BUSINESS

Road to Retirement: Retired, now what should you do?

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If you are retired and need to live off distributions from your portfolio, this is a particularly challenging time. The rule of thumb advice to just "wait out bad markets" doesn't work that well when you need money every month from your portfolio. As John Maynard Keynes is credited with saying, "the market can stay irrational longer than you can stay solvent." Yes, markets will recover, but will they recover before you run out of money?

Let's look at some prior recovery cycles to get a sense of how long this particular crisis could last. In the technology bubble that burst in early 2000, the S&P 500 declined about 50% from its high and took almost seven years to recover. In the financial crisis that started in late 2007, it took the stock market about 5.5 years to recover. Those are the most recent data sets to consider and likely the most relevant.

So, what does that tell you? It tells you that in a big financial crisis, you should consider that it can take five years or more for the value of your stock portfolio to recover. Consider if you take 4% per year (the generally recognized base distribution rate for retirement) for five years, you've consumed 20% of your portfolio. If you do that during a period when the portfolio falls 50%, you are digging a big hole. As the saying goes, when you find yourself in a hole, stop digging.

If you are retired, you've got to avoid taking distributions from stocks while they are down. Moreover, at the start of any crisis, you should plan on not taking money from the stock part of your portfolio for at least three to five years. Now, the market could come roaring back and maybe it won't last that long, but you should plan for that. Because if it does take that long and you don't have a plan, you're in deep trouble.

Photograph by Ellen Jaskol

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If you have to take money from the nonstock part of your portfolio for at least three to five years, that means you'll need a minimum of 12% to 20% of your money in something other than stocks (assuming you take out 4% per year). But you'd also want an additional margin of safety because what if a recovery takes seven years like it did after the technology bubble? That means you'll need almost 30% in something other than stocks.

Maybe you are now feeling like you shouldn't have anything in stocks because they are so prone to these huge collapses. But the problem is there is no safe place for your money that provides the opportunity to earn enough to cover a 4% annual distribution. The bond market, which is the place retired investors generally went for income and safety, now provides little or no income return. Thus, it's hard to live off your money for 30 years with no return.

If you have a financial adviser and you aren't sure how things are structured for this crisis, you should talk to them and make sure you have a plan for these scenarios. But if you don't have anyone you can talk to, here are three suggestions that may help.

First, use your interest and dividends to help meet your distribution needs. If you have a diversified portfolio of stocks and bonds, you probably can generate 1.5% or so in cash flow, and that can serve as a portion of your 4% distribution. Remember, using interest and dividends does not consume principal because these are payments being made to you as an investor. That means you only need another 2.5% from somewhere else.

Second, consider keeping at least 30% of your funds in stable assets, that means cash, FDIC-insured CDs, Treasury bonds, or other high-quality diversified bonds. This gives you a reservoir to tap while your stocks are down.

And finally, cut your distributions. While you might like to live on 4%, in a financial crisis, anything you can do to reduce distributions will improve the survivability of your portfolio. I know it's not fun to live on less, but most of the working world will be living on less for the foreseeable future, as people lose their jobs, see bonuses disappear and salaries reduced. If you are retired, consider cutting your distributions to survive this. I expect if you do these three things, you're likely to both make it through the crisis and be in a position to grow your portfolio once the crisis is over.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.