
Should retirees own any stocks? It seems ridiculous to ask that question. Of course, they should. People are living longer than ever before and need higher returns on their assets to see them through an extended retirement. And many target date funds are responding by maintaining elevated amounts of stocks through at least the early years of retirement. **How else to get those returns than from stocks?** Not so fast, says economist Allison Schrager who wrote a recent article for Quartz asking the provocative question:

> ***?If you?re about to retire, should you pull out of the stock market??***

After all, weeks such as the last one remind investors that stocks are far from a sure thing, and can vaporize wealth quickly. It?s true that most people haven?t saved enough to retire easily, and stocks ? or the returns they?ve historically provided -- may be a way to overcome savings shortfalls. But there are two problems with this argument. First, stocks may not deliver the returns we have grown accustomed to receiving from them. The best indicator of long term ? say, future ten-year ? returns is the Shiller PE, which is the current price of the market relative to the past decade?s worth of inflation-adjusted average earnings. That metric is over 30, despite last week?s correction. It?s two highest readings previously have been 34 in 1929 and 44 in 2000. And stocks did poorly from those two peaks over the next decade. Basically, it's very hard for stocks to perform well for the next decade starting from this valuation.

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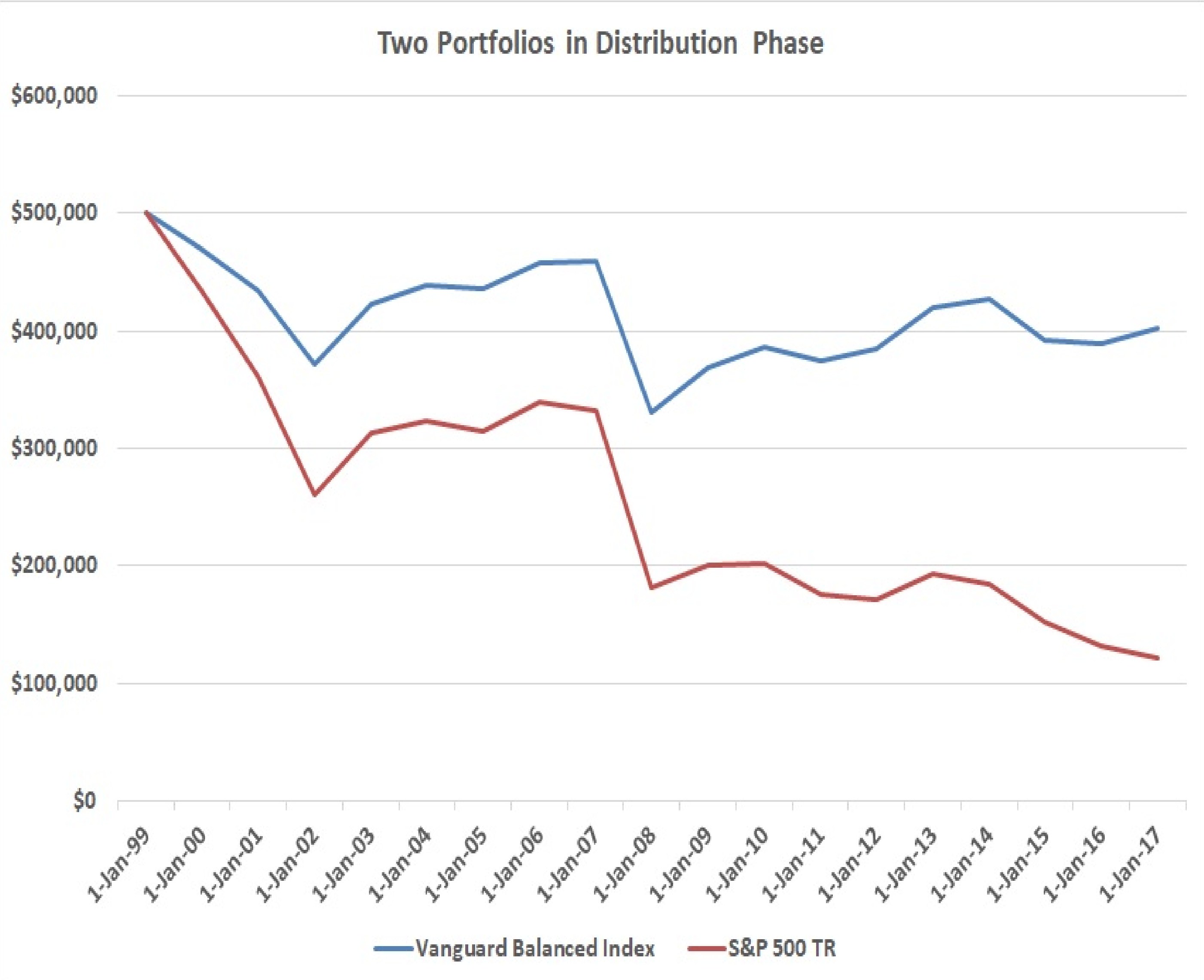
**Because of their high valuations, stocks may not outpace bonds.** The 10-Year US Treasury is now yielding around 2.8%, and investors can own an index of investment grade corporate bonds that pays nearly 3.6% in the form of the iShares Investment Grade Corporate ETF (LQD). And if investors can get a highly probable return of over 3% from bonds, it?s not clear that domestic stocks will outstrip that by a lot or even at all. Moreover, the volatility stocks often deliver can destroy retirement plans, even if stocks eke out higher average annual returns than bonds. This is because of something called ?sequence of return risk.? That basically means that ,during distribution phase, when and how returns are delivered matters at least as much as the average annual return itself. I did a study of two portfolios ? one all domestic stocks, and one balanced ? starting in 2000 using the famous ?4% retirement rule.? That means the retiree is taking 4% of the portfolio as income in the first year and boosting the first year?s dollar payment by 4% every year thereafter.




Source: Morningstar, Yahoo!Finance

The results are ugly for the all-stock portfolio, which reduced the account by nearly 80% after 18 years at the end of 2017. **The balanced portfolio, by contrast, was reduced by only 20% of the original balance after 18 years of applying the 4% rule.** The starting point for the test is admittedly random, and it includes two big stock market drawdowns. But it shows how an unfortunate starting date combined with a lot of stock exposure can hurt a retiree. None of this is to argue that retirees should eliminate their domestic stock exposure altogether. **Stocks may outpace bonds over the next decade, after all; we?re just saying the chances of that happening are low.** Also, foreign stocks, especially emerging markets stocks, present better valuations, and their likely future returns are at least somewhat higher than what their domestic counterparts are offering. Although many mutual fund families have target date funds that contain more than 50% stock exposure at the time of retirement, Schrager says the average target date fund in Morningstar?s database has 40% of its assets in stocks. That?s meaningfully lower than the classic balanced portfolio, which has 60% in stocks. There?s a big difference between having 60% stock exposure and 40% stock exposure. In 2008, for example, a portfolio that had 60% in the S&P 500 and 40% in the BloombergBarclays U.S. Aggregate Bond Index lost around 20%, but a portfolio that had the reverse exposure ? 40% stocks and 60% bonds ? lost around 13%. That?s a big difference for retirees taking 4% or more from accounts in income. There are limits to how much stocks can help savings shortfalls in retirement. Don't put a burden on them they're not equipped to handle. **As always, your stock exposure depends on your personal risk tolerance *(which is much harder to estimate than you might think),* your spending needs, and how well funded you are.** But Schrager is correct to note that things are different in retirement than they are when investors are saving or accumulating assets. As Bill Sharpe, whom she quotes, says, investing in retirement is *?the nastiest, hardest problem in finance.?*