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Retirement and ROI- Reliability of Income versus Return on Investment

Saving for retirement is a very hot and important topic in most developed countries across the planet.

Western economies' fiscal balances are stretched by the stimulus efforts following the financial crises. Although it is five years behind us, and there have been an array of stimulus packages, the effect remains an omnipresent burden on government budgets. Adding to the burden is the aging of Western society. Our country has been fortunate to have decreasing mortality rates in recent decades and high relative income of the post World War Two period; combined with relatively high fertility rates, we have seen significant growth in population and the so-called "Baby Boom" . The initial wave of 1946 and 1947 births in the US is hitting retirement now with less confidence and greater uncertainty than many prior generations.

The disappearing yields of the last decades have not been kind to this generation. Here is a table of yields calculated as the average of investment grade corporate (BBB) corporate and ten year Treasuries and the resultant monthly annuity amount based on $100,000 initial savings and a 20 year life expectancy:

	1960	1970	1980	1990	2000	2012
Average Yield	4.92%	8.33%	11.61%	9.08%	7.48%	3.28%
Monthly Annuity Amount	$655.54	$857.09	$1,074.02	$904.88	$804.37	$568.72
Life Expectancy (yrs)	69.7	70.8	73.7	75.4	76.8	78.9

The deflationary impact of deleveraging, combined with QE Rounds 1, 2 and 3 has led to a very painful squeeze on savings and yields.

Regrettably, the conservatism that most of us have grown up with that encouraged taking less risk as we age has not paid off and in fact, has hurt the probabilities of having a successful retirement. People approaching retirement have more to lose and less time to recover from bear markets. Typically, they want greater certainty as to how much they can safely spend in retirement and less risk that a decline in the value of their investments will demolish their retirement plans.

Most of us who are involved in financial planning have counseled our clients to embrace this flawed premise of buying more fixed income the older we get. Extrapolating the wisdom and experience of the past has caused more consternation than confidence. Rather than retirement bliss, many seniors face a retirement abyss. Simply put, the past is not prologue. Forty years of sensible savings has given us a pretty lousy future spending stream.

Making matters worse is the reality of governments around the world extending the retirement age to receive benefits. For example, the French government faced riots last year as the retirement age was extended to 62 from 60. Spain is lifting the retirement age and cutting down on early retirement for the second year in a row as part of its debt-reduction efforts. Greece, as part of its austerity, is lifting retirement to 67 from what three years ago was 53! Who knows how long the US can maintain full retirement age at 67 for those born after 1960?

From a human point of view, lower realized mortality rates constitute positive news. Unfortunately, for both government and corporate defined benefit (DB) pension plans this increases the average length of time over which benefits are provided and, given that the size of global DB pension promises is substantial, means the potential costs of longevity risk are worthy of serious examination. A recent IMF paper, **"The Impact of Longevity Improvements on U.S. Corporate Defined Benefit Pension Plans"** suggests that the impact of an additional year of life expectancy on the liabilities of both U.S. private and public pension funds corresponds to an amount equivalent to 1.5% of U.S. Gross Domestic Product (GDP). At a time when GDP growth is strained at best, the negative impact of increasing pension burdens strains all systems. On a global basis, the aggregate value of private DB pension liabilities amounts to $23 trillion, implying that a similar longevity shock could raise global private pension liabilities by as much as $2.8 trillion.

According to a recent survey by Credit Suisse, nearly all U.S. defined benefit pension funds are already underfunded, at an estimated 97% of companies? Defined benefit plans owe workers $2 trillion in payouts, and they have only $1.5 trillion in assets set aside to cover them, according to estimates by consulting firm Mercer. Like the federal budget deficit, this private sector deficit just keeps widening. Needless to say, corporations are attempting to extricate themselves from this mess by freezing DB plans and moving into defined contribution plans to reduce these liabilities.

Though the message in the US is muted by electoral rosy tinted glasses and politicians who are whistling past the grave, the message elsewhere and from the corporate sector is quite clear…we will need to learn to get by on our lifetime savings and we have to become much more self-reliant when it comes to our retirements.

Following the experience, of 2008, many investors have embraced yield wherever they can find it. With yields on Treasuries, municipals, and high-grade paper so low as to be insulting, and the Fed's intent to maintain short term rates at extremely low rates, these distortions have encouraged many investors to chase high yield. Involvement in high-yield stocks, REITs, and preferred stocks can be alluring and appear falsely prudent. The argument is that putting a higher reliance on the income stream preserves capital by not forcing us to liquidate assets to pay our bills.

In a yield-starved world, high-yield bonds have become acceptable and a bit of a misnomer. With their yields at about 6.5%, and some recent issues having a '4' handle on the coupon, the rates seem dangerously low to me. Even worse, many closed-end funds which use junk bonds as their mainstay universe also deploy 30% or greater leverage to lure yield hungry investors. The giddiness of the junk bond market has allowed many questionable issuers to access more capital and lower costs than they "deserve," in my view.

Reaching for yield in the municipal markets requires acceptance of very long maturities and hence, very long durations. This leaves portfolios vulnerable to significant downside if interest rates embark on a long march upwards at some point.

Finally, a strategy that is wholly reliant on fixed income leaves a portfolio vulnerable to inflation, which has generally been the largest risk to investors over decades of retirement. Four percent yields may meet required minimum distributions out of qualified accounts, but do little to maintain purchasing power over an extended period of time.

So what is the solution? Typically financial planners have separated income and growth, meeting current spending needs with interest and dividends and pursuing growth with stocks. Institutionally, investors such as foundations and endowments have taken a more blended perspective to meeting their income needs, combining income and capital appreciation. I believe this is a far sounder approach for coping with unanticipated inflation and preserving long-term purchasing power. Hence, I think retirees need to be more focused on total return from a portfolio, not just the income that a portfolio "needs."

By looking at an overall portfolio of stocks and bonds, it is feasible to embrace volatility, selling off bonds in periods such as we have had in recent years and purchasing stocks. Generating cash flow should come from the sale of the most expensive assets in order to achieve re-balancing and to recalibrate portfolios. Trimming bonds when their prices have surged to meet withdrawals makes far more sense than dedicating ever larger allocations to fixed income in order to meet spending requirements.

Rather than hoping for a repeat of the past, which achieved substantial returns earned on a foundation of far higher yields than today's yields, we should probably shape expectations based on the current outlook.

As we all know, we are generally compensated for taking equity risk over longer periods of time. At current yields, I believe we need to develop a strategy of "Ownership" rather than "Loanership." In other words, invest capital in equities rather than lend it through bonds.

I continue to believe that we can be successful in these markets. Rational, unemotional thinking can help you find your way to some decent values. The key to successful investing is maintaining a discipline, maintaining patience, and avoiding emotion.

Great investors have a strange capacity to suffer. And the best returns develop from those times when you suffer the most. There is rarely a bell-ringing moment that tells you are looking at a bottom. We try to fight the complacency that we could succumb to in bear markets, that feeling of why bothering to do anything, because next month the price will probably be cheaper.

Finally, I think as we look back on this period I believe that we will have learned that yield on fixed income instruments is not as important as ROI***. ROI in this case refers to reliability of income, not return on investment.***

Old models of retirement planning simply have to come to grips with benchmark yields that provide little basis for future spending. Intelligent allocation will win the retirement funding battle.