The Bucket Concept

An Old Idea for a New Market

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After 2008, every financial services firm rolled out risk-reducing products, but as with any service, the benefit of these products disappeared as everyone paid a premium for that service. Risk protection, in other words, became priced out. Rather than finding a way to manipulate the so-called efficient frontier of investment opportunities, a better way to manage a client's investment process may be through different portfolios, or buckets.

The concept of buckets is simple. A client has a set of portfolios (two or more) that match different needs instead of one portfolio for all needs. Take someone with $1 million who has just completed a risk-return questionnaire and invested that $1 million in a 50/50 mix of equities and bonds (or an even more-conservative mix because of the short-term focus of many questionnaires). The alternative approach would take the $1 million and divide it into two portfolios, one for the more immediate years of living expenses in a 30/70 mix and another with a more-aggressive 70/30 mix. This division would have the advantage of explaining to the client how risk ties to immediate liquidity needs. It also would protect a portion of the portfolio from the negative effects of premature withdrawals. These two different buckets would overcome some of the limitations of the single portfolio approach. Moreover, this approach would work more easily with higher levels of wealth, depending on the level of complexity the advisor and client would like to engage.

The Total Return Dilemma

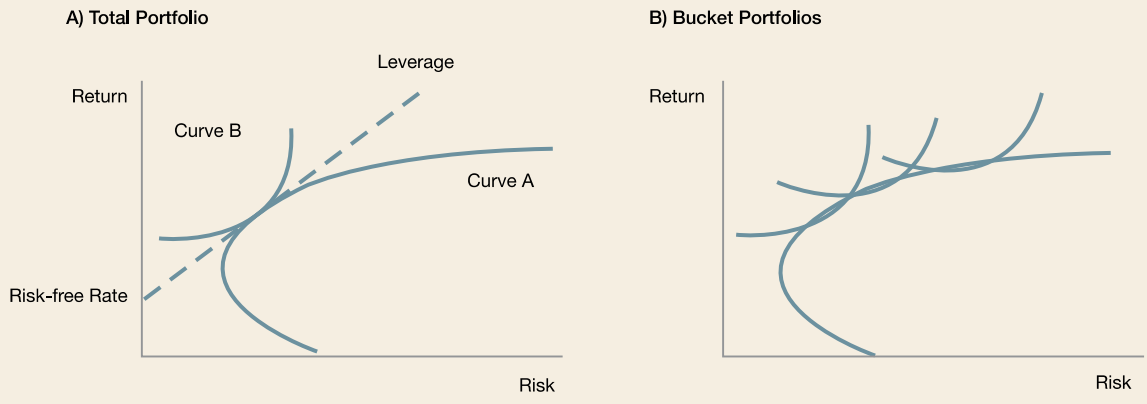
Too often, however, we tend to think of the investment process as an efficient frontier and what economists call an indifference, or utility, curve. There's an efficient frontier (curve A) and the investor's utility function (curve B). Where the two meet is the investment portfolio. This is the foundation of modern portfolio theory and is the total return approach to the investment process. The total portfolio is one portfolio for all of a client's needs (figure 1A). Investors can, then, achieve different objectives by being sellers or buyers of leverage, as represented by the leverage line.

In practice, however, individual investors rarely have the means to do so. As a consequence, a more practical means of exploiting the best opportunities on the efficient frontier may be to think of investors as having a set of utility curves, or buckets.

Splitting portfolios into separate buckets or solutions for specific purposes (figure 1B) goes a long way toward improving the utility curve and identifying client preferences. Goals can be defined and explained much better to a client than the esoteric concept of indifference curves, the realm of economists with advanced training. They go one step further, moreover, than simple risk-return questionnaires and better connect client psychology with the investment strategy.

Most advisors, however, do not use this approach. According to the

FIGURE 1: TWO VIEWS OF PORTFOLIO MANAGEMENT



Financial Planning Association's 2011 Financial Advisor Retirement Income Planning Survey, about three-fourths of advisors employ the systematic withdrawal approach, the one-portfolio-for-everything concept (FPA 2011).

Liquidity Preference

The idea of bucketing is by no means new. It is grounded in the work of James Tobin (1958), a Nobel laureate who examined why investors would want to hold balances in cash as opposed to other monetary assets. Bucketing, however, goes a little further, taking many of the conceptual ideas from the work of Tobin (1958) and others, and considers dividing investments into high-risk and low-risk buckets in order to pursue the highest returns for these segmented assets.

The idea behind bucketing is actually a best practice among institutional investors. Insurance companies, for example, bucket all the time, especially when they use their surplus assets, after expected liabilities, in more-aggressive investment strategies.

Avoiding the Knee-Jerk Reaction

When following a single portfolio approach, clients may be more prone to not staying invested when markets suffer a downturn. Investors are twice as concerned with losses as they are with gains, so it is easy to imagine scenarios where investors are more unnerved when the value of a total portfolio is impacted by a loss in equity values, especially during a black swan event. This scared investor may order an advisor to liquidate all investments into cash, even though the portfolio is designed for short-term and long-term needs. These problems become more acute when withdrawals, systematic or not, come as portfolio balances shrink.

A bucket strategy aims to address these concerns by taking withdrawals from reliable cash and fixed-income holdings and giving riskier fixed-income and stock holdings time to recover from market downturns.

Mitigating the Risks of a Bear Market

The greatest advantage to a bucketing approach, therefore, may be before a market downturn. When an investor takes systematic withdrawals can have a significant impact on the size of a nest egg. During the distribution phase of retirement, starting withdrawals during a bear market can significantly erode what an investor has accumulated. Table 1 shows two simple but different hypothetical market scenarios. Starting retirement in the bear market can erode the nest egg by more than $255,000 in seven years versus a sequence of returns that are its mirror opposite with a level 4-percent withdrawal rate on the initial investment. In fact, the client would have saved more than $90,000 simply by taking withdrawals from a cash portfolio during these seven years.

Even placement into a conservative bucket—even if it isn't cash—improves the outcomes of this portfolio over a hypothetical bear market. Nearly $23,000 in a nest egg's losses

TABLE 1: DISTRIBUTION STRATEGIES UNDER DIFFERENT MARKET SCENARIOS

	Bear Returns	Starting Portfolio of $1 million	Bull Returns	Starting Portfolio of $1 million
Year 1	–18%	$785,000	18%	$1,135,000
Year 2	–6%	$697,900	6%	$1,163,100
Year 3	–3%	$636,963	3%	$1,193,993
Year 4	0%	$596,963	0%	$1,189,993
Year 5	3%	$574,872	–3%	$1,150,293
Year 6	6%	$569,364	–6%	$1,077,276
Year 7	18%	$629,003	–18%	$884,752
		Lost Portfolio Value:	($255,749)	

Note: For the illustrated example, withdrawals and reinvestment occur at the end of each year.

TABLE 2: SAVINGS FROM AGGRESSIVE AND CONSERVATIVE BUCKET*

	Aggressive Portfolio		Conservative Portfolio		Only One Portfolio	
	Returns	Starting value of $500,000	Returns	Starting value of $500,000	Returns	Starting value of $1 million
Year 1	–30%	$350,000	–5%	$435,000	–18%	$785,000
Year 2	–10%	$315,000	–2%	$386,300	–6%	$697,900
Year 3	–5%	$299,250	–1%	$342,437	–3%	$636,963
Year 4	0%	$299,250	0%	$302,437	0%	$596,963
Year 5	5%	$314,213	1%	$265,461	3%	$574,872
Year 6	10%	$345,634	2%	$230,771	6%	$569,364
Year 7	30%	$449,324	5%	$202,309	18%	$629,003

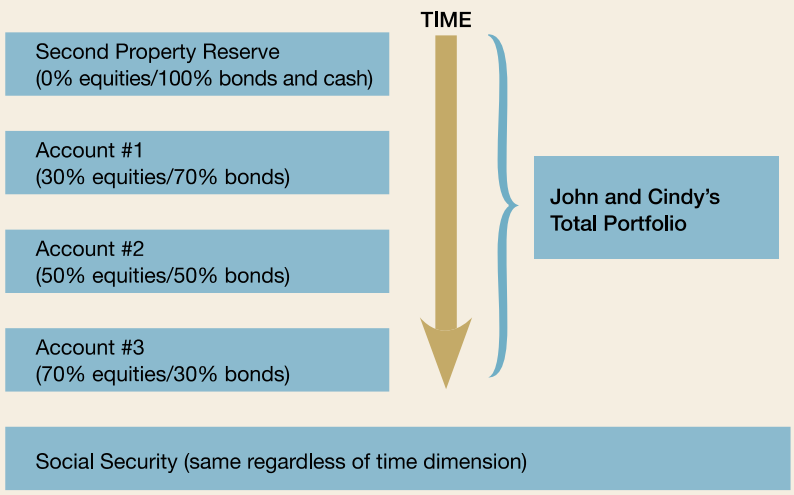
Aggressive & Moderate Portfolio Value: $651,633

Total Portfolio Value: $629,003

Lost Portfolio Value: ($22,630)

*For the illustrated example, withdrawals and reinvestment occur at the end of each year.

FIGURE 2: CLIENT'S ACCOUNT ITEMIZATION (OR BUCKETS)



would be avoided over these years simply by dividing the cash into aggressive and conservative components and pulling withdrawals from the conservative bucket rather than relying on one portfolio (see table 2).

With our own clients, moreover, we have seen our success rates for retirement improve through Monte Carlo simulations when buckets—different liquidation strategies—are used for different financial goals.

Implementation of the Buckets: More Wealth and Complexity

Let's take a more-complicated example than the one introduced earlier and introduce more accounts. As assets reach a certain point, financial complexity almost always increases. The same principles, however, apply.

Assume, for example, that your clients John and Cindy want to purchase a second property on the beach within the next year. These funds would be in cash and cash equivalents. Assume, furthermore, that John and Cindy also had $3 million to invest (constructed in three separate portfolios of $1 million each). The portfolio for earlier retirement needs would be less aggressive (30/70) than that required later on in life. The two other portions, above and beyond current living expenses, would be more aggressive (50/50 and 70/30). John and Cindy would draw from first bucket (30/70) before touching the other buckets.

The latter two, more-aggressive, portfolios then would provide opportunities for inflation hedging and leave possibilities open for gifting any remaining assets. More important, these portfolios would take advantage of the phenomenon that, historically, the risk and volatility of more-aggressive investments decreases the longer the time horizon. These latter buckets would have longer time horizons than the first by nature of the purpose of each (see figure 2).

John and Cindy would not only be sunning by the beach at their second property, but they would have the extra peace of mind of knowing how each bucket fits into their future income needs.

This mental accounting benefits John and Cindy not only by helping them understand their own utility from each portfolio but also by avoiding some of the behavioral finance issues that identify mental accounting as a deterrent to optimized returns. Correlations between assets within each portfolio still can be viewed together. At the firm level, buy and sell decisions could be made irrespective of how gains and losses would be perceived by individual tolerances for risk. And the portfolio, a combination of Accounts #1, #2, and #3, still could be a mix of 50-percent equities and 50-percent fixed income in aggregate. The number of buckets could adapt to the complexity of the client situation, with more wealth requiring more customization.

Best of Both Worlds

All in all, there are ways to still have the benefits of total portfolio management with the heuristic benefits of a bucketing approach to wealth planning. The bucketing approach, moreover, mitigates the sequence risk that impacts systematic withdrawals in down markets. These considerations are especially important as we enter the fifth year of a bull market. It is our expectation that more clients will demand alternatives to the most-traditional concepts behind portfolio management, which are not so much a radical departure from sound financial theory but a modification of what is an approach that can benefit all clients.

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