Interest Rates Are Going to Stay Higher. 3 Ways to Benefit in Retirement.

Three moves to take advantage of higher rates.

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Inflation may be cooling, but it isn't going away. Interest rates will probably settle at higher levels than held sway from 2009 through 2021. In other words, the market is returning to more normal conditions than we've seen since the 2008-09 financial crisis.

It's time for retirees to take stock. Those who stopped working before the pandemic made their financial plans under very different circumstances. Those who retired into the pandemic might have gone straight into survival mode. No matter where you are in your retirement journey, this is a prime opportunity to readjust your portfolio for these changing times.

Retirees are particularly sensitive to market shifts. While you can generally put your 401(k) contributions on autopilot during your career, most people will need to carefully manage their portfolio withdrawals once they no longer have a paycheck coming in. And while it's understandable to want more clarity on where the economy and markets are going before tweaking your investments, the time to act is now, experts say.

It's likely that the Fed has stopped raising interest rates. Pauses between the last rate hike of a cycle and the first rate cut tend to be favorable for bonds. By the time the central bank begins to cut rates, it will be too late for investors to take full advantage of opportunities in fixed income, says Kristy Akullian, senior iShares strategist at BlackRock.

And yet, investors don't seem eager to leave the warm bath of cash, which in fairness has been a cozy and lucrative spot over the past 18 months or so. "There is an urgency to this trade that isn't reflected in current investor positioning," Akullian says.

Below, three interest-rate-sensitive areas of retiree portfolios that might be ripe for a rethink.

Buy Bonds

Money-market funds garnered a record $1 trillion in inflows this year—and no wonder, with yields now around 5%. But cash's reign is drawing to a close. Yields will fall when the Fed begins cutting rates, and history suggests that it's time for investors to exit their defensive crouch. Since 1995, stock and bonds have both performed better during rate pauses than during the six months before the last hike of a cycle and after the first rate cut, according to BlackRock. They also outperformed cash during the pause period.

index gained 9% for the month, while the Bloomberg U.S. Aggregate Bond Index rose nearly 5%. Fueling the rally were investors' expectations that the Fed would cut rates early next year. Bond yields move inversely to bond prices, and November's price rally was the biggest since the 1980s.

Bonds' stellar showing may have eased the pain of the rout that preceded it. In October, 10-year Treasury yields flirted with 5%, their highest levels in 16 years, as prices fell. And retirees may still be smarting from last year, when U.S. bonds lost a staggering 13%.

November's bond rally was so strong that some might wonder if opportunities in fixed income are over. Not so, some pros say. It's a good time to lock in yields to avoid reinvestment risk—that is, the risk that when a bond matures, rates will have fallen since the time of purchase, so you can't reinvest the proceeds in a similarly yielding security.

There's still potential for capital appreciation, Akullian says. If investors continue to anticipate Fed rate cuts, yields may continue to fall and prices rise. Most price appreciation will happen before the first cut, she notes. So, if investors wait until that time to move from cash into bonds, they will have missed the moment.

"By staying in cash, you're actually exposing yourself to the risk of missing the upside," Akullian says. "There are risks to playing it safe."

Some investors believe that inflation will stay stickier than many market participants expect. They make a case for TIPS, or Treasury inflation-protected securities. Phillip Colmar, managing partner and global strategist at MRB Partners, doesn't see inflation returning to the Fed's target rate of 2% anytime soon. Instead, he sees it settling higher, with serious consequences for retirees on a fixed income.

TIPS offer protection against inflation, and some say they're more attractive than they have been in years. TIPS' yields have two components: an inflation adjustment that tracks the consumer price index, plus what's known as the "real yield." The real yield is now about 1.9% for a 10-year TIPS, whereas a 10-year Treasury note yields 4.1%. That means that if inflation exceeds 2.2% over the next 10 years, the current break-even rate, TIPS investors will come out ahead of those holding traditional Treasuries.

Rand Spero, a Lexington, Mass.–based financial planner and president of Street Smart Financial, has been buying TIPS for his clients at auction. He says that while his approach might strike some as overly cautious, he'd rather be safe than sorry, given the corrosive impact of high inflation on retirees' nest eggs.

ETF offer an easy alternative for investors who don’t want to buy individual TIPS. Note: TIPS have a tricky tax treatment and may be best held in tax-deferred accounts.

Revisit the 60/40 Portfolio

There has been plenty of hand-wringing over the past year about the merits of the classic asset allocation of 60% stock and 40% bonds. The rationale for structuring your portfolio in this way is that it allows for growth when equities outperform, but provides a measure of protection when they decline. That’s because bonds have historically provided ballast, either gaining or losing comparatively less when stocks are down.

But 2022 upended the conventional wisdom, with both stocks and bonds falling significantly, tanking the 60/40 portfolio by nearly 16%. Some experts declared 60/40 dead. Not only did the portfolio fail in its mission to cushion market losses last year, but some pros also fretted that the model might be permanently broken, predicting that stocks and bonds would continue to move more in tandem than they have in recent decades.

Others say last year was an anomaly, and that the need for diversification is still very much alive. The 60/40 believers have one recent piece of evidence that seems to bolster their case: In November, the balanced portfolio notched a 9.6% gain, its best month since 1991, according to BofA Securities. “The 60/40 remains attractive for the long term,” says John Rekenthaler, vice president of research for Morningstar.

Retirees who fled to cash amid last year’s losses should venture back into the markets. Your exact asset allocation matters less than staying the course with a diversified portfolio, pros say. Some even recommend a 40% stock, 60% bond split in the near term, to take advantage of the comparatively attractive outlook for fixed income. Andrea DiCenso, portfolio co-manager, alpha strategies team, Loomis, Sayles & Co., says that could be an advantageous positioning for the next 12 to 18 months.

After all, the 60/40 allocation was always more of a starting point than a strict prescription. Retirees with a pension to cover essentials may be able to afford more equity risk than 60%, while others might prefer a more conservative mix of 50/50 or 40/60.

Beyond the changing interest-rate environment, retirees should check their portfolio against other market movements this year. For example, the Magnificent Seven tech stocks have contributed an outsize role to the S&P 500’s performance in 2023, leading to an overconcentration in the large-cap index, some pros say.

Those whose entire stock bucket is composed of U.S. large-cap stocks should expand beyond that. Assets to consider include emerging markets stocks, dividend payers, and real estate, says Nick Nefouse, head of LifePath at BlackRock.

Raise Your Safe Withdrawal Rate

You've probably heard of the 4% rule, which posits that a retiree can safely withdraw 4% of their portfolio in their first year of retirement, and then continue to withdraw that same amount, adjusted for inflation, each year with a very low probability of running out of funds.

But in reality, the exact rate has varied—most recently because of a one-two punch of market conditions and rising costs. In 2021, Morningstar, which runs the numbers on withdrawal scenarios each year, advised new retirees to spend just 3.3% of their nest eggs; last year, it was 3.8%.

This year, though, higher bond yields and moderating inflation have restored the four in the 4% rule, according to Morningstar's calculations. At that rate, someone retiring in 2023 could continue withdrawing more every year adjusted for inflation, and have a 90% probability of not running out of money in 30 years, Morningstar found.

This approach assumes that most retirees prefer a "paycheck" system, where their income remains steady (aside from rising with inflation) over time. Those who are willing to give up that stability could tweak their annual withdrawals based on the state of the markets. This approach can allow for higher starting withdrawal rates—as long as retirees have the flexibility to adjust their spending each year and the willingness to do some more complicated math.

Besides market conditions, the safe withdrawal rate hinges on a retirees' longevity and asset allocation. In general, portfolios with a higher stock allocation returned more over time and thus allowed for higher withdrawals than more-conservative portfolios. Under the best-case market scenario, a 100% stock portfolio allowed for a starting withdrawal rate of 6.9% in rolling 30-year periods from 1926 to 1993, Morningstar found.

But a 100% equity portfolio carries the most risk, and in the worst-case market scenario, the safe starting withdrawal rate was just 1.7%, according to Morningstar's calculations. More-secure options were in the neighborhood of the classic 60/40: This year's 4% safe withdrawal rate used a portfolio of 20% to 40% equities and the remainder in bonds and cash, Morningstar found. A 60% stock/40% bond and cash split would yield a 3.9% withdrawal rate for a 90% chance of success.

Spero, the Lexington, Mass.–based planner, says he generally starts clients at 4% and then adjusts the rate for their particular situation. If a client is single and has no plan for long-term care, for example, she might want more certainty than a 90% chance of not outliving her money. If that's the case, she might start with a lower rate. On the other hand, someone retiring in their mid-70s probably has fewer decades to fund, and might be able to start with a slightly higher rate.

Spero says that people shouldn't fear spending down their principal over the course of retirement. "If you have the ability to live off interest, it feels better, but I'm not locked into that," he says. "I tell people, 'This is what your savings are for.' "