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Withdrawal Symptoms

June 2006

The Challenges of Managing Your Retirement Portfolio During the Distribution Phase

In the last issue, we explored top-level subjects facing people planning for and grappling with retirement. Yet we did not discuss the fact that many investors focus too much time and energy on securities selection and market movements. Not only do such activities distract from financial fundamentals, investors are unlikely to have the skill—or luck—to improve their results through these means. This article focuses on management practices that are more likely to increase your chance of producing a steady, inflation-adjusted (*i.e.*, increasing) income stream during what is expected to be a long life.

With the diminishment of traditional income sources and life expectancies into 90-plus years, it may turn out that *saving for retirement* is child's play compared with *spending for retirement*. Retired investors now must practice skills that have been the exclusive purview of foundations and endowments to have a reasonable chance of making their savings last. Unlike your local endowment, we cannot hold a silent auction to shore up a flagging retirement portfolio.

However—despite a lack of guarantees for success—astute portfolio design and distribution planning can help you more comfortably replace your paycheck. That means becoming acquainted with determining a safe withdrawal rate, budgeting, managing taxes and cash flow principles. Here, I'll discuss the background you need to understand these practices and provide some initial steps to get you started.

What is a Safe Withdrawal Rate?

Determining an appropriate withdrawal rate given your needs and portfolio can be a high wire act. You might spend too much and run out of money; or, you might not spend as much as you could and end up denying yourself the fulfilling life you worked so hard to achieve.

Fortunately, there has been a tremendous amount of excellent academic and industry research on determining a safe and sustainable withdrawal rate. Beginning in October 1994, William Bengen published a series of papers in the *Journal of Financial Planning* attempting to establish a universally safe initial withdrawal rate—which could be increased thereafter for inflation—over a 30–year retirement time horizon. * He identified the "4% solution" (actually between 4% and 4.5%).

But for many, the 4% solution seems like no solution at all.

* *Bengen's model was based upon historical data using a variety of asset allocations and was described in the following articles: 1. Bengen, William. October 1994. "Determining Withdrawal Rates Using Historical Data,"* Journal of Financial Planning. ***http://www.fpanet.org/journal/articles/1994_Issues/jfp1094-art9.cfm****; 2. Bengen, William. August 1996. "Asset Allocation for a Lifetime,"* Journal of Financial Planning. ***http://www.fpanet.org/journal/articles/1996_Issues/jfp0896-art10.cfm****; and 3. Bengen, William. December 1997. "Conserving Client Portfolios During Retirement, Part III,"* Journal of Financial Planning. ***http://www.fpanet.org/journal/articles/1997_Issues/jfp1297-art12.cfm***

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In October 2004, ten years after Bengen's first article, Jonathan T. Guyton set out to determine whether there might be a way to increase the safe initial withdrawal rate, on which he placed the following constraints:

- never requires a reduction,
- permits increases for the prior year's inflation rate, and
- would last at least 40 years.†

Guyton succeeded, but the resulting model requires that one adhere to certain portfolio management and withdrawal practices (see right). For example, if an investor forgoes an increase in years when the portfolio has a negative return *and* caps inflation adjustments at 6%, Guyton determined that the safe initial withdrawal amount can be 5.8% for a 65% equities portfolio and 6.2% for an 80% equities portfolio.‡

Investors should note how much discipline is required to take advantage of these revelations and craft a plan that is suitable to their financial goals and their investment personalities, including their risk tolerance.

Guyton's Portfolio & Withdrawal Rules

Portfolio Rules

- **Portfolio must hold multiple asset classes (including small cap, international stocks and real estate) to benefit from modern portfolio theory's diversification assumptions.**
- **Disciplined rebalancing must be conducted.**

Withdrawal Rules

- **Withdrawals must be ordered by asset class (from cash first, then fixed income, then from equities in order of performance).**
- **Withdrawals cannot exceed limits in certain years (e.g., forgoing an increased percentage withdrawal in years with a negative return and capping inflation adjustments).**

Budgeting: How Much Will I Spend?

In concert with determining how much you can safely withdraw from your portfolio, you must also determine how much you are likely to spend in retirement. After all, you cannot create a realistic budget unless you have an idea of how much you have to fund it. Likewise, you won't know what a "safe" withdrawal rate is unless you can estimate how much you need to spend and for how long.

Experts have debated extensively about whether spending increases or decreases during retirement. The standard has been to plan on spending 80% of your pre-retirement income. Recently, however, some have suggested that we spend more in early retirement and less when we are older. But, does that assumption properly account for rising healthcare expenses as we age?

† *Guyton, Jonathan T. October 2004. "Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?"* Journal of Financial Planning. ***http://www.fpanet.org/journal/articles/2004_Issues/jfp1004-art6.cfm***

‡ ibid. *Guyton's research used the 1973–2002 period for investment returns, which included two bear markets and one period of above average inflation. In a subsequent article, Guyton confirmed this research using Monte Carlo analysis. Guyton, Jonathan T. March 2006. "Decision Rules and Maximum Initial Withdrawal Rates,"* Journal of Financial Planning. ***http://www.fpanet.org/journal/articles/2006_Issues/jfp0306-art6.cfm***.

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To determine how much our clients can withdraw and how much they can spend, we like to run real numbers and adjust for inflation. This exercise provides initial estimates that, while useful from a practical perspective, will likely be proven wrong over time. The remedy for that dilemma is to frequently review actual spending and monitor performance, adjusting budgets and withdrawals accordingly.

What About an Annuity?

Fixed annuities provide lifetime income in exchange for a one-time premium and may have a role in a retirement portfolio—but they are not a panacea. Unless purchased with a special rider that reduces the initial payment, annuities do not keep up with inflation. And, the interest rate is fixed at the time of purchase, requiring a long-term commitment based upon economic conditions at a random point in time. Plus, there is always the risk that the financial institution may not last as long as you do. An annuity may have a supporting role but is unlikely to provide a comprehensive solution.

Managing Taxes: Location, Location, Location

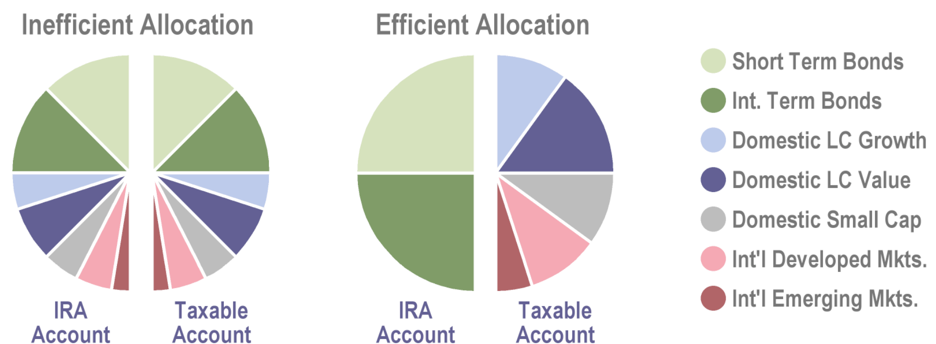
Most investors will require a portfolio with some risky asset classes to create the possibility of growth during retirement—which virtually guarantees some years of negative returns on those assets. If those bad years occur early in retirement, they can become very difficult to overcome. Therefore, during the withdrawal period, a reasonably balanced portfolio that is likely to produce consistent returns will provide a better chance of success than an extremely aggressive portfolio with higher average returns.

Such a balanced portfolio will include a variety of investment vehicles, each with different tax attributes. That means the adage about the three most important things in real estate may be just as true for your investment assets.

For example, stocks produce capital gains and dividends that are taxed at lower rates than bonds. But if stocks are held in a tax-deferred account, such as a traditional IRA, withdrawals are taxed as ordinary income. Therefore, it generally becomes more tax efficient to hold ordinary income producing assets in the IRA and stocks in the taxable account. This maxim is particularly true if stock investments are held in passive strategies, such as index funds, which are more tax efficient than actively managed funds. This strategy also allows for tax loss harvesting in choppy markets.

The least tax efficient—but higher return—asset classes, such as high yield bonds or high turnover active managers, might do best in a Roth IRA, because Roth distributions are never subject to tax.

The charts to the right illustrate one example of how to allocate assets into different types of accounts in order to optimize the tax impacts of different asset classes.[§] Paying attention to asset location certainly



[§] *All charts are for illustrative purposes only.*

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complicates portfolio management—especially rebalancing—but it will likely add sufficiently to after tax wealth to make the effort worthwhile.

Understanding Cash Flow in Retirement

We would all like to have a portfolio that generates reliable income *and* provides sufficient growth to keep up with inflation. Unfortunately, with the dividend yield on the S&P 500 remaining at historic lows, the equity portion of a portfolio is not currently contributing much to income. Accordingly, retirees need to improvise other ways to generate cash flowing in to cover the cash that is flowing out for living expenses.

Some advisors recommend setting aside cash reserves for two to three years' worth of living expenses and not worrying about income or cash flow from the rest of the portfolio. Others think such a reserve creates a needless drag on returns and plan on frequent transactions to provide the necessary cash. We recommend a combination: moderate cash reserves, short-term bonds for stability and eclectic income-generating vehicles such as convertible bonds, preferred stocks and higher-yielding equities.

Rube Goldberg, CPA?

- Conventional wisdom suggests spending after-tax assets first and preserving the IRA. However, a surviving spouse will be subject to much higher marginal tax rates because of Required Minimum Distributions than the married couple.
- Assets with a high basis in a taxable account are more efficiently liquidated than assets with a low basis, compared with the ordinary income generated by an IRA.
- If bonds are more predominantly held in the IRA, choosing to liquidate those first may upset the portfolio's asset allocation.
- From a tax perspective, Roth IRA's are ideal inheritances, followed by capital gain type assets (stepped-up basis) and then traditional IRA's.

But from what accounts should cash actually flow? Which accounts should be depleted and which preserved for later life or for the estate? The decision matrix resulting from this issue is likely the most complex of all those in retirement portfolio management, offering more moving parts than a Rube Goldberg contraption. In order to define this matrix clearly, you must define your goals clearly. From the perspective of cash flow, your goals often may contradict each other, such as between maximizing after-tax income versus having a higher ending balance for your heirs. See the box at left for sample issues to monitor.

Download 1
Retirement Planning Survey

Getting a handle on the simpler aspects of your retirement cash flow can be as easy as filling out a short form to get some numbers on paper. Find our "Retirement Questionnaire" on the **"Financial Tools>Planning Tools"** section of our website. This set of questions will help you focus on how much money you have coming in and how much you have going out. You are welcome to use these tools on your own, or contact us for assistance with follow-up analysis, as well as additional, related tools and resources.

The Fundamentals: More Important Than Ever

For younger investors—who can regularly invest their paychecks at lower prices—a bear market is a blessing. However, those nearing or already in retirement face a profound risk in a bear market: they

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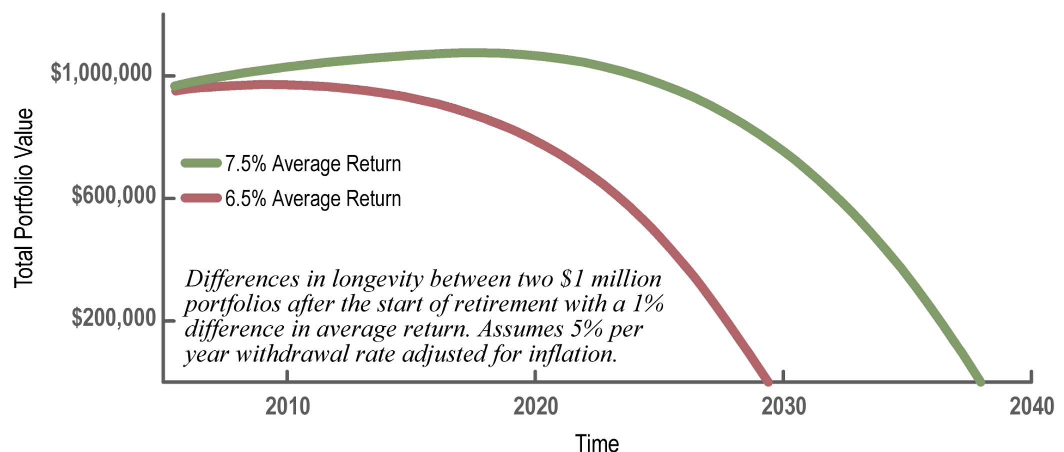
cannot add to their portfolios and may be at the mercy of the markets. Consequently, focusing on investing fundamentals can significantly impact the success of a plan. To illustrate, let's assume attending to each of the following areas improves your return by 0.20%:

- Coordinate—and stick to—an appropriate withdrawal rate with a budget that permits you the enjoyable essence of your lifestyle.
- Manage tax costs through appropriate location of assets.
- Make certain your portfolio is highly diversified to smooth out market bumps and properly allocated to ensure it continues to match your needs and goals—and rebalance regularly.
- Ensure cash is flowing from the most efficient accounts.
- Reduce imbedded investment expenses by anchoring your portfolio in low-cost passive strategies, such as index funds.

Paying attention to the above areas could, for example, create an overall additional 1% in return. As the graph at right shows,[§] that additional 1% in return—gained through good management fundamentals—can have a profound effect on the longevity of a portfolio.



Download 2
"What If" Comparison

For another way to look at the benefit of reaping that additional 1%, download our "What If" comparison. It illustrates how that additional boost in returns can make it possible to fund more of the goals you want to achieve in retirement.

Of course, staying on top of these investment management basics can be time consuming—or even overwhelming. If you have questions about how to get started please feel welcome to contact us. We want you to get the most out of your portfolio—and your retirement years—that you possibly can.

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