

StrategicPoint of View[®]

GUIDE TO RETIREMENT INCOME PLANNING

You have worked long and hard to reach retirement. Now that you have decided to stop working, enjoy your grandchildren, travel or simply pursue interests that have been on hold, your thoughts turn to spending, and, more importantly, how to make your spending last.

One of the biggest fears for retirees is out-living their money. Increased longevity and spiraling medical costs could jeopardize even the best planned retirement. On the other hand, few want to hoard their money to the detriment of a decent retirement lifestyle.

How can you position your assets and your income stream to plan for a retirement that could last for 30 years? What sources of income are available? How much can be safely withdrawn from a portfolio each year? And how should you coordinate withdrawals with various tax strategies to ensure the desired use of your money? We will tackle all of these questions in this article.

Sources of Income in Retirement

Income Payments

Most of us have more than one source of income during retirement. The fortunate ones have earned a *pension* and can expect monthly payments during retirement. The very lucky have an inflation rider attached to their pension.

Many of us (but not all) can rely on *Social Security*, which is another type of pension income with an annual inflation adjustment. Of course the Social Security system is destined to change, but for most eligible participants, changes are unlikely to affect those nearing retirement.

Some people purchase *immediate annuities* as an additional source of income, since these contracts can provide a series of payments subject to the participant's life expectancy or for a particular period of time. Immediate annuities are created through the annuitization of a deferred annuity or by direct investment with an insurance company and are dependent upon the financial security of the underlying company.

Others plan to use *living benefits* on their variable annuity contracts. Living benefits provide a promise of a predictable income stream, provided that the policy owner follows the rules of the contract.

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Still others can expect retirement income in the form of *rents* from properties; *installment payments* from the sale of a business; or some may receive *inheritances* of varying sizes.

Real Estate

While rental properties and second homes can be converted into retirement assets available for spending, your primary home should not be considered a retirement asset, unless downsizing is a real possibility or you are willing to take money out of the house in the form of a reverse or traditional mortgage later in life.

Investment Portfolios

When most people think of their retirement nest eggs, they think of their *employer-sponsored plans*, *IRAs* or *taxable brokerage accounts*. Your retirement portfolio picks up where your stable income payments leave off, but requires the most planning.

Your investments have to be large enough to offer flexibility — to accommodate the uncertainties of longevity and unexpected expenses, particularly those related to health and long term care. They should also be diversified among asset classes, to help weather market volatility. Over time, depending on your investment strategy and market performance, invested assets have the potential to keep pace with inflation and build up balances beyond the original nest egg.

Investment assets can create adjustable income streams. Unlike pensions, Social Security and annuities, whose payments are determined by set formulas, you choose the timing and amount of withdrawals from investment assets. This allows you to take as little or as much as you need to meet expenses at any point in time. The tradeoff for this flexibility is that you assume the market risk of the underlying assets.

Your portfolio assets should be invested according to your risk tolerance, which may change over time.

Remember that retirement could last thirty years or more. A long time frame allows you to assume more risk, which theoretically can extend the life of the portfolio. However, because down markets at the beginning of retirement have a greater negative impact on assets than do market fluctuations later in retirement, you should select an investment strategy that allows you to weather both the ups and downs of market cycles without being tempted to rapidly change your asset allocation. A good strategy is to check your risk tolerance at the beginning of retirement and regularly thereafter with your advisor.

Cash Reserves

Before retirement you establish and fund an emergency reserve to buffer against unforeseen events. We suggest that you expand your emergency reserve in retirement to include one to two years of anticipated withdrawals from your investment assets. This reserve can be tapped when markets underperform and be replenished when markets outperform. For instance, if you have a stable income (pensions/Social Security/annuities) that provides \$70,000 per year and you need \$100,000 to live on, you would ideally hold \$60,000 in CDs and/or money market accounts. By creating a cash reserve, you reduce your exposure to variability in the markets and the risk of withdrawing assets that have recently lost money.

In addition, you may want to consider setting aside (or not spending down) an additional amount for special purchases, such as cars or gifts to children. The set-aside could be kept in taxable or Roth accounts. Since every withdrawal from retirement accounts for a specific dollar need must be “grossed up” (have taxes added) in order to match the purchase amount, withdrawals from taxable or Roth accounts are less likely to increase your marginal tax rate.

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Creating the Right Balance

It is important to maintain a balance between stable income and investment income. In an ideal retirement, your stable income would cover your non-discretionary expenses (such as utilities, insurance, food, etc., which must be paid regularly) while your investment nest egg would cover your discretionary expenses (travel, entertainment, new clothes, etc.) as well as health care needs.

StrategicPoint Safe Withdrawal Rates

Now that you understand what your sources of income are, the next question is how much can you safely withdraw from your portfolio, each year, and be assured that you are unlikely to run out of money. This is called the “Safe Withdrawal Rate.”

Let’s start with a clear definition: an initial retirement income withdrawal rate is the amount of money you receive during your first year of retirement. It is a percentage of your investment portfolio value. Each year, the initial withdrawal amount is increased by the rate of inflation to provide you with a constant standard of living. Traditional wisdom has espoused a “safe” 4% withdrawal rate. With further research, this number has been increased slightly to 4.4%, depending on the definition of safe and the underlying asset allocation. A higher withdrawal rate, above 4.4% can be achieved, depending on additional adjustments—such as a withdrawal rate that is partially tied to market performance or a shorter time horizon. However, withdrawal rates over 5% carry additional risks and require special planning.

StrategicPoint believes that a safe retirement income withdrawal rate is one that allows no more than a 10% chance of your running out of money. This means that 90% of the time, you will die with a balance in your investment accounts. A 90% success rate is tolerable, because we assume that your available retirement assets do not include your primary

residence. This exclusion provides a buffer in the event of unusual market volatility.

Based on recent literature and experience, StrategicPoint recommends the following initial retirement income withdrawal rates for those concerned about the ultimate safety of their portfolios: Conservative investors: 4%; Balanced and Growth investors: 4.4%.

Special Situations

Since every client’s retirement is unique, exceptions to the above general guidance can exist. For example:

- Increasing the withdrawal rate to 5% is possible if you are willing to adjust your spending to reflect changes in the market. This means that in down market years you would forego inflation adjustments. Or you might plan to reduce discretionary spending as you get older (Caveat! This only works reliably if you have long-term care insurance). The onus of responsibility is on you to make these cash flow adjustments work.
- A reduced rate of less than 4% may be advised if you would like to leave a legacy to charity or heirs; if your retirement is expected to last longer than the assumed thirty years; or if your risk tolerance is low.
- A withdrawal rate of more than 5% is possible under special circumstances such as: if you have a shortened life expectancy, anticipate an inheritance or are able to downsize your primary residence. Investing more aggressively can statistically help maintain a higher withdrawal rate; however, it can also dramatically shorten the life of your portfolio in a down market.

Remember, the amount you withdraw from your portfolio is designed to supplement your stable income. For instance, if a married couple has saved \$1,000,000 at the start of retirement, needs \$75,000

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a year for retirement spending and expects \$35,000 in social security payments, then the initial safe withdrawal of \$44,000 (4.4% times \$1,000,000) puts them comfortably within their retirement spending goal.

Sequencing of Withdrawals

Let's suppose that you have a traditional IRA, a Roth IRA and a taxable individual or joint account. Does it make a difference where you take the money from first? The answer depends on your effective tax rates, whether or not you are currently taking required minimum distributions from your retirement accounts and the anticipated rates of return on the accounts. In addition, you should factor in pensions, annuity income and/or Social Security payments as well as unrealized capital gains and your estate planning goals for inherited assets.

Sequencing

The traditional rule of thumb is to utilize taxable accounts first (these are your individual/joint and trust accounts that pay taxes on interest, dividends and realized capital gains each year), thereby allowing you to stretch out the tax-deferral on your retirement accounts and make your money last longer. However, sometimes it is better to use a different sequence or a combination of taxable, retirement and non-taxable accounts, such as a Roth IRA.

Examples

1) Assume you retire in your sixties, prior to receiving your IRA required minimum distributions (which begins when you turn 70½). In addition to taking money from your taxable accounts, you might consider withdrawing sufficient dollars from your IRAs to fill the lower two tax brackets (currently the 10th and 15th percentiles). This not only ensures a relatively low tax rate, but also reduces future required minimum distributions that might be taxed at a higher rate. This strategy also works during years when you have high

deductible medical (or long term care) bills or other expenses, which temporarily pull you into a lower marginal tax bracket and allow you to withdraw from your retirement accounts at low tax rates.

- 2) You plan on bequeathing an inheritance to heirs and prefer not to leave assets subject to income taxes. Since inherited IRAs, annuities, etc., pay ordinary income taxes on the distributions, you may want to consider paying the taxes yourself and leaving your heirs a portion of the assets that receive a step-up in cost basis at your death. (A step-up occurs when a person dies and the cost basis of assets in taxable accounts is increased to the valuation on the date of death. This effectively eliminates any capital gains tax from the time the deceased purchased the asset until the time of death.) IRAs, retirement plans, savings bonds and annuities do not receive a step-up in basis.
- 3) If you have both taxable and tax-deferred accounts and plan to leave your assets to charity, you are better off spending the taxable accounts and naming the charity as a beneficiary of your IRA.

Other factors

Roth Accounts: Studies show that withdrawals from Roth accounts, in coordination with other accounts, can help to control taxes. While some people may want to save these accounts for their heirs (who pay no taxes on withdrawals), Roths can be effectively used to manage taxes during your lifetime.

Asset Withdrawal: Distribute proceeds from assets consistent with your portfolio model. This means that when you take money from an investment account, you should sell assets in such a manner as not to change the overall recommended asset allocation. Some studies show that withdrawing assets with expected lower after-tax returns first (usually fixed

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income), extends the life of the account. This is because riskier assets, which can yield higher returns, are left in the account and because stocks have a lower tax rate (dividends and capital gains) than fixed income assets. However, we are not comfortable with a retiree's portfolio becoming riskier with age. You should take withdrawals consistent with your stated risk tolerance. (One exception to this rule is for older clients with large unrealized capital gains in their taxable accounts. They may wish to hang onto these assets to benefit from the step-up in basis at death, assuming these assets are not expected to be spent.)

Conclusion

Many people financially prepare for their retirement but forget to plan during retirement. It is equally important to think about spending down your assets as it is about accumulating those same assets. Just as you seek to avoid too much risk in your investment strategy, so must you pursue spending strategies that also reduce your risk of out-living your assets.

Retirement can provide for financial security if you take the time to plan ahead. Outline what stable income you can expect to receive, understand how much you can and should be spending during retirement, and develop a strategy for safely withdrawing assets from your investment portfolio. While you may not be able to pursue everything you want to do in retirement, with proper planning, you can feel confident that you are allocating your resources in the best manner to meet your goals.

Questions about this article:

Please send an email to info@strategicpoint.com.

To schedule a meeting with a StrategicPoint advisor:

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