DOW THEORY FORECASTS®

Think long term . . . in retirement

It's not unusual for new retirees to strip an investment portfolio of risk by eliminating stocks. After all, some argue, you can't afford to lose money if you no longer earn income to make up for investment shortfalls.

The reality, however, is that you cannot afford not to take some risk with your investments, even at or in retirement. And history suggests you can prudently take on more risk than you probably think.

An American retiring at age 67 today has a life expectancy of 16 years (men) to nearly 19 years (women). That's a long time for your money to last. But it is also long enough to handle some risk in your investment portfolio.

Individuals with time horizons of at least five years have historically done well in the stock market. Consider these statistics:

• According to Morningstar's Ibbotson Associates, a portfolio invested 100% in large stocks posted positive returns in 65 of the 89 years since 1926, for an annual winning percentage of 73%.

• Lengthen the time horizon to five years, and there have only been 12 rolling periods out of the 85 since 1926 in which stocks lost money, a winning percentage of nearly 86%.

• In 10-year rolling periods since 1926, large stocks lost money only four times in 80 periods — a winning percentage of 95%.

• Finally, there has never been a 20-year rolling period when large stocks didn't produce a positive return.

The story is pretty much the same for small stocks. According to Ibbotson:

• Small stocks have posted positive returns in 62 of the 89 years since 1926, a winning percentage almost as good as large stocks.

• For five-year rolling periods, small stocks matched the nearly 86% winning percentage of large stocks.

• Small stocks have done better than large stocks if held for 10 years, with a winning percentage of nearly 98%.

• And, just like large stocks, there has never been a 20-year period when small stocks lost money.

These high winning percentages for all-stock portfolios beg the question — could investors boost their odds by reducing risk with bond exposure?

The answer is yes. Portfolios consisting of large stocks and a 10%, 30%, 50%, 70%, and 90% allocation to bonds all have higher winning percentages across one-, five-, and 10-year holding periods than a 100% large-stock portfolio.

A 30% stocks/70% bonds portfolio offered the best winning percentage, producing a positive return in 72 of the 89 calendar years since 1926, and positive returns in every five-year, 10-year, and 20-year period. Furthermore, the 30% stocks/70% bonds portfolio was less than half as risky (measured by annual standard deviation) as the 100% stock portfolio.

But before you rush out to add a lot of bonds to your retirement portfolio, remember that cutting your equity allocation via bond exposure reduces expected returns. For example, while a 30% stock/70% bond allocation has a higher winning percentage across all time periods than an all-stock portfolio, its average annual return was three percentage points below the all-stock portfolio since 1926.

Conclusions

• While the historical trends are strong, outliers do occur. Although rare, there have been 10-year periods when stocks produced negative returns.

• For most investors, going to all cash or bonds at or in retirement is a mistake. Your investment time horizon is probably longer than you think, which means you can take some risk.

• Nearly all retirees should maintain some exposure to stocks, regardless of age. If you are searching for the allocation that will give you exposure to stocks but still allow you to sleep at night, consider 50% stocks/50% bonds or 30% stocks/70% bonds.

• If you require big returns from retirement investments to maintain your lifestyle, you will need to own mostly stocks. Since 1926, a portfolio 100% invested in large stocks has averaged an annual return of just over 10%. In our view, 10% is probably too high an expected return even for a fully invested equity portfolio — but you won't get anywhere near 10% with bonds.