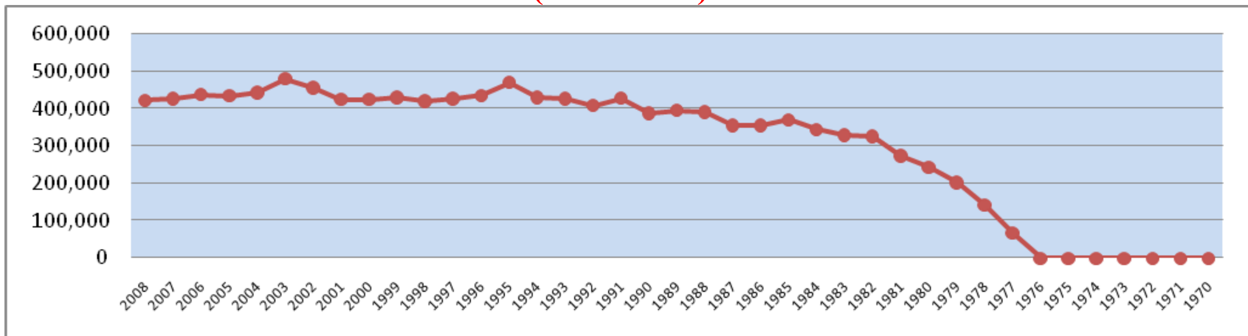
Normal Annual Returns (1970 - 2008) for a Distribution Portfolio



Reversed Annual Returns (2008 - 1970) for a Distribution Portfolio



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