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The Problem With Bonds in a Retirement Portfolio

One problem with relying on a bond portfolio in retirement is that the income can't last forever, says Wealth Management Expert Benjamin Harris. PHOTO: GETTY IMAGES/ISTOCKPHOTO

By

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Most investors are probably familiar with the 60/40 rule-of-thumb dictating that portfolios hold 60% of assets in equities and 40% in bonds. For retirees, the 60/40 rule can provide a low-volatility way to see assets grow while providing income through the bond side of the portfolio.

But when it comes to retirement planning, are bonds the best path to a predictable cash flow? For many retirees, probably not.

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One problem with relying on a bond portfolio in retirement is that the income can't last forever. Retirees who have been out of the workforce for years or decades might very well need to dip into the bond principal to meet expenses, which means the bonds collectively provide less income. Over time, the compounding effects of this cycle may be severe. Long-lived retirees may wish they had chosen a different path.

The challenge is closely related to what economists refer to as "longevity risk"—the notion that nobody knows how long they'll live. A 65 year-old woman, for example, has a 15% chance of dying in the next decade, but also has a 13% chance of being alive 30 years later.

In the face of this tremendous uncertainty, risk-averse retirees may stockpile their savings due to a fear of outliving them. The result is that retirees end up spending less on all the things that make for a happy and comfortable retirement.

Many economists think there is a better way. Enter income annuities, which provide a stream of income for life. Economists tend to favor annuities because these products are well-suited to address longevity risk. After all, if we knew the precise date of our deaths, bonds would win out every time. But since longevity is inherently uncertain, the best way to handle it is through insurance. And income annuities can (and should) be thought of as insurance against outliving assets.

The real benefit of income annuities, though, isn't that they pay income for life, it's that they mitigate the impulse to stockpile. As retirement expert Wade Pfau explained, annuities provide "a license to spend more from the outset of retirement." Put differently, it's a lot easier to spend hard-earned retirement savings if you know an annuity payment is coming for the next 30 years.

Economic models can help quantify just how much the certainty provided by annuities

THE EXPERTS

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means to the typical retiree. A recent paper by economists Vanya Horneff, Raimond Maurer and Olivia Mitchell found that retirees who put 10% of their 401(k) wealth into a deferred annuity—an income annuity that pays out at advanced ages—will boost spending by $700 per year for the average 85-year-old retiree.

There are of course drawbacks to investing the nonequity part of the 60/40 portfolio in annuities. A person dying young will have less to leave to their heirs. Fees paid for annuities typically dwarf those paid for bonds. And many income annuities do carry some risk, like rising inflation or the minuscule chance of default.

But when it comes right down to it, unknown longevity is the biggest risk faced by any retiree. And the only way to mitigate unknown longevity is to include an annuity in your retirement portfolio. In the end, your financial comfort in retirement shouldn't depend on how long you live.

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