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The key to sustainable wealth is to tie your level of consumption spending to the product of your total wealth (including financial wealth and human capital, or the present value of future net income) and the after-tax real rate of return. If you do this, the affluence that you enjoy in your youth, due to the prospect of future earned income, will not be dissipated over time and you will have plenty of valuable options in your declining years, like supporting family member education or business pursuits, or charitable activities.

I have recommended that moderately risk tolerant people use 3% as a reasonable estimate of the future after-tax rate of return. Using this 3% rate to discount future income, I estimate total wealth to be approximately $300 trillion for the US, or about 25 times aggregate disposable income. Thus, my consumption rule of 0.03 times wealth turns out to be equivalent to 0.75 times disposable income and thusly a personal savings rate of 25%. Since we observe savings rates closer to 5% of disposable income, it is clear that my Sustainable Wealth model is not a good descriptor of actual behavior. That's OK by me. The intent of the plan is not to explain what people actually do, but rather to provide one simple means by which to achieve a desirable financial objective.

Based on observed savings behavior, it seems very likely that many if not most people will be forced to significantly retrench their spending in retirement. Of course, it could be that realized investment returns will be much higher than the 3% I think is reasonable. Indeed, over the last 100 years or so equity returns in the US have been roughly on the order of 10% per year. So, what is wrong with extrapolating these results going forward? Well, there are a number of issues including: 1) the 10% actual return is nominal, pre-tax not real after-tax; the historical after-tax real return is closer to 5-6%, 2) most people would not be comfortable with a 100% allocation of financial capital to equities; a fifty/fifty equity/bond split would have generated a net real return more like 3-4%, 3) prospective returns today are probably lower than they have been on average over the past 100 years due to lower current dividend yields and slower economic growth, and higher current valuations, as indicated by relatively high current price earnings multiples. Each of these three factors suggests lower prospective equity returns. 4) Finally, as documented extensively by John Bogle, retail investors do not come close to achieving the returns offered by the market. This is due to a combination of bad timing and payment of large fees and costs for little or no benefit.

Whew. Maybe 3% is too high! In fact, achieving a 3% return is not like falling off a log. But I think that it can be achieved and one strategy for doing so is outlined below. The first question to ask is: do you have special investment skill? Some people do have such skill, but most do not. If you fall into the former category you should apply your skill, but if you like most people fall into the second category you should invest in low cost highly diversified index funds and you should refrain from active trading.

Asset Allocation for Mom and Pop

Here is a simple five step plan.

Step one.

Select one or more passive investment vehicles, like Vanguard's total US stocks (symbol VTI) or Vanguard's total global stocks (symbol VT). This will be the "stock" portfolio.

Step two.

Select a low-risk portfolio consisting of Treasury securities, Treasury inflation-indexed securities (TIPS) and money market funds. Call this the "bond" portfolio.

Step three.

Through a process of self-reflection, assess your tolerance for return volatility. The greater your tolerance, the higher is your portfolio weight to equities. For young people, whose total wealth is primarily composed of human capital, you should follow retirement specialist Miles Milevsky and ask this question: "is your job more like a bond or a stock?" For most people, their jobs provide relatively steady income, like a bond. But some people, like actors or professional athletes, have very volatile incomes that are more like stocks. If your job is like a bond, you should consider a heavier equity allocation in your financial portfolio, and vice versa if your job is like a stock.

Step four.

Suppose you determine that you are comfortable with a fifty/fifty allocation between the bond and stock portfolios. The next step is to set up a brokerage account and implement the strategy.

Step five.

The next step is to wait. Once the stock market moves dramatically in one direction or the other, it may be time to take further action. If the stock market declines 50 percent, let's say, then on a market value basis your allocation to equities has declined from 50% to 33%. It is appropriate to "re-balance" by selling a portion of your bond portfolio and re-investing in the stock portfolio until you have re-established the initial fifty/fifty allocation (in this example, it would require liquidating about one quarter of the bond portfolio).

Similarly, if the stock market moves up dramatically, the re-balancing logic would suggest selling a portfolio of the stock portfolio in order to move back to the fifty/fifty split. The consequence of the rebalancing strategy is to force you to sell after prices rise and to buy after prices fall.

Finally, as you age and the financial portfolio becomes a greater percentage of total wealth, you should gradually decrease the allocation to equities in the financial portfolio. One rationale for this is that the older you are, the less time you have to recover from a market downturn. Also, to the extent your job is like a bond (probably the case for most people), the decline over time in the weight of human capital in total wealth means that your bond "allocation" is falling. So it appropriate to offset this by carrying more bonds in the financial portfolio.

Bottom line, is this the best investment strategy ever devised? The answer is no. Almost surely you can do better if you have a real skill in economic forecasting or security analysis or manager selection. However, the strategy summarized here is easy to comprehend and deploy and it will keep you away from most of the debacles that seem to visit the average retail investor. In that sense, it is a major step forward.