



Bucket Portfolios



Preparing for a longer retirement

Today, the average 55-year-old Canadian can expect to live to the age of 84, a gain of 24.6 years since 1926.¹ While a good reason to celebrate, it also means that Canadians are now spending nearly as much time in retirement as they do in their working lives. This poses a challenge to retirement savings, which have to last longer than ever before.

How bucket portfolios can help

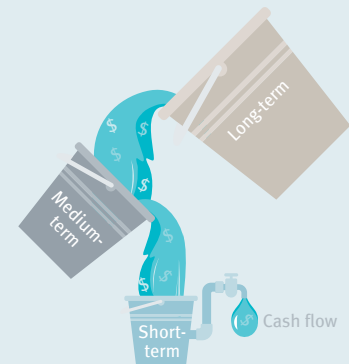
A well-structured approach to portfolio construction can help sustain retirement income over the long run and bring peace of mind.

“Bucketing” means dividing a portfolio into three main investment time horizons: a long-term bucket, a medium-term bucket and a short-term bucket.

The goal is to insulate the long-term bucket from near-term cash flow needs, allowing the equity portion of the portfolio to remain invested longer and grow over time. Annual retirement income is drawn from the short-term bucket, which holds several years in reserve and is topped up from the medium-term bucket. The top-up process is tailored to the investor’s unique circumstances and general market conditions.

How they are structured

The size and holdings of each bucket are determined by an individual’s initial wealth, income requirements and cash flow needs, as well as the risk and return characteristics of the individual asset classes.



Long-term – Growth (Years 10+)

Holds growth-oriented equity funds, which are more volatile but offer higher potential for capital growth to sustain the portfolio for the later years of retirement.

Medium-term – Buffer (Years 6-10)

Holds income-generating investments, including low risk, low volatility equities for stable capital gains. This bucket serves as a buffer between the cash bucket and the long-term growth bucket.

Short-term – Income (Years 1-5)

The short-term bucket holds cash and cash-like short-term investments for income withdrawals and emergency funds. It also helps to reduce the impact of short-term market volatility on the portfolio.

¹ Yves Decady and Lawson Greenberg, “Ninety years of change in life expectancy,” Statistics Canada, Cat. No. 82-624-x (2011).

THE BUCKETING PROCESS

STEP 1

- Determine how much annual cash flow you will need from your retirement portfolio.
- **Guide:** Estimate your annual expenses in retirement, and from these deduct other sources of cash flow you'll have (e.g. pensions and guaranteed income). The shortfall, if any, is the annual cash flow you'll need from your bucket portfolio. Annual cash flow of up to 4% of your portfolio's value is more likely to be sustainable over long investment periods.

STEP 2

- Ask yourself how many years of cash flow you want to have readily accessible, including emergency funds.
- **Guide:** The short-term bucket is not meant to grow. It is designed to provide you with a higher degree of certainty that your cash flow needs will be met for the next few years (typically 3-5 years of cash flow).

STEP 3

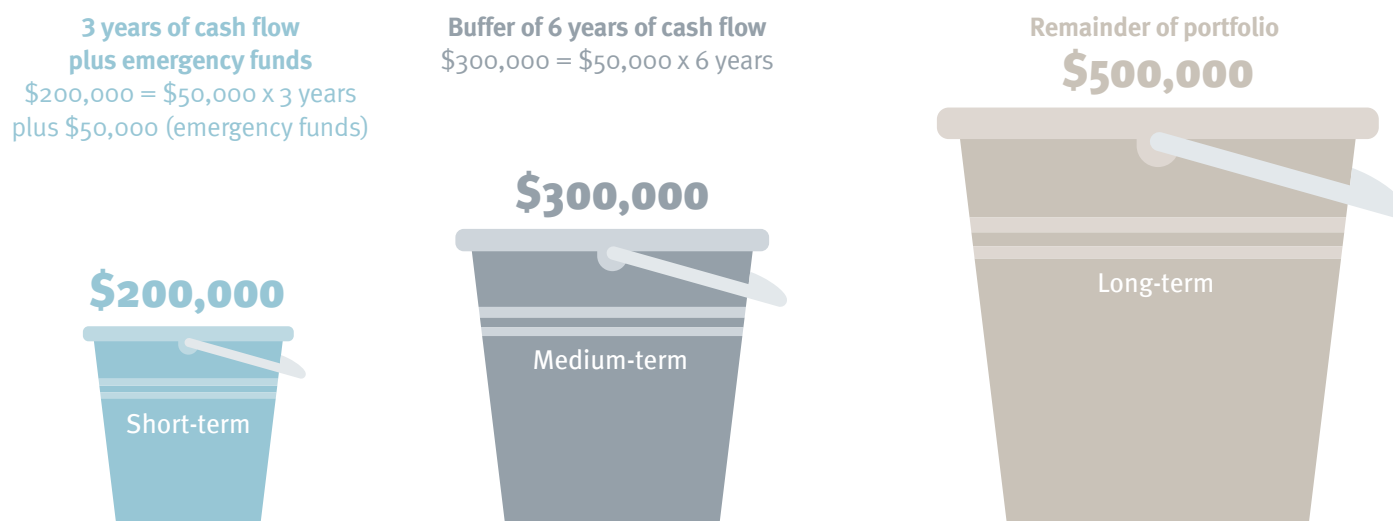
- Create a "buffer" between short-term cash flow needs and long-term growth investments.
- **Guide:** A portfolio's longer-term sustainability could be hurt by selling growth-oriented investments on short notice. The medium-term bucket allows your growth bucket to remain invested. It holds more conservative investments than the growth bucket and can be used to top up the short-term bucket if needed (usually 3-7 years of cash flow).

STEP 4

- Invest the remainder in growth-oriented securities.
- **Guide:** The long-term growth bucket represents the remainder of your portfolio and is comprised primarily of equities. It will vary in size depending on the size of your total portfolio and the number of years of income allocated to the short- and medium-term buckets.

Example of a bucket portfolio strategy

Jane, a new retiree, discusses her retirement cash flow needs with her financial advisor. Together, they estimate that she should have three years of annual cash flow on hand (\$50,000 for each year), in addition to \$50,000 in emergency funds. The value of her initial retirement portfolio is \$1,000,000. They decide to allocate the portfolio to the three buckets as follows:



Consider the following hypothetical outcome for Jane in the tables below. In both examples,

- The returns in Scenario A are constant;
- Scenario B starts with two years of negative returns; and
- Scenario C starts with two years of positive returns.

In example 1, Jane has not had to sell growth-oriented investments from her long-term bucket during the first 10 years of retirement to fund annual withdrawals. The long-term bucket remains fully invested in growth-oriented equities, while her annual income has been drawn from the other two buckets. Since the return streams in all three scenarios result in a 6% compound annual rate of return, Jane's portfolio would have grown to the same amount after 10 years in all cases.

Example 1: Growth of the \$500,000 long-term bucket without annual withdrawals

Returns	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Compound annual return	Value
Scenario A	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	\$895,424
Scenario B	-9.3%	-4.5%	8.9%	-2.2%	13.7%	9.7%	-3.0%	18.4%	21.6%	11.4%	6.0%	\$895,424
Scenario C	8.9%	13.7%	-9.3%	18.4%	-4.5%	11.4%	21.6%	-2.2%	3.0%	9.7%	6.0%	\$895,424

In example 2, however, we assume Jane has sold \$25,000 each year from the long-term bucket.

Example 2: Growth of the \$500,000 long-term bucket with annual withdrawals of \$25,000

Returns	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Compound annual return	Value
Scenario A	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	\$565,904
Scenario B	-9.3%	-4.5%	8.9%	-2.2%	13.7%	9.7%	-3.0%	18.4%	21.6%	11.4%	6.0%	\$489,935
Scenario C	8.9%	13.7%	-9.3%	18.4%	-4.5%	11.4%	21.6%	-2.2%	-3.0%	9.7%	6.0%	\$572,677

Drawing from the long-term bucket has two negative consequences for Jane:

1. The negative market performance in the first couple of years in Scenario B hurts the growth potential of the portfolio.
2. By leaving her long-term bucket untouched, Jane would have reached the 10-year mark with at least \$72,000 in additional portfolio value.

	Example 1	Example 2	
	Portfolio value	Portfolio value (including \$25,000 annual withdrawals)	Difference
Scenario A	\$895,424	\$565,904 + \$250,000 withdrawals = \$815,904	\$79,520
Scenario B	\$895,424	\$489,935 + \$250,000 withdrawals = \$739,935	\$155,489
Scenario C	\$895,424	\$572,677 + \$250,000 withdrawals = \$822,677	\$72,747

Why the long-term bucket matters

The potential benefit of leaving the long-term bucket untouched for longer is clear. The long-term bucket is designed to increase the lifespan of your retirement portfolio. It does this by helping to maximize the time that a portion of your portfolio remains invested in growth-oriented securities. Since cash flow withdrawals are taken from the short-term bucket, your equity securities can be left to grow for a longer period. From the previous examples, we see that this can be especially important if stock markets experience negative returns in the early years of your retirement.

DALBAR, a research firm that tracks investor behaviour, has arrived at the same conclusion after studying investor behaviour from 1985 to 2014. Over that 30-year period, the S&P 500 had a compound annual return of 11.06%. The average equity investor's return over the same period, however, was only 3.79%. DALBAR attributes the difference to timing — when investors buy, sell and switch into and out of mutual funds over short and long-term timeframes. The study, DALBAR says, shows that “mutual fund investors who hold on to their investments have been more successful than those who try to time the market.”²

HOW TO GET STARTED

Your financial advisor can help you tailor a convenient bucket portfolio that is right for your needs.

Bucket Portfolios

- Focus on your cash flow needs in retirement.
- Provide a different way of thinking about the components of your portfolio and how they align with your needs.
- Increase the likelihood that you are able to maintain a strategy designed to meet the needs of a longer retirement by staying invested in growth-oriented securities for longer.

² Dalbar's 21st Annual Quantitative Analysis of Investor Behavior 2015 Advisor Edition. Available at: www.dalbar.com.

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