

## Retirement risk, rising equity glidepaths & valuation-based AA

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Angela Ashton | PortfolioConstruction Forum | 03 October 2014

"Retirement risk, rising equity glidepaths and valuation-based asset allocation" by Michael Kitces, Pinnacle Advisory Group and Wade Pfau, The American College, September 2014

The dynamic duo of Kitces and Pfau are at it again. This time, in their search for the ultimate truth about retirement income planning, they look at the relationship between market valuations, different glidepaths (for the uninitiated, that's the level of equity exposure in a retiree's portfolio), some simple dynamic asset allocation strategies and sustainable withdrawal rates in retirement.

Before we consider this particular paper, though, take a step back and have a look at the conversation they've started on rising glidepaths – the idea that rising equity exposures in portfolios during retirement might actually lower rather than increase, the chance that retirees will run out of money.

[Kitces and Pfau first wrote on this topic last year.](#) They found that rising glidepaths potentially improve retirement outcomes – which effectively means decreasing the probability of running out of money. This is because it limits sequencing risk by lowering equity exposure during the early part of retirement, when the impact of any losses is likely to be greatest. Their general conclusion was that "portfolios that start off in the vicinity of 20% to 40% in equities and rise to the level of 60% to 80% in equities generally perform better than static rebalanced portfolios or declining equity glidepaths". Exceptions to this rule include when equities are expensive and when the client's withdrawal rates are high, thereby justifying high equity weights throughout.

That paper appeared and been reviewed in a number of places. Issues that have been raised include the fact that only US data was used in the analysis. What would the analysis look like if, say, only Japanese data had been used? Recently, [a critique by Jared Kizer appeared in various media.](#) He believes that the differences in the success rates that Kitces and Pfau find when using this new approach are small and sensitive to capital market assumptions (the Japanese data argument in a different guise). To my mind, this does make sense. Simply mechanically applying a rising glide path could work against the investor – you may increase exposures just as returns fall. Market are fickle and you can't expect mean reversion to save you.

Kizer also believes that Kitces's and Pfau's results are partly due to the fact that the initial weights in portfolios differ significantly (for rising glidepaths, they move from say 30% to 60% and for falling glidepaths, they do the opposite). He controls for this and shows that rising

glidepaths aren't generally superior – they work out to be about the same as declining glidepaths. [Pfau then responded in his blog](#), saying that Kizer's approach is flawed. His arguments become quite technical – suffice it to say, Pfau does some further analysis and shows that rising glidepaths are pretty good.

In their latest paper, Pfau and Kitces take their analysis further. They test various dynamic asset allocation approaches, fixed asset allocations and rising and falling glidepaths. Again, they use only US data. In short, they find that it is hard to beat a scenario where equity weightings are high. This tells us little other than equity returns in the US have been great.

But what this paper finds that IS of value was that adjusting equity exposure in response to some simple valuation rules is useful in protecting from drawdowns. When markets are overvalued (using the Schiller PE ratio as the measure) at retirement, it is best to use what they call "an aggressive rising glidepath". This starts with low exposures to equities and increases weightings over the first 10 years or so of retirement. This valuation approach can also be used to adjust equity exposure throughout retirement. Although there is definitely an element of timing in this – you'd expect mean reversion to work over that 10 year time period – the general idea of lower weightings to equities when they are expensive is logical.

Further, Pfau and Kitces also find that results were generally better with equity/cash portfolios than equity/bond portfolios. Although the returns from bonds were higher, the lower correlation of cash and equities acted to smooth returns more effectively, lowering the size of any drawdowns. The positive effect of cash on the portfolio was most notable when equity markets were either fairly valued or overvalued.

So – who to believe? And what to do about it? I think the most valuable points from all of this research are probably those that are the most obvious.

Firstly, there is no magic bullet or simple prescription for retirement portfolios. Rising glidepaths, falling glidepaths, aggressive glidepaths – all can work in the right situation.

Secondly, the principles of diversification, as illustrated by the equities/bond versus equities/cash portfolio, work.

Finally, the most important things to be aware of are the investor's needs, the market environment, and to tailor your approach to take these factors into account.

In short, Kitces's and Pfau's latest paper shows us that you do not have to take a seriously active approach to dynamic asset allocation to benefit from it. Some very simple rules help provide good guidance on how portfolios should be adjusted in order to try and minimise drawdowns.

[Read "Retirement Risk, Rising Equity Glidepaths and Valuation-Based Asset Allocation"](#)