KEY STEPS FOR BUILDING A SUCCESSFUL RETIREMENT PORTFOLIO

For more articles and White papers, visit our website www.mamportfolios.com

STEVE MCCARTHY
CPA, CFP®,
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com

(Originally Published in October 2015 Monthly Commentary)

Note: This article is based on an American Funds research article titled, "Key Steps to Retirement Success: How to Seek Greater Wealth and Downside Protection", that was published in July 2015.

The key to building a successful portfolio for retirement is generating sustainable income while managing risk. In retirement, investors must balance two key risks: longevity risk (the risk of outliving assets) and market risk (volatility). That balancing act has become more difficult in recent years due to low bond yields, which has increased the importance of a meaningful equity allocation in retirement. Since compared to bonds, equities have greater total return potential accompanied by higher volatility, an increase in equity can reduce longevity risk—but at the cost of higher market risk.

Three Key Traits: In this environment, investors need an equity allocation that can generate strong returns to address longevity risk while also providing downside resilience to protect against market risk. New research from American Funds, which offers an excellent family of actively-managed mutual funds, has identified a group of active equity and balance funds that have delivered on these goals. While past results aren't a guarantee of future success, these funds share three traits:

- **Low expense ratios**
- **High firm-level manager ownership**
- **A history of outpacing indexes in market declines (a trait known as "low downside capture")**

Mutual funds that contain these three traits have a history of outpacing indexes in scenarios where regular portfolio withdrawals are being taken, while experiencing less volatility and greater risk-adjusted returns.

The benefits of the first two traits (low expense ratios and high manager ownership) were discussed in our April 2015 Monthly Commentary article "When Actively-Managed Funds Have an Advantage." Funds that combine these two traits have performed well relative to index funds over time. American Funds extended its research to focus on the distribution phase for portfolios (i.e. when investors take regular withdrawals to fund their retirement). In doing so, it found that adding a third trait—low downside capture—to the investment selection process enhanced results during withdrawal scenarios.

"Mutual funds that contain these three traits have a history of outpacing indexes in scenarios where regular portfolio withdrawals are being taken, while experiencing less volatility and greater risk-adjusted returns."

Downside Capture: Morningstar calculates "downside capture" for a mutual fund by taking the fund's monthly returns during the periods of negative S&P 500 index performance and dividing it by the S&P 500's return. *A downside capture ratio of less than "100" indicates that a fund has lost less than the S&P 500 in periods when the stock market fell.*

At MAM, we have used "low downside capture" as one of the criteria we evaluate when selecting funds to include in a client's portfolio. As a result, most of the equity mutual funds used in portfolios have a downside capture of less than 100. In particular, per recent Morningstar figures:

Name of Fund	10-Yr Downside Capture Ratio
American Funds AMCAP	93 (i.e. 93% of S&P 500's drop)
Capital World Growth & Income	77
FMI Large Cap	80
Yacktman Fund	79

Results of American Funds Study: To evaluate the results of the study, American Funds tested *two hypothetical portfolios containing funds that satisfied all three key traits (i.e. "select active funds")* over a 20-year withdrawal scenario ending December 31, 2014. They assumed a $500,000 initial investment and a 4% initial withdrawal rate (growing 3% annually thereafter).

The first portfolio (shown in the left-half of the chart on page 3) consisted of a 50% allocation to the select U.S. large-cap funds and a 50% allocation to the select foreign large-cap funds. This was compared against an index blend consisting of 50% allocated to the S&P 500 and 50% to the MSCI All Country World ex USA index. Because these portfolios did not include a bond allocation, they are not representative of MAM portfolios. Nonetheless, the "select active funds" significantly outperformed the index blend over the 20-year period.

The second portfolio (shown in the right-half of the chart on page 3), which is more representative of a relatively conservative MAM-managed portfolio, consisted of a 50% allocation to the select Moderate Allocation funds and 50% to World Allocation funds. It was compared to a portfolio consisting of 60% allocated to the MSCI All Country World Index and 40% to the Barclays Global Aggregate Bond Index. As shown in the chart below, the select portfolios (i.e. which contain all 3 key traits) significantly outperformed the indexes for the 20-year withdrawal period.

The one caveat I have is that with interest rates currently near historical lows, I expect the next 20 years will be a more challenging time for a balanced stock/bond portfolio because bonds will not perform nearly as well as they did in the past 20 years when bond prices benefited from falling interest rates. The key takeaway, though, is that selecting mutual funds that contain all three of the traits discussed above is likely to help a retiree generate sustainable income while managing risk.

McCarthy Asset Management, Inc.
Personalized Wealth Management

Our Services

Investment Management Services:

- MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.

Financial Planning Services:

- The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.
- "Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

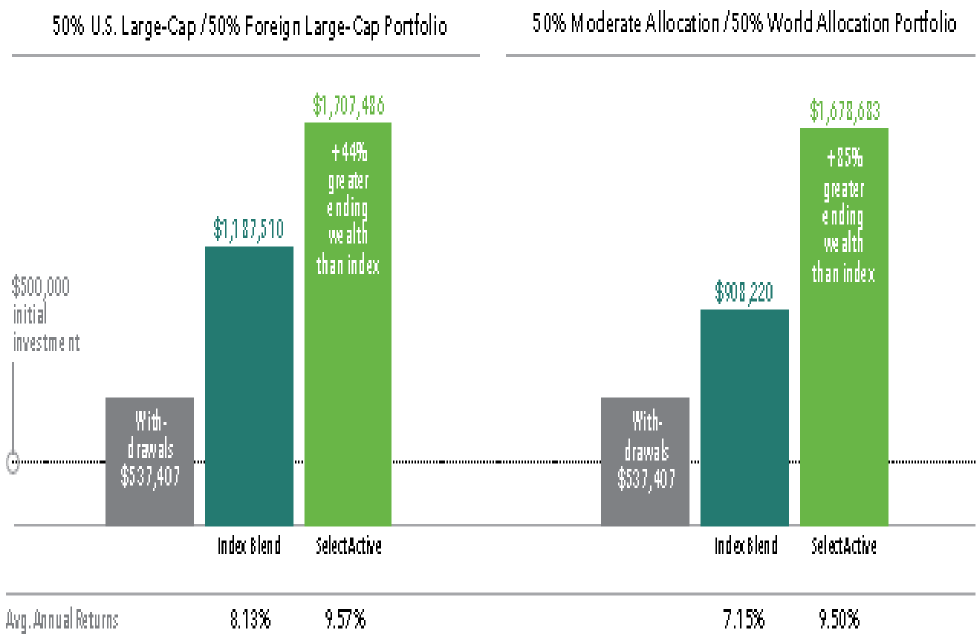
- Tax Return Preparation
- Income Tax Projections
- Tax Minimization Ideas
- Tax Authority Representation

Other Services: MAM has retained several outside experts, whose services are available at no cost to our clients:

- Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.

Select Active Portfolios Delivered Greater Wealth in Distribution

Return of a hypothetical $500,000 initial investment, with a 4% initial percentage withdrawal rate, increasing by 3% each year thereafter for the 20-year period ended December 31, 2014



Source: Capital Group, based on Morningstar data. Based on monthly returns. Average annualized returns are at net asset value and include withdrawals. See Appendix for methodology. U.S. funds are those in the Morningstar Open-End Large Value, Large Blend and Large Growth categories. International funds are those in the Morningstar Open-End Foreign Large Value, Foreign Large Blend and Foreign Large Growth categories. Moderate Allocation and World Allocation funds drawn from Morningstar categories of the same name. Moderate Allocation index is 60% S&P 500 and 40% Barclays U.S. Aggregate indexes. World Allocation index is 60% MSCI All Country World Index and 40% Barclays Global Aggregate Index. U.S. index is S&P 500. Foreign index is MSCI All Country World ex USA. The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.