Income Conundrum

Extraordinary times may require adjusting expectations.

MORNINGSTAR CONVERSATION

John Rekenthaler

With interest rates at unprecedented low levels, bond markets are in uncharted territory. As bond market theories struggle to keep pace, asset allocators and income investors must adapt in real time. This is a particularly challenging climate for those who need to live off their investments.

The three panelists in this Morningstar Conversation bring three different perspectives. Michael Finke holds doctorates in both consumer sciences and finance and is professor of wealth management at the American College of Financial Services. Jonathan Guyton is a Certified Financial Planner who advises clients as a principal of Cornerstone Wealth Advisors and has been a retirement columnist for the *Journal of Financial Planning* since 2010. And Larry Siegel, who has a long background in practical investment analysis, serves as the Gary P. Brinson Director of Research at the CFA Institute Research Foundation.

Our discussion took place on Feb. 10 and reflects rates and yields as of that date. This transcript has been edited for length and clarity.

John Rekenthaler is a vice president with Morningstar Research Services LLC.

Michael Finke, professor of wealth management at the American College of Financial Services.

John Rekenthaler: Ten years ago, 10-year Treasury notes were yielding 3.5%. Ten years before that, they were 5%. Today, they're 1.1%. How did we get here, and did anybody see this coming?

Larry Siegel: I did not see it coming. Even in the Great Depression, long rates did not go much below 2%. Now, they've gone below 1% in an environment where we may have below-average growth, but there's no extended depression on the horizon. There's really nothing wrong with the economy other than COVID-19, which created a supply collapse and briefly a demand collapse when people stopped getting paid. But now, they're being paid more than they were before the disease through various sources, so there's no demand collapse, and there's really nothing for the monetary authorities to fix.

However, when you're a rock star central banker, it's always an emergency. They're like firemen. They benefit from an abundance of fires. They run to the rescue, and they have only one tool, which is a fire hose: They purchase long-term bonds.

If the current price and yield of long-term bonds were a market-equilibrating price, central banks wouldn't need to buy them, and real-money investors—pension funds, people preparing for retirement, and so forth—would buy them. But most of the purchases have been through central banks, so we can see that it's a manipulated rate. That's how we got here.

Michael Finke: Larry, that's one way to look at it. The other way to look at it is that maybe we could have seen this coming. We have the largest and wealthiest cohort of near-retirees in the history of the United States. We have a lot of other countries that have a much higher taste for savings than we do and that are becoming increasingly wealthy and are having a bigger impact on capital markets.

One of the most amazing things to look at is the supply of bonds over the last decade or so. The supply of corporate and government bonds has just kept going up, which you would expect would have a negative impact on bond prices, but it hasn't. The demand for especially safe assets right now is remarkable. It almost seems like there's no filling the appetite for safe assets.

Jonathan Guyton, principal of Cornerstone Wealth Advisors.

Larry Siegel, director of research of the CFA Institute Research Foundation.

Central banks are providing a tremendous amount of liquidity to the market. There's a lot of money in people's bank accounts. It's got to go somewhere, and it's going in many cases to financial assets. People are just not spending money. They're putting it away in some sort of savings vehicle. If everybody does that at the same time, then the prices of bonds go up and the yields go down.

Jonathan Guyton: For me, a big takeaway is that if the Federal Reserve wants interest rates to be low, they will be low. And if the Fed wants rates really low, they'll be really low. What's interesting is not just what did happen over the past 10 or 20 years, but what didn't happen. Quite a few things in both fiscal and monetary policy were supposed to cause higher interest rates and higher inflation, but they didn't. Unfortunately, a lot of people have incurred some high opportunity costs by betting that these things would happen.

As a practitioner who advises primarily retirees and people over 50, and who has contributed research in this area, the other big takeaway is this: If you had pretty much done what the evidence-based solutions would have told you to do 20 years ago, and 10 years ago, you'd actually have come through all of this fairly well.

Siegel: What are those evidence-based solutions?

Guyton: I'm referring to the safe withdrawal research. You have a pot of money, and you want to maximize the income that can come from that. How should you deploy that money? How can you utilize it? The answers to that research say that this will carry you through times that may be fairly close to unprecedented, with what we've seen with interest rates.

Siegel: But at a negative real interest rate, the amount of money you need to produce an income is infinity. So, people have to withdraw from principal, and that changes the game radically.

Guyton: Not necessarily. There are four options for getting income from a portfolio of money. You can take interest from fixed-income investments, get dividends from equity investments, draw down the principal of your fixed-income investments, and/or sell shares of the equity investments. Clearly, this is a low point in what you can receive simply by drawing on dividends and interest.

A Bigger Base

Rekenthaler: Maybe I'm misinterpreting, but I still think we're talking about taking principal.
Guyton: It depends on how you define principal. If a retiree had $1 million a year ago, and today they have 20% more than that, and they draw against some of that increase, is that taking from principal?

Siegel: If we let accountants drive our thinking, it's not. But an economist would say that the principal is whatever you have now, and then the cash flows generated by that principal would be regarded as income.

to drive the longevity of your investment portfolio and the lifestyle that you can lead. What we have now is a market where financial assets are more expensive than they've ever been. We don't know what the future is going to look like, because we've never had a period that looks like right now.

So, it's hard to project the safety of any type of withdrawal strategy, and it's also hard to grasp the impact that such low portfolio returns will have on lifecycle saving. It means that we're going to have to save a lot more. We will live worse because we have to save more, because income in retirement is going to be more expensive. It's a depressing message, but that's what happens when assets become very expensive.

Siegel: That's why this policy of radically low interest rates is so upsetting to me. It discourages savings, yet you need more savings, not

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>
> **Michael Finke**

less, to generate the same income. It's capital destruction. When it happened in the 1970s with very sharply negative real interest rates (although there were high nominal interest rates), two economists called it *financial repression*. That's what we're experiencing again, but more so.

Guyton: But the other part of the picture is that people also have quite a bit more wealth today, depending on how they allocated their assets, than any reasonable projection would have made a couple of years ago. It's not all bad news.

Siegel: Especially if you bought U.S. equities.

Finke: But earnings really haven't gone up that much. In fact, they've gone down over the last year. So, you are holding an asset that's now more expensive than it used to be, and the expected returns are naturally going to be lower. Do we celebrate the fact that your assets are more expensive, or are we cautious because they are?

Guyton: Or do we take that uncertainty, combined with a bigger sum total of assets, and say we can be a little more conservative going forward? Can we expose ourselves in the future to less volatility, less uncertainty, and have a greater amount of fixed assets to weather whatever storms might be coming?

Rekenthaler: So, someone who's had some exposure to equities will have a larger pool of assets than they would have planned on 10 or 15 years ago. Presumably, they can afford to have a more conservative withdrawal strategy?
Guyton: Certainly. Say someone who was planning to retire in 2021 made a reasonable projection five years ago that their assets would be worth $1 million and planned to take out $50,000 a year. But now they actually have $1.2 million. It's a lot safer to take $50,000 out of $1.2 million than $1 million. Even if future returns are lower, I'd rather have more money in my pocket today than not have it and hope that returns will be higher.

Siegel: The question is, is it more money if the fecundity of the assets is so much lower that it produces a lower income? You might prefer to have less money earning 6% than more money earning 1%. How that balances depends on the price of the assets and the interest rate.

Rekenthaler: What might this mean for asset allocation for, say, a newly retired client in 2021, as opposed to a new retiree in 2011, when new Treasury yields were literally 3 times as high as they are now?
Finke: I don't know if it has much of an implication on asset allocation. If you look at real returns on safe assets, our best guess based on the market price of Treasury Inflation-Protected Securities is that you're going to get about negative 1%. And

Finke: We just did an article where we looked at the cost of buying income from 10-year T-bills and from the S&P 500 in the traditional sense; that is, dividends and yield on bonds. Right now, it costs more to generate a dollar of income from a balanced portfolio as it ever has in the United States and 3 times as much as the historical average.

That said, I'm uncomfortable thinking in terms of income generated from a portfolio, because I think that distracts us from the most important aspect of the portfolio: its ability to generate aftertax returns. That's the only thing that's going you shouldn't expect much more than that on corporate bonds, with credit spreads as low as they are right now. We're looking still at a risk premium of 2.5% to 3% on equities. Equities are not so expensive that you would not consider investing a portion of your assets in them.

But the bottom line is that you are getting a 3% risk premium on top of a nominal risk-free return of only 1%, or a real return of negative 1%. There's still a reward, potentially, for taking risk, but it's not going to be the same nominal reward that investors received historically. That has large implications on the amount of lifestyle that you can generate from your investment portfolio in the future.

Buying Time

Siegel: What I would say is keep going to work in some fashion, because human capital has not depreciated, and a small amount of work can produce as much income as a very large amount of money.

Finke: That's a great point, and especially important for younger savers. Because asset prices are so high, an investment that you make in your own human capital comparatively is going to have a far bigger payoff.

Siegel: I'm not even sure you need to *invest* in your own human capital. Just using the human capital you already have, by continuing to work, is a better way to increase your retirement income than taking additional investment risk to get a higher yield.

Guyton: Two things to add to that. All equities don't come with the same valuation concern. For example, U.S. large-cap growth stocks are very different than emerging-markets equities or even large-cap value stocks.

The other thing is that when we talk to retirees about bond allocation, we point out that risk is usually described vertically. How high is the market? How low might it fall? Those are very vertical terms. But in retirement, the risk is more horizontal. If you need your equities to help generate some income and there's a period of time when they're not helping, you need to be able to wait that out. That's where the fixed income comes in. You are literally buying time. As long as your bonds are the right kind and behave in the right way, then the question is, how much time do you want to buy?

With that, you would have to think that with things at the level they are right now, there are going to be rebalancing opportunities in the coming years. Some of the things that people would like to have in their portfolios are going to become less expensive. We saw perhaps the best one we'll see for a while in March 2020, but that doesn't mean there aren't going to be other ones, as occurred at the end of 2018, for example.

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Siegel: The market will fluctuate, but do you really know when to get in when the market is down 20%, or in the case of last year, 34%? Behaviorally, you're not likely to move money from fixed income into something that is just going down 4% or 5% a day at the final stages of a market panic. So, how do you play that, if you play it at all? What I do is I just sit there and watch.

Guyton: When you have those large swings like you described, you don't have to get everything right. You just need to do some rebalancing. Let's not forget, retirees who are taking money out of their portfolio have a rebalancing opportunity all the time. It's simply which side of the ledger am I going to take my withdrawals from right now? Unfortunately, it means that people have to be able to act in the ways that you describe or have an algorithm that acts for them in the management of their portfolio.

Rekenthaler: Jonathan, you mentioned subasset classes—large growth versus emerging-markets funds versus large value. Do I take that to mean that you don't recommend a buy-the-market approach?

Guyton: Last year, large-cap value indexes were barely positive for the year, while large-cap growth indexes were up nearly 40%. There is no way to leave the value stocks alone and take from the growth stocks if all you have to sell are shares of your S&P 500 fund. Breaking a portfolio up into subasset classes, as you put it, John, allows you to pick and choose. It's not that important in the accumulation phase. It is much more important in the distribution phase.

Finke: But isn't selling your winners just a countermomentum strategy? Isn't that going to lose in the long run?

Guyton: We're talking about the sources of upcoming withdrawals. We're not selling all the winners.

Finke: I do think you can make a very strong point in the accumulation stage in a nonqualified account to hold multiple equity investments so that you can take advantage of tax-loss harvesting strategies. But market-timing strategies, that's a tough one. Getting it right is easier said than done.

Guyton: It's not so much timing. Let's say that someone's approach is at the beginning of every year to decide where the next year's withdrawals are going to come from. It might be all from interest, dividends, and fixed income. Or they might want to sell some equity shares. The question then is, which shares do you want to sell? After 2020, you would have wanted to reduce your holdings in large-cap growth as opposed to large-cap value by most traditional measures.

Siegel: I see your point. But that's still timing. When I have tried to actively manage my asset mix that way, I've usually underperformed. When I see something getting expensive, I sell it. Then, it gets even more expensive.

Finke: I tilt toward small-cap value, like a lot of academics. We've been losers for a decade now. Every year, you say, "Well, next year is going to be the year that small-cap value finally outperforms." I would have sold my large-cap growth, and I'd just be digging myself a bigger hole.

Siegel: That's what I've done with value, and it hasn't paid off at all. I've also overweighted international, so I've found a number of different ways to lose the timing game.

Finke: The more you know, the better you get at it!

Sticker Shock

Rekenthaler: How about fixed income? Is the general advice different now with rates where they are?

Siegel: I have bought a lot of TIPS. They've lost money, but if we start getting 4% or 5% inflation, which is very possible, they'll make a lot of money. I'm hedging against risks that I face personally—like the apartment I'm renting here on the beach in California. The rent has gone up 40% in a year. That's a lot of inflation.

Finke: Larry makes a very good point about inflation for assets that people with money want. Inflation in general hasn't gone up as much as we would have expected, but it has for the kind of stuff that people with money want to buy—like a home in Pacific Grove, California. Because I wanted to make this point, I went on Zillow before this conversation and looked at the price of houses in Pacific Grove, which is one of my favorite spots in the United States, one place where I would like to retire. Housing prices have pretty much doubled over the last four or five years in Pacific Grove. Houses in Santa Fe have probably gone up by a third over the last two or three years.

Even though the cost of milk hasn't gone up all that much, it's important for retirees to recognize that the things that they want to buy in retirement might be a lot more expensive than they'd anticipated. Jon made the point earlier that you might have $1.2 million today instead of $1 million because the market's gone up so much. But if what you wanted to buy is a house in Pacific Grove, then you really haven't come out ahead at all.

Guyton: These are good points, especially as retirees' tastes change. Things that people desire today might be things that they wouldn't have thought they desired a couple of years ago. So, you plan knowing that you need a certain amount of capital to support your core standard of living. I don't have to go rent a house in Pacific Grove to go somewhere warm in the winter, even though I might want to.

Then, structure your retirement assets so that you know how much other money you have—in our firm, we call it discretionary. You can draw from that on a much more spontaneous and less structured basis if you do want to rent a house where the rent has gone up 40%. You know how much money you have for those off-budget items, and you can monitor your plan that way.

Rekenthaler: Retirees often tilt toward higher-income investing: corporate bonds over Treasuries, or higher-dividend stocks for equity investments. What are your thoughts on such practices?

Siegel: It sounds good until you go to do it. Then, you realize that a certain amount of efficient-market theory kicks in and that the higher income means a lower capital gain. The main thing it does is raise your tax bill. Income is a legal concept, not an economic one. It's whatever is subject to the income tax. And the way that a cash flow is divided between capital gain and income should be irrelevant to the total return.

Finke: I agree with Larry completely. I might even go a step further. I'd say that paying attention to income is a behavioral phenomenon that investors are punished for generally. Income investments are less tax-efficient, and on top of that, there's a lot of evidence right now that assets that are producing higher yield are expensive relative to historical standards. And when they are this expensive, they historically underperform. Given the relatively small spread between lower-quality bonds and higher-quality bonds, I'd guess that the returns are going to be no higher, but with an absolute certainty of far greater risk. By focusing too much on income, investors are setting themselves up for a very disappointing outcome.

Guyton: To add to that, there are going to be times when the equities in your portfolio are going to decline in value. At that point, it is vital that your fixed-income holdings not also be participating in the decline.

One of the great features of boring old Treasuries is they have a tendency to be negatively correlated with the stock market at exactly the time you want them to be negatively correlated with the stock market. Research bears this out. There are studies comparing portfolios with a bond component of corporate bonds to either intermediate Treasuries or T-bills. The portfolio with T-bills leads to a higher safe withdrawal rate. When equities are in the tank, interest rates might be going up or going down. If they're going down, any kind of Treasury will work. But if they're going up, you want the shorter-term ones.

Right now, having that short-term element with the most ironclad fixed income to get you through the next downturn is going to be a big difference-maker. The Fed bailed out corporate bondholders by liquefying that market at the end of March 2020. Otherwise, it was a real bloodbath for a while.

Siegel: I agree with all of that. I've been saying the next interest-rate move is up for a long time. My only concern here is that I was wrong so many times and I still could be wrong, and the time when I'm right could be a long way off. In 1,000 years, we'll look back on this as an aberration in the history of capital markets, kind of like we look back on the Great Depression.

What About Annuities?

Rekenthaler: We've been talking about stocks and bonds for retirees' asset allocations. Where do annuities fit, if at all?

Siegel: If you buy a deferred annuity that begins its payout at age 85, you're not going to pay much. You're getting a huge return conditional on being there to collect it. It seems to me to be a sensible strategy, because if you retire at, let's say, 68, and you begin to collect the deferred annuity at age 85, you only have to save enough for 17 years. That's a manageable problem that you can get your mind around. Let's say I need $100,000 a year to live. Even at a zero interest rate, if I save $1.7 million, I'm all set.

Without annuities, the retirement problem is almost insoluble. We don't know how long we're going to live, but everybody knows somebody who's lived to 105, so we want enough money for that possibility. So, you can never spend anything. Letting an insurance company worry about those last decades, if you happen to live that long, is a strategy that I've become very interested in.

Finke: When TIPS rates are negative, that increases the value of income that is inflation-protected. There's one way to get more inflation-protected income, and that's by delaying Social Security. This low real-interest-rate environment that we're in right now increases the value of delaying Social Security to age 70. For most retirees, that's probably one of the most overlooked strategies for generating income.

I agree completely with Larry on annuities. Annuities are inexpensive. We have done research on the pricing of annuities in today's market, and one of the upshots of having easy, immediate access to annuity quotes is that it's made annuity payments more generous. The implied loads on what annuity manufacturers are providing to people is pretty much nothing, if you compare their promised income to the amount of income that you could generate to the expected average longevity with Treasuries. Competition seems to have bred more attractive pricing relative to bonds. Annuity manufacturers are giving you something for nothing. You should probably take it.

And you're going to live better in retirement for it. Some combination of immediate annuitization, delayed Social Security, and deferred annuitization through qualified longevity annuity contracts is really the best way to get an attractive lifestyle from your money in a high-asset-price environment. Now, the income that you're going to get is less than it was five years ago, but the income that you're going to get with bonds is even lower than that.

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>
> **Larry Siegel**

Siegel: Do you worry about annuity default risks?

Finke: I do a lot, Larry. Some of the quotes are so attractive, especially among lower-rated insurance companies, that I get concerned. Especially with a deferred-income annuity, where I'm not going to see that income for another 15, 20 years, I'd pay close attention to the credit ratings of those insurance companies.

Guyton: That's where Michael's point about Social Security is so important. Retirees who decide to hold off on collecting the full-bore Social Security and use their assets to get them to that point are effectively buying more annuity income. Delaying Social Security is the best first annuity.

The other piece of the annuity decision is that when retirees look at what they believe can be generated from their portfolio, they say, eh, maybe I can do a little better [than annuity income], and I don't have to give up the money. I would love to see somebody write an article—whether it's academics or financial planners—where they actually fess up to whether they have bought these annuities for themselves.

Siegel: They're going to have to admit that they haven't bought them. They keep looking at them but are afraid to give up the capital. It's nice to have money. We used to collect pensions from jobs, supposedly guaranteed income—until somebody buys the company and finds a legal way of avoiding making the payment. Now, we accumulate assets, and it gives you a feeling of security to know that you could possibly buy a house in Pacific Grove, whereas you can't with the pension. Nobody's going to give that up easily by going to the annuity market and buying themselves a pension with all their cash. You do it with a little bit. That's where the deferred annuity comes in, as it only costs a little bit of your total net worth.

Rekenthaler: People love their pensions and hate to give them up for a 401(k), but then once they have a 401(k), they don't want to go back to a pension. This probably belongs in the behavioral researcher "people are not always fully rational" camp.

Siegel: It's bounded rationality. You're working within the framework that you have.

Rekenthaler: For those who seek to live off their investment income, it's a critical topic. Thanks to you all for your insights on these unprecedented times. IM

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