



Using a Hierarchy of Funds to Reach Client Goals

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The financial planning and investment industries use a common mental map, a framework that serves to focus, simplify, and constrain thinking and recommendations. This framework, modern portfolio theory,¹ is deeply embedded in the psyche of financial advisers and is applied to institutions as well as individuals, including individuals at or near retirement.

Modern portfolio theory has drawn investors into markets by touting historical long-term average stock returns. This perspective (long-term averages, law of large numbers) may best apply on a group basis—for pension funds, insurance pools, etc.—where there is an institutional time horizon of 40 years or more. Personal finance is not institutional finance; therefore, we believe that there is an alternative mental map that changes the way advisers and individuals think about the unique questions retirees must answer, and offers a hierarchy of funds to reach client goals in any market. We call this alternative mental map modern retirement theory (MRT).²

MRT suggests that historical long-term averages may not apply in individual client scenarios and seeks to offer a sustainable benefit to individuals. It proposes a perspective on retirement planning that seeks to meet the individual client's retirement goals under any market condition or life event. The model recognizes

potential limits in asset growth in good markets, but seeks to use retirement sheet assets³ versus portfolio assets. The theory defines success as a sustainable lifestyle throughout retirement.

MRT is the comprehensive alternative mental map within which modern portfolio theory fits.

Institutions Versus Individual Retirees

To understand why applying modern portfolio theory and its historical long-term averages may be misapplied to individual clients, consider the differences between institutional and personal finance.

Institutional finance deals with the ways large organizations, such as banks or insurance companies, manage risk, cash flows, business cycles, and market cycles.

Corporations were created in part for perpetuity. While dependent on people to run a business, management teams can change over time and allow the business to continue. Corporations do not worry about longevity, only sustainability. Institutions never physically get sick and die. A corporation may be financially

“sick,” but “death” typically looks like a corporate restructured bankruptcy, government take-over, or merger.

Inherent in an institution's approach to investing is the entity's substantially long (that is, more than 40 years) time horizon. This offers the institution the ability to weather market volatility, including a lost decade. Institutions do not need to manage for the decumulation of a finite asset base over short periods of 20 to 30 years. Additionally, in tough economic or

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business cycles, some organizations such as banks or insurance companies can diversify revenue streams or increase fees to help sustainability.

Personal finance, as defined by modern retirement theory, is the way individuals manage two risks: (1) longevity and (2) conditions within longevity. Individuals must manage

Table 1: Institutional vs. Personal Finance

Characteristic	Institutional Finance	Personal Finance: Retiree
Entity	Institution	Individual
Time horizon	Perpetual	Finite, unknowable
Conditions	Business cycles, market cycles, economic cycles	Market cycles, economic cycles, healthcare issues, retirement income
Decumulation strategies	None	Contractually guaranteed income for base expenses
Taxes	Corporate rates	May be lower for the retiree than pre-retirement, meaning less gross income is actually required
Outcomes	Stochastic process, mean regression, law of large numbers, Monte Carlo	One life, one retirement date
Income	Diversified income streams	Contractually guaranteed; secure, stable, sustainable (3-5 model)

their retirement assets based on an unknowable but finite lifespan. Retirees need enough income to maintain their at-retirement lifestyle without running out of money. Additionally, retirees must be prepared to handle the conditions within longevity. These conditions include managing cash flows through a predictable decumulation of assets for life, healthcare costs or issues, a planned retirement date, monetary family obligations, a changing legislative environment for estates, and market cycles.

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Many complex assumptions, changing life factors, market fluctuations, and human emotions get in the way of accurately predicting an individual’s future in a financial plan. At best, a financial plan will offer a compass heading into retirement. Rather than constructing a plan that is primarily dependent on performance of a

portfolio and a safe withdrawal rate, every retiree must face up to and plan for the unknowable questions of longevity and conditions within longevity.

Using Modern Retirement Theory for the Retiree

The MRT standard is that individual retirement goals are absolute and therefore must result in a sustainable lifestyle throughout the retirement phase. To this end, MRT seeks to employ strategies that meet the client’s stated objectives in any market climate, mitigate and transfer longevity risk and conditions within longevity risk, are tax efficient, and maximize assets by disbursing the client’s retirement sheet assets into four broad categories. Listed in order of priority, these four categories, or

funds, are: base fund, contingency fund, discretionary fund, and legacy fund.

Base Fund. The core philosophy of this fund is to provide guaranteed income that can be produced in good market conditions or poor market conditions. Base income should be characterized as secure, stable, and sustainable. This

income should also adjust for inflation over time and remain in place for a surviving partner. Social Security is viewed as a portion of this guaranteed base. Base income is defined as $B=B1+B2$ where $B1$ is Social Security and $B2$ is other income-producing assets.

Contingency Fund. This fund offers a hedge against the unpredictable yet highly consequential events (black swans) that may occur from a personal medical issue, changes in estate laws, or with markets. Laws related to the types of events covered in this fund may change over time, so individuals should seek a legal review of their documents every three to five years. Not only do estate laws change, but there is the potential for estate taxes to be due in a negative market cycle.

Discretionary Fund. After lifetime income is secure and catastrophic scenarios mitigated, a flexible income fund can be established.

Legacy Fund. The final MRT set-aside is the legacy fund. These assets are intended to be used for inheritance or charitable purposes and will not be used to satisfy any of the prior-mentioned funds. Therefore, this fund may be more aggressively invested and may avoid inclusion in the estate through attorney-recommended trusts.

Conclusion

The recent decade has challenged advisers, the investment industry, and retirees in unexpected ways. Advisers have felt the tension between encouraging the client to ride out market storms in the hopes of achieving long-term market averages and fighting retirees’ negative emotions and declining portfolios. The most significant challenge has come to the individual retirees themselves, whose investment portfolios have been severely tested and for most of whom the historical averages have not been realized. These retirees are left feeling as though they have descended into a financial purgatory.


Table 2: Modern Retirement Theory's Hierarchy of Funds

Funding Priority	Fund	Purpose	Time Horizon for Portfolio Assets	Possible Tools	Potential Hazards that Must Be Managed
1	Base Fund	To provide guaranteed income in good or poor market conditions with investing options that extend some form of protection and are not subject to market risk	Immediate	Social Security, laddered CD interest, laddered fixed annuity income, variable annuities with guaranteed income, defined benefit pension plans, reverse mortgages, TIPS (alternative income may be generated from income-producing real estate assets or raw land, such as timber and hunting leases)	Primarily inflation and credit risk; using non-qualified assets prior to consuming qualified assets is preferred for tax efficiency, institutional exposure (FDIC or SIPC, or State Guarantee Association)
2	Contingency Fund	To mitigate and transfer risk to maintain a sustainable retirement lifestyle by having assets that are available on short notice and that will not suffer market loss even in negative market cycles	Immediate to 1 year	Short-term FDIC structured notes, laddered CDs, life insurance for estate planning, market neutral or inverse funds, cash	Primarily an issue of risk acceptance, mitigation, or transference. Medical risks may be mitigated with Medicare along with an appropriate medical supplement; a long-term care event may be mitigated with long-term care insurance (preferably purchased before age 60) or buying into a continuing care facility as an independent resident
3	Discretionary Fund	To handle travel expenses, auto purchases, and other events that are flexible in need or occurrence	2 to 10 years	Laddered CDs, laddered FDIC-insured structured notes, cash value from life insurance, and TIPS on the more conservative end; a more moderate approach would use a conservative investment portfolio or dividend-paying preferred stocks	Inflation, institutional exposure (FDIC or SIPC, or State Guarantee Association)
4	Legacy Fund	To be used for inheritance or charitable purposes	> 10 years	Charitable trusts (e.g., CRAT, CLUT), donor-advised funds, a diversified stock and bond portfolio, whole or permanent life insurance, life insurance trusts	Changes in estate tax laws

Advisers must attempt to offer alternatives that reform, reframe, and reshape the context of retirement thinking. Alternatives may strive to more effectively manage or avert dangerous declines in asset value that leave retirees with the undesirable choices of work longer, increase savings, or die early. Planners should be ready to chart a new course for retirees while taking advantage of modern portfolio theory.

In "Spending Retirement on Planet Vulcan," Moshe Milevsky, Ph.D., says, "Many of the popular products used and strategies employed by individuals in their portfolios are at odds with financial economics."⁴ A new course should be in harmony with financial economics and offer a comprehensive approach to the goals of an individual

retiree. That new course is modern retirement theory.



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Endnotes

1. Markowitz, Harry M. 1959. *Portfolio Selection: Efficient Diversification of Investments*. New York: John Wiley & Sons. Modern Portfolio Theory: A theory on how risk-averse investors

can construct portfolios in order to optimize market risk for expected returns, emphasizing that risk is an inherent part of a higher reward. Also called portfolio theory or portfolio management theory.

2. Branning, Jason, and Ray Grubbs. 2009. "Modern Retirement Theory: Reaching Client Goals in Every Market." *Journal of Financial Planning's Retirement Distribution Supplement* (December).
3. Retirement sheet assets: a client's balance sheet, Social Security income, pension income, annuity income, and human capital.
4. Milevsky, M., and H. Huang. 2010. "Spending Retirement on Planet Vulcan: The Impact of Longevity Risk Aversion on Optimal Withdrawal Rates." Retrieved from The Individual Finance and Insurance Decisions Centre: www.ifid.ca/pdf_workingpapers/Spending_Retirement_Vulcan_14MAR2010.pdf.