Retirement May Not Be So Rosy

On the Holmes and Rahe Stress Scale used by psychologists to determine stress levels, retirement is rated as the 10th most stressful event, even though retirement ideally represents the reward for a lifetime of labor. Undoubtedly, no small part of that stress is linked to the pressing need for retirees to replace the income they once earned during their working years with investment-related income they require during retirement.

The Holmes and Rahe Stress Scale

<table>
<thead>
<tr>
<th>Rank</th>
<th>Stress Score</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100</td>
<td>Death of a Spouse</td>
</tr>
<tr>
<td>2</td>
<td>73</td>
<td>Divorce</td>
</tr>
<tr>
<td>3</td>
<td>65</td>
<td>Marital Separation</td>
</tr>
<tr>
<td>4</td>
<td>63</td>
<td>Imprisonment</td>
</tr>
<tr>
<td>5</td>
<td>63</td>
<td>Death of a Close Family Member</td>
</tr>
<tr>
<td>6</td>
<td>53</td>
<td>Personal Injury or Illness</td>
</tr>
<tr>
<td>7</td>
<td>50</td>
<td>Marriage</td>
</tr>
<tr>
<td>8</td>
<td>47</td>
<td>Dismissal from Work</td>
</tr>
<tr>
<td>9</td>
<td>45</td>
<td>Marital Reconciliation</td>
</tr>
<tr>
<td>10</td>
<td>45</td>
<td>Retirement</td>
</tr>
</tbody>
</table>

TABLE OF CONTENTS

Retirement May Not Be So Rosy ..............................................1
Income Is Hard to Come by .............................................2
The Pitfalls of Chasing Yield ........................................4
Purchasing Power .........................................................5
Investment Considerations ............................................6
Consider Municipal Bonds .............................................6
Consider Investment Grade and High Yield Corporate Bonds ....7
Consider Dividend-Paying Stocks ....................................7
Conclusion ........................................................................8

* The Holmes and Rahe Stress Scale, also known as the Social Readjustment Rating Scale (SRRS), Holmes, T. H. and Rahe, R. H. 1967, Journal of Psychosomatic Research.
Retirement May Not Be So Rosy (continued)

The dramatic increase in average life expectancy during the 20th century ranks as one of society’s greatest achievements. Although most babies born in 1900 did not live past age 50, life expectancy at birth now exceeds 80 years.

Life expectancy improvements have set off a broad set of changes and challenges for Americans whose average age of retirement is 65 (see Chart 1). Yet few have adequate retirement savings. Given most families — even those approaching retirement — have little or no retirement savings, it is easy to understand why many Americans have legitimate worries that they will outlive their retirement savings.

In the past, when yields from bonds, dividend-paying stocks and other fixed-income investments such as CDs were higher, a retiree could invest primarily for income and hold onto his or her principal. With today’s low fixed-income returns, however, income-oriented investors are left in a bind.

FOR EXAMPLE

The average man turning 65 years old in 2010 can expect to live another 16.6 years in retirement — almost four years more than in 1970. Meanwhile, women can expect to live to almost 84 years of age, nearly 20 years beyond retirement age. (see Chart 1).2

Income Is Hard to Come by

Unconventional monetary policy from central banks around the world over the past eight years has driven yields to historically low levels, and even into negative territory in many regions.

Even the widely watched 10-Year Treasury yields less than 2%. A decade ago it yielded more than 4.5%, and 20 years ago, higher still — more than 6.5% (see Chart 2). Beyond U.S. government bonds, the universe of sub-zero-yielding debt — primarily government bonds in Europe and Japan but also a mounting number of highly rated corporate bonds continues to surpass all-time records.


2 The World Bank, July 31, 2016.
As cash flow from fixed-income investments decreases, investors must assess how much risk they are willing to take in search of yield.

Alternative assets may be used as an income replacement for some of the traditional fixed-income allocation in an investor’s portfolio, but that may require an increase in the risk budget.

Investors who currently hold bonds for income must also consider the potential for rising inflation and how that negatively impacts the value of future coupon cash flows.

Even with inflation at relatively low levels, it can still diminish purchasing power. Investors that do not account for it in their portfolios and income assumptions might find that their dollar doesn’t go as far as they expect or need in the future.

Just because yields are currently lower than the historical average doesn’t necessarily mean that they will get back to where they used to be anytime soon.

Many central banks around the world are still pursuing easy monetary policy and foreign flows have put downward pressure on U.S. interest rates. Waiting for income payments from bonds and other fixed-income investments to rise isn’t a foolproof strategy for enhancing income during retirement.
The Pitfalls of Chasing Yield

With high-quality bonds paying meager yields, investors understandably may be tempted to take increased risk in order to achieve a return that meets their income needs. Riskier asset classes usually compensate investors with higher levels of income.

Yet that risk isn’t “free.” Longer-term Treasuries, for example, generally pay higher yields than their shorter-term counterparts. But that incremental yield comes with added risk (see Chart 3). Longer-term bonds have more duration, which measures the sensitivity of a bond’s price to changes in interest rates. The higher a bond’s duration, the more its price falls as rates rise, all else being equal.

Higher yields can also be found among bonds with higher credit risk — the risk that a bond’s credit rating could be downgraded due to weakening company fundamentals or potential bankruptcy. Losses from credit risk have been significant in recent years. For example, many U.S. oil and gas producers are struggling lately due to low oil prices, with some suffering credit rating downgrades and others teetering on bankruptcy. In cases such as these, principal price declines from credit problems can overwhelm incremental portfolio yields and lead to negative overall return for investors.

Most importantly, investors currently aren’t adequately compensated for credit risk. The incremental yield investors receive to take on duration and credit risks has decreased since the peak following the global financial crisis in 2008, reflecting investors’ robust appetite for yield over the past several years, which has reduced the price of risk that bond issues have to pay.
Purchasing Power

While inflation typically only slightly increases the costs of goods and services from year to year, it represents a serious risk and challenge for retirement income planning. That’s because inflation’s impact is magnified over an extended period of time.

The impact of inflation is often referred to as a decline in purchasing power, as one dollar does not buy as much in 10 years as it does today. An income plan that doesn’t take into account inflation and the potential decline of purchasing power could be potentially harmful to retirees, especially in the later years of retirement. When taxes are taken into consideration, real yields look even less attractive.

The average annual inflation rate in the U.S. from 1913 through 2015 is 3.18%, which sounds low but prices would double in about 22 years. In certain time periods such as the 1970s and 1980s, inflation was much higher, averaging 7.25% in the 70s and 5.82% in the 80s.\(^3\)

\(^3\) BNY Mellon calculations, using Bureau of Labor Statistics Consumer Price Index (CPI) data.

Sources: BNY Mellon and Bloomberg, as of October 20, 2016. Real Yield assumes CPI inflation rate of 1.5%, as reported on September 30, 2016, and a tax rate of 25%. Past performance is no guarantee of future results.
Investment Considerations

Given the current ultra-low-yielding global bond market, advisors will be challenged to find alternatives to help build successful retirement portfolios. Investing in traditional, long-only fixed income assets that provided adequate income over the past 30 years may no longer fulfill investors’ needs going forward. Clients may need to broaden their investment horizons by adding assets with more income potential and less sensitivity to rising interest rates.

Portfolios that balance the need for income with both capital preservation and high-risk adjusted returns should offer investors the potential to enhance income and defend against a moderately rising interest rate environment.

For investors concerned about the prospect of rising interest rates, U.S. municipal bonds may be a good opportunity. U.S. municipal bonds can be a high-quality, low-volatility complement to an overall asset allocation. In addition to the potential diversification benefits, U.S. municipal bonds may enhance the overall risk-and-return profile of an investment portfolio.

Certain features of the municipal bond market help explain this observed defensiveness of municipals when interest rates rise. First, municipal bond valuations tend to respond to demand trends among individuals and households, who together own over two-thirds of all municipals, either directly or through funds. Higher interest rates often lead to an increase in muni bond purchases since investors hope to lock in higher coupon rates. Supply conditions also support the defensiveness noted above. Often when rates rise sharply, issuers lose the ability to refinance existing debt by issuing refunding bonds. Choking off refunding activity can cut new issuance by as much as 30%, creating relative scarcity and tempering the price declines caused by rising interest rates. After factoring in the tax exemptions municipal bond income qualifies for versus other bonds, there is a compelling case for adding an allocation to this sector.

CONSIDER MUNICIPAL BONDS

**CHART 5**

**RISK/REWARD OVER THE PAST THREE YEARS**

<table>
<thead>
<tr>
<th>Index / Category</th>
<th>Total Return (%)</th>
<th>Standard Deviation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Dividend Index</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>U.S. High Yield Bonds</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>U.S. Investment Grade Bonds</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>U.S. Municipal Bonds</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>U.S. Aggregate Bond Index</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>U.S. Treasury Bonds</td>
<td>5.0%</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

CONSIDER INVESTMENT GRADE AND HIGH YIELD CORPORATE BONDS

In a rising rate environment, credit bonds are expected to outperform government bonds due to both higher yields which can cushion against price declines, as well as lower duration compared to a government bond of similar maturity. This is due to the idiosyncratic credit risk component that is one of the main drivers of returns in corporate debt instead of just interest rate changes for government bonds.

In addition, central banks often embark on a rate hike cycle because the economy is firming and growing stronger. Higher interest rates prevent economic growth from becoming overheated. For most companies, this is a positive signal and should lead to stronger corporate profits going forward, which would reduce the implied credit risk for corporate bonds. In this sector, we believe that active management is critical due to the asymmetric risks specifically high yield bonds offer within the universe. Through extensive due diligence and research, active managers seek to navigate the minefield of opportunity and avoid sectors and companies that can be over-leveraged with deteriorating fundamentals.

CONSIDER DIVIDEND-PAYING STOCKS

While it may seem like a stretch to recommend replacing part of an investor’s fixed income allocation with equities, dividend-paying stocks exhibit significantly less return volatility than equities overall due to the dividend income stream which lends these stocks bond-like characteristics.

During the last rising rate period (2004–2006) in the U.S., dividend-paying stocks outperformed many of the other traditional income asset classes (see Chart 6). Compared to high yield bonds, stocks are not substantially affected by interest rate movements. This can provide additional diversification potential in the income-producing assets held in the portfolio, especially if they are heavily fixed income-oriented. If clients require high current income to sustain their lifestyle in retirement, dividend-paying stocks may offer both high yield and also total return through price appreciation during rising rate periods.

Conclusion

Today, investors face more challenges than they have in a very long time. The risk of not meeting investors’ objectives, especially in both funding for, and then generating income in, retirement continues to rise given the uncertainty about future financial market returns. Fortunately, investors do have some options to consider to help meet these challenges.

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RISKS

All investments contain risk and may lose value. Bonds are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Municipal income may be subject to state and local taxes for out-of-state residents. Some income may be subject to the federal alternative minimum tax for certain investors. Capital gains, if any, are taxable. High yield bonds involve increased credit and liquidity risk than higher rated bonds and are considered speculative in terms of the issuer’s ability to pay interest and repay principal on a timely basis. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. There is no guarantee that dividend-paying companies will continue to pay, or increase, their dividend.

INDEX DEFINITIONS

The BAML High Yield Master Index II is a market capitalization-weighted index of all domestic and Yankee High-Yield Bonds. Issues included in the index have maturities of at least one year and have a credit rating lower than BBB- Baa3, but are not in default. Bloomberg Barclays Global Aggregate Index represents the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. Bloomberg Barclays U.S. Aggregate Index represents the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. Indexes are unmanaged and one cannot invest in an index. The Bloomberg Barclays U.S. Corporate Bond Index is a rules-based market-value weighted index engineered to measure the investment grade, fixed-rate, taxable, corporate bond market. The Bloomberg Barclays U.S. Municipal Index tracks the performance of the U.S. municipal securities. The Bloomberg Barclays U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. S&P 500 is one of the most commonly used benchmarks for the overall U.S. stock market, and is an index that tracks the performance of the largest 500 U.S. companies. S&P 500 Dividend Aristocrats® measure the performance of S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The Index treats each constituent as a distinct investment opportunity without regard to its size by equally weighting each company.

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