



Time for Retirees to Look to Bonds

Commentary: Too many retired Americans ignore the need to generate income

By [Robert Powell](#), MarketWatch
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BOSTON (MarketWatch) -- When it comes to investing, most retired Americans have it backwards. Instead of investing in bonds -- things that provide a return on capital, those seeking retirement-income security tend to invest in things that provide a guaranteed return of capital. Doing so could lower one's standard of living, especially when short-term interest rates fall.

"Retired households seeking a secure and dependable income should prioritize return on capital over return of capital," wrote Anthony Webb, author of a report released this week by the Center for Retirement Research at Boston College.

"Households need to make a conscious effort to learn to focus less on the market value of their investments and more on the consumption they can support," he said.

To Webb's way of thinking, "the true risk-free asset is a portfolio of bonds and, in particular, inflation-protected bonds of appropriate maturities." In other words, Treasury Inflation Protected Securities or TIPS. [Read his report.](#)

That's not what most investors are doing now. Most retired Americans prefer investments such as Certificates of Deposit and T-bills -- investments that provide safety and liquidity. For instance, 86% of households nearing retirement have bank accounts, while just 33% own stocks directly and just 7% own bonds directly, according to another CRR study. [Read that study \(PDF\).](#)

Yes, short-term deposits do provide a guaranteed return of capital, but they don't offer guaranteed returns, Webb said. And that's what most retired households need.

"The ultimate objective of retirement saving is to finance consumption," Webb wrote. "The standard of living of a household that invests in short-term deposits is at risk if short-term interest rates fall. In contrast, changes in interest rates and bond prices may have no effect on the standard of living of a household investing in bonds."

Given that, how might you re-jigger your portfolio?

Ladder your bonds

In a perfect world, if you knew in advance how much of your capital you planned to consume or spend in the future, you would put together a bond portfolio with income payments that matched your consumption needs. In other words, you would ladder your portfolio. And you would match your asset (the bond) with your liability (your expenses.)

For his part, Michael Zwecher, author of a forthcoming book on retirement, said another way to achieve the nearly same result is to ladder Treasury STRIPS or what are sometimes called zero-coupon securities. These are securities that pay a fixed rate of return and are stripped down to single payment components, he said. As single payments, they sell at a discount and rise over their life to pay par on maturity.

"They can be set up in a ladder to provide steady or customized income streams," he said. Plus, STRIPS are highly safe and liquid. What's more, STRIPS are standardized and mature on either Feb. 15 or Aug. 15 each year. Currently they can be bought to cover maturities ranging from 2010 to 2039, he said. [Learn more about Treasury STRIPS at this site.](#)

Meanwhile, Aaron Skloff, chief executive officer of [Skloff Financial Group](#) said that corporate bonds currently provide "excellent risk/reward" for retirees. "Fears of mass defaults have waned, as the 'definite' collapse of the global financial system has once again become a remote probability." He said investors concerned about buying a "bad" bond should consider a basket through an ETF or bond fund.

Duration matching

Unfortunately, laddering a bond portfolio "probably requires more knowledge and patience than most households possess," Webb said. Instead, you might try what he calls the simple version of this strategy. "Invest in a mutual fund or exchange-traded fund investing in bonds with an average duration that equals the household's life expectancy," he said.

"Early in retirement, the household would invest mostly in long-dated bonds. Later in retirement, it would gradually rebalance its remaining assets in favor of shorter maturity bonds, matching the reduction in its remaining life expectancy," Webb said.

Optimize your asset allocation

To be sure, you wouldn't invest 100% of your retirement nest egg in bonds. Instead, Webb suggests that to optimize the amount you invest between stocks and bonds. And to do that you need to consider your entire retirement-income portfolio. For instance, he said Social Security is similar to owning TIPS. And having a defined-benefit pension plan is similar to owning regular or what he calls nominal bonds.

"Those sources of income are good substitutes for inflation-protected and nominal bonds in household portfolios, and households with large amounts of these sources of income should invest larger proportions of their financial assets in equities than otherwise similar households," he said.

Others also urged investors not to over-invest in bonds just because they provide a guaranteed rate of return. Don't confuse certainty with safety, said Harold Evensky, the president of Evensky & Katz. "The payment on bonds, assuming no default, may be certain but for most investors a total allocation to bonds is certainly not safe," he said.

"The problem is that most investors require a real after-tax return that significantly exceeds the return provided by fixed-income investments. As a result, an over-concentration in bonds will result in a gradually decreasing living standard."

What's more, Evensky said it's important to consider all the risks that come with investing in bonds, including interest-rate risk, credit risk, and inflation risk, before you start moving money out of CDs and T-bills.

"Unless the [Center for Retirement Research] is in the business of pumping bond sales, I think that it would do well to frame the results of its study with the reality of risks other than market volatility." he said.

Robert Powell is the editor of Retirement Weekly. [Learn more about Retirement Weekly here](#) .