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Using a distribution glide path

The allocation strategies of target date funds may work well in the distribution phase

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April 28, 2008

What is the best way to allocate a distribution portfolio? While optimization tools, such as a mean variance optimizer, may help a user determine the most efficient way to construct a portfolio across different asset categories, these tools provide little insight as to the best allocation strategy for a distribution portfolio.

Unlike the accumulation years when higher equity allocations tend to increase an investor's probability of achieving an accumulation goal, higher equity allocations during retirement do not always benefit a retiree.

Distribution research has focused primarily on the relative benefits of static, or constant, equity allocations in retirement. This body of research has attested to the long-term importance of equities in order to hedge against longevity risk, which is the risk of outliving one's retirement savings, yet it has largely ignored the potential benefits of more dynamic allocation strategies, in which equity allocations change over time. Financial planners commonly recommend that their clients become more conservative throughout the distribution period, although many maintain that significant equity exposure is still necessary to compensate for longevity risk.

A recent paper that I wrote for the Journal of Financial Planning, "Dynamic Allocation Strategies for Distribution Portfolios: Determining the Optimal Distribution Glide Path," seeks to explore the best way to structure a distribution portfolio throughout retirement. To refer to the shape, or change, in the equity allocation during the distribution period, I used the term "glide path." This is a term that commonly is used with target-date mutual funds to describe their changing allocations.

To conduct the analysis, I tested five different glide path shapes: a constant approach, where the allocation stayed the same throughout the distribution period; a linear decay strategy, where the equity allocation decreased by 1% per year; a stair decay strategy, where the equity allocation was reduced by 10% every 10 years; a convex hyperbola strategy, where the equity allocation decreased at a decreasing rate; and a concave hyperbola strategy, where the equity allocation decreased at an increasing rate — which is the shape taken by most target date funds during the accumulation phase.

While results varied across scenarios, the static glide paths, or the portfolios that maintained a constant equity allocation throughout the distribution period, were actually the most efficient among the five different glide paths tested. However, among the decay strategies, or those that became more conservative throughout the distribution period, the concave hyperbola proved to be the best allocation model.

Ironically, the concave hyperbola is also the shape of the glide path for most target date funds. This suggests that a methodology used for accumulation also works well for distribution.

An important advantage of the concave hyperbola glide path over the constant glide path is risk control. While retirees differ in their risk tolerances, they share one vulnerability: As time passes, they are less able to recover from market losses in order to maintain their standard of living.

Since the concave strategy becomes increasingly conservative over time, it better matches the risk tolerance of most retirees. To replicate a concave hyperbola glide path, an adviser would maintain a relatively constant equity allocation during early retirement years and then decrease the equity allocation more aggressively over time. For example, the equity allocation may be 60% for the first 10 years, drop to 55% by year 15, drop to 45% by year 20 and drop to 30% by year 25.

While the unique needs of each retiree will determine the best approach to structuring a distribution portfolio, it is worth considering the potential benefits of a non-constant equity allocation when working with clients.

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