Afraid of retiring into a bear market? Tips to hedge bets

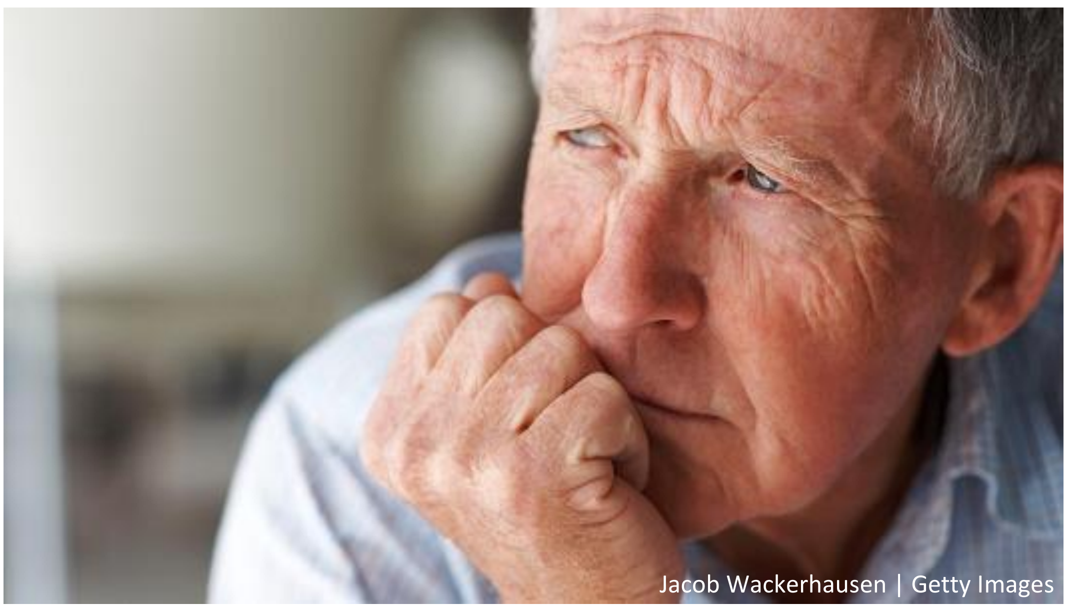
Scott Bishop, director of financial planning at STA Wealth Management

Sunday, 23 Nov 2014 | 9:00 AM ETCNBC.com

Who would want to retire into a bear market? Certainly stocks are roaring now, but the problem is, we never know when one will happen.

Bear markets are defined as a decline in the S&P 500 Index of at least 20 percent from the previous high. They are not infrequent and have happened, on average, about every three years over the last 80 years, with an average decline of 35 percent.

So for all the talk of 2008–2009 being the "worst recession since the Great Depression," the S&P 500 losing 37 percent in 2008 was very close to that average decline. Even with this in mind, it seems that we, as investors, are surprised every time there is a market correction or bear market.



Jacob Wackerhausen | Getty Images

Each year that we work allows us to earn and save more money to replace capital lost in a market correction. Moreover, the money we invest toward the bottom of that correction earns a great return during the recovery.

However, in retirement—when you are not working—not only can you not replace that lost capital with future income, your predicament is compounded by three additional factors: You have less time for the market to correct itself; the loss of the market is compounded by the fact that you are withdrawing money from your portfolio to live on each year; and bear markets can lead to uncertain times, which leads to bad investment decisions.

As a financial planner, I work with clients as they prepare to enter retirement. Like many financial planners, I utilize sophisticated financial-planning tools to project various outcomes in retirement so that I can help retiring clients answer their No. 1 question: "Will I run out of money if I retire?"

In running all the scenarios, whether using traditional straight-line financial-planning software assuming 6 percent to 7 percent average returns, or even using more sophisticated, Monte Carlo simulations, it is very possible for a client whose projections show a very high likelihood of success to still run out of money if they retire into a bear market.

A Monte Carlo simulation is a problem-solving technique used to approximate the probability of certain outcomes by running multiple trial runs, called simulations, using random variables.

A 2014 T. Rowe Price retirement research report ran Monte Carlo simulations to show that a client with a balanced portfolio who withdrew 4 percent of the portfolio assets the first year and grew that distribution by 3 percent annually had an 89 percent probability of sustaining those withdrawals for 30 years of retirement. In the financial-planning world, it was a winning plan.

I wanted to test that "winning plan" to see how it would fare in the first 10 to 20 years of retirement using recent market returns. To do this, I used the return figures from 1991 to 2010 for the S&P 500 Index, the iShares Core U.S. Aggregate Bond ETF and even a balanced (50/50) split of both indexes.

I used the same withdrawal and inflation assumptions from the T. Rowe Price study, gave the retiring individual a portfolio of $1 million and started his first year in retirement with a $40,000 distribution for living expenses and taxes.

If all of the assets were from an individual retirement account, he would actually have less to live on as these distributions would be fully taxable. I used two retirees, one starting in the year 2000 and the other in 2010. I had some startling results.

If a "bull market retiree" who started with $1 million in January 1991 took annual distributions totaling $40,000 and increased the distributions each year for inflation, he or she ended Dec. 31, 2000, with $2.9 million if invested 100 percent in stocks; $1.4 million if 100 percent in bonds; or $2.1 million if in a balanced portfolio. Not too shabby, and it gets even better for bull market retirees.

They were still in great shape by 2010, even if they lost 37 percent in the stock market in 2008, as well as stock market losses of 12 percent and 22 percent back in 2001 and 2002, respectively.

By 2010, the bull market retiree would have $2.4 million if he or she invested 100 percent in stocks; $1.6 million if 100 percent in bonds; and $2.2 million if in a balanced portfolio. By this time, annual distributions after inflation total $84,000. After 19 years of retirement, our retiree took out $1.2 million dollars in distributions and still had more than he or she started with.

In contrast, how did a "bear market retiree" fare when beginning retirement in 2001? Not so well, actually.

> "Create a disciplined investment and distribution plan to protect against downturns, remove emotional reactions to market declines and determine ahead of time what the plan is in terms of spending during a market downturn."

If the bear market retiree started with $1 million in January 2001, took out the same $40,000 per year and followed the same strategy 10 years later—on Dec. 31, 2010—he or she was left with only $567,000 if invested 100 percent in stocks; $1.1 million if 100 percent in bonds; and $880,000 if in a balanced portfolio.

By early 2009—at exactly the wrong time—bear market retirees were probably thinking about "going to cash" in their portfolios to stop the losses. They are not feeling good about things, and they are wondering what the next decade has in store for them.

So what should people near retirement do to avoid being in the shoes of the bear market retiree? There are several things, but to start with:

1. Meet with a financial planner or CPA to "run the numbers" and help them build a plan for retirement.

2. Calculate their "hurdle rate," their personal minimum rate of return needed to meet their retirement goals. This is more important than any index return. If their hurdle rate is 3 percent, they should be fine. If their hurdle rate is 15 percent, they will need to reevaluate their retirement date and goals.
3. Create a disciplined investment and distribution plan to protect against downturns, remove emotional reactions to market declines and determine ahead of time what the plan is in terms of spending during a market downturn.

   —By Scott Bishop, special to CNBC.com. Bishop is a certified financial planner and director of financial planning at STA Wealth Management.