Debunking the “safe instruments for retirement” myth

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MOST statements in life, when repeated often enough, will be taken as the indisputable truth. This is especially the case if our general, everyday observations sort of suggest that the statements are right. Few will stop to question their validity – what are the assumptions embedded in those statements, who made those statements and to what purpose, have robust tests been done to verify claims made in those statements.

In the field of finance, one wisdom which is often purveyed is that of life cycle investing. The theory goes that young people should be more aggressive in their investments, i.e. they should allocate a higher proportion of their portfolios to equities for the long term compounding effect to take place. But as a person nears retirement age, he or she should cut their exposure to equities and hold more of their portfolios in bonds and cash.

This makes intuitive sense. Equity prices are more volatile than fixed income instruments, and unlike the latter, there is no assurance of regular pay-outs from equities. As such, it would be “safer” for retirees, who are dependent on their life savings for their daily expenses, to park their money in a less volatile portfolio.

What if the retiree had her entire life savings in equities, and saw her portfolio diminish to less than half during the global financial crisis in 2008? That would be a nightmare scenario, wouldn’t it?

But here’s the thing. Image of this scenario is likely to be most vivid when the stock market crash is at its worst. At that point, we see in our minds retirees with their wealth halved compared to the pre-crisis level. “Poor thing!” we’d think. “That’s why, retirees shouldn’t put all their nest eggs in the stock market.”

Market recovers

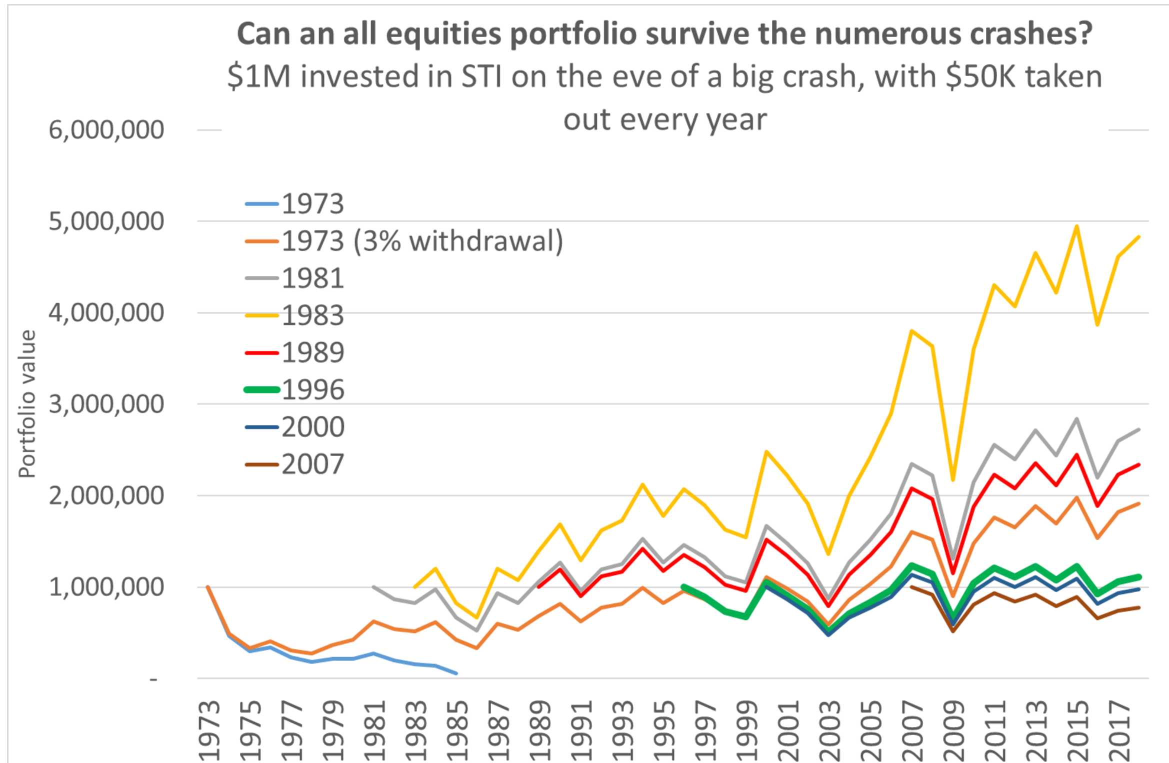
But you know what? Market recovers even from the worst of crisis. As long as a retiree doesn’t panic and cash out the entire portfolio at the bottom of the market, there is a good chance that she would see her portfolio recover.

I did a stress test on an all-equities portfolio at each of the previous market peaks in the Singapore market going as far back as 1 Feb 1973 – the earliest available data from Reuters Datastream. Let’s assume that there were seven retirees. Each retired with $1 million and decided to put the entire sum into the stock market. The bull markets at the time of their retirement gave them confidence that the stock market was a good place to keep their savings. So each of them plonked their $1 million into the market on the first of February in each of the following years: 1973, 1981 1983, 1989, 1996, 2000 and 2007. And each wanted

to withdraw 5 per cent from that $1 million, or $50,000 a year, to pay for their living expenses.

As it turned out, the years that the seven retirees put their money into the market were the years of market peaks, i.e. worst possible times to put money into the market. Soon after, major crashes or market corrections took place.

Can the $1 million equities portfolio last them till today?



The chart above shows the portfolios of the seven retirees after accounting for their 5 per cent withdrawals every year. And the table below shows where the portfolios stand as of 26 April 2017.

An all equities portfolio for retirement							
A five per cent withdrawal is "safe" enough							
Retired on 1 Feb:	*1973*	*1981*	*1983*	*1989*	*1996*	*2000*	*2007*
				$'000			
Initial portfolio value	1,000	1,000	1,000	1,000	1,000	1,000	1,000
At 5% withdrawal							
Amount withdrawn:	650	1,800	1,700	1,400	1,050	850	500
Portfolio as at 26 April 2017	Port depleted in 85	2,726	4,833	2,335	1,112	977	777
Portfolio at its lowest		528	670	789	508	477	513
At 3% withdrawal							
Amount withdrawn:	1,290	1,080	1,020	840	630	510	300
Portfolio as at 26 April 2017	1,913	5,982	7,616	3,921	2,057	1,627	1,045
Portfolio at its lowest	272	610	720	937	624	525	545
Source: THL, Inclusif Capital							

Six out of the seven portfolios survived. The initial $1 million portfolios were worth between $777,000 and $4.8 million as at April 2017. For the person who retired in 1 Feb 1983 with $1 million invested entirely into the Singapore stock market, her portfolio as at 26 April 2017 using the total return of Datastream-calculated Straits Times Index as a proxy was worth $4.8 million. This was after she had withdrawn $50,000 a year for the last 34 years for a total of $1.7 million from the portfolio.

As for the person who retired on the eve of the Asian financial crisis, her portfolio at 26 April this year was worth $1.1 million (see table above). Twenty one years after she retired, after taken out $1.05 million from her original $1 million retirement sum, and having subjected her entire portfolio to the ravages of the dotcom bubble burst in 2000, the Sept 11 terrorist attacks in 2001, the SARS epidemic in 2003 and the Global Financial Crisis in 2008, her portfolio is today still higher than the original $1 million that she put into the market back in 1996!

From the table above, you can see that the retirees who retired on the eve of the two most recent market crashes – the dotcom bubble burst in 2000 and the global financial crisis in 2008 – still have $977,000 and $777,000 in their portfolios respectively.

At five per cent withdrawal rate, besides the person who invested in 1973 and saw her money run out in 1985, the lowest the other six retirees' portfolios ever fell to was $477,000. That was for the person who retired just before the dotcom bubble burst. But as long as there is still money in the market, there is a chance of recovery.

The only retiree whose portfolio didn't survive was the one who put her money into the market during the massive 1973 bubble in the Singapore market. At that time, according to data from Reuters Datastream, the Singapore index was trading at a price-earnings ratio of 35 times. It was the time when OCBC was trading at $50 a share and Metro was at $26. In other words, the Singapore stock market at that time was way over valued.

At a 5 per cent withdrawal rate, her money was depleted by 1985. But if she had reduced her withdrawal rate to 3 per cent, i.e. take out $30,000 instead of $50,000 a year to spend, she would have survived the numerous crashes that followed and she would still have an equities portfolio of $1.9 million as at 26 April this year.

As mentioned, for the above calculations, we use the total return of Reuters Datastream calculated Straits Times Index as a proxy for how an all equities portfolio would have performed. Total return means capital gains plus dividends reinvested. No transaction costs are taken into account. The portfolios were valued once a year on 1 Feb, except for the latest figure on 26 April 2017. Withdrawals are assumed to be done on 1 Feb as well.

Main takeaways

So what are the main takeaways from the above study?

It is that, chances of an all equities portfolio being completely wiped out at a withdrawal rate of five per cent a year is minimal under **normal market conditions**. The exception is when someone buys into the market at the peak of a massive bubble, as was the case in 1973. (For readers who would like to stress test their retirement funds over various cycles in the US going as far back as 1871, you can go check out the website <www.firecalc.com>.)

Also for the above study, I used the Straits Times Index. If one is able to construct a portfolio of stocks that can outperform the market index over time, than there is an even greater margin of safety.

Another noteworthy point is that as long as the portfolio is not too decimated, and so long as the money stays invested in the market, there is a good chance of recovery given time. But admittedly, the ride can be quite rough at times. The portfolio can plunge by half in a year. The key is to hang on tight.

So the upshot is that someone who has $1 million can relatively safely withdraw $50,000 a year to fund his or her retirement for as long as they live, and yet still leave an estate for their loved ones or favourite causes if they put the entire sum in the equities market!

Time to say goodbyes to perpetuals, annuities and bonds – which usually form the core of a retirement portfolio!

But there is one very important caveat here. The equities portfolio must be made up of a diversified basket of stocks of real businesses, and purchased at cheap or fair prices which are not likely to result in a significant permanent loss of capital. Buying into speculative stocks which have scant business prospects and at way overvalued prices, is a sure-fire way for one to outlive that $1 million in the shortest possible time.

Teh Hooi Ling is a multiple award-winning financial journalist turned fund manager. Her articles have been compiled into eight best-selling books under the Show Me the Money series.