Increase your financial confidence with the “3-Bucket Approach”

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When I meet with a new client, one of the first things they usually ask is how to target high rates of return for their portfolio. And while you can’t blame anyone for asking the question (we all want to know what we can expect to make on our money), my response is nearly always the same:

“The most important question isn’t your rate of return. The question is *where* should you be investing to address your *short-term*, *mid-term*, and *long-term* financial goals.”

Introducing the 3-Bucket Approach to Investing

The idea of investing separately into three time-specific buckets is simple. Known in the financial world as liability-driven investing, or LDI, the 3-Bucket Approach focuses not on maximizing total asset returns, but on addressing future liabilities, including home mortgage and living expenses, college tuition, healthcare expenses, and—the biggie—retirement income. By assigning a “bucket” to three unique time horizons and identifying expected (and unexpected) liabilities for each, you can use this approach to focus on ensuring the right amount of cash flow when you need it. Here’s how it works:

- **Bucket #1: Providing short-term cash**
  The need for short-term cash is always a concern, especially during times of market volatility and low interest rates. Keeping a small amount of emergency cash in the bank, enough to cover three months of living expenses, is standard practice. But when looking at a slightly longer term of two to five years, it may no longer make sense to keep these funds holed up in a bank account earning 2% or less annually—a rate that could be equivalent to *losing* money every day in the face of inflation. Investors can consider placing these assets into short-duration bond funds or institutional funds that provide a monitored combination of diversified assets that could deliver a return of 4-5%. At that rate, your money can potentially earn enough to keep ahead of inflation, yet remain available to cover short-term expenses.

- **Bucket #2: Funding mid-term expenses**
  Allotted for five to ten years into the future, assets in this longer-term portfolio may include diversified mutual funds (both U.S. and international), institutional funds (which can offer greater diversification and lower fees), emerging markets, and perhaps some ETFs. With the goal of 5-7% annual growth, Bucket #2 is designed to hedge against inflation and provide you with greater growth potential at slightly greater risk.

- **Bucket #3: Saving for retirement**
  With a time horizon of ten or more years, assets in Bucket #3 are slated for use in the distant future—either to fund retirement or leave to your heirs. Since the assets won’t be used for some time, this portfolio can sustain greater risk exposure while offering the potential for a greater long-term return. With a goal of 8%+ annual growth, assets might include annuities (many of which now offer income-stream guarantee riders), overfunded life insurance, and tax-deferred savings accounts. Bucket #3 should be built with an eye to tax diversification and balancing access to pre- and post-tax assets at retirement time.

A clear path to financial confidence

The 3-Bucket Approach is a simple concept that does three things. First, it clearly differentiates *where* your money is at any given time and *when* it’s targeted for use. Second, it simplifies the reassigning of assets. If Bucket #1 is getting low, it’s a simple process to draw assets from Bucket #2 to continue to fulfill your short-term cash flow needs. The same is true if, later on, Bucket #2 needs additional funding. Lastly, it provides emotional peace of mind by giving you clear insight into how much you have available to spend at each point in time—and how much more you need to save to achieve your goals. Throughout the process, it’s vital to monitor and adjust each bucket consistently, and to stay current on developing products and changing tax laws. Talk to your advisor about the best way to keep your own strategy on track as your needs and options change over time.

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