A STRATEGICPOINT WHITEPAPER

Retirement Income Planning

Are You Afraid of Running Out of Money in Retirement?

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One of the biggest fears of retirees is outliving their assets. Increased longevity and spiraling medical costs could jeopardize even the best planned retirement. At the same time, it's important not to become so anxious that you become financially paralyzed and afraid to spend in retirement; after all, you've worked so long and saved so hard that you are entitled to enjoy your retirement!

We find that many folks who struggle with the balancing act of spending and saving lack a plan for understanding and managing their retirement finances. This whitepaper will attempt to answer some key factors that we find lead to the most anxiety. Here's a list of some key items that we will discuss:

How much income will I need in retirement to maintain my standard of living?
What sources of income are available?
How much can be safely withdrawn from a portfolio each year?
Where should I pull my money from first?
Some other keys & tips!

How Much Income Do I Need?

This simple question is often the one pre-retirees have the hardest time answering. If you are like most people and are unsure at what you will need, one of the most often quoted figures around retirement is that you'll need at least 75% of your current annual income to cover expenses in retirement and maintain the lifestyle you have while working, throughout your retirement.

To put it simply, the assumption is that if your salary is $100,000 and you plan on retiring at age 65 and want to maintain your current standard of living you will need "replacement income" of $75,000. The definition of income here includes Social Security benefits, payments from pensions and distributions from your savings, such as your 401k and IRAs.

There are a few core factors that explain why the income replacement is less in retirement:

- Social Security Taxes (FICA deductions) cease upon retirement
- Saving for retirement is no longer needed
- Income taxes are traditionally less, due to extra deductions and less taxable income
- Benefit of partially or fully tax free Social Security Benefits
- Work related expenses should dissipate

While the 75% assumption is a great starting point for many, the real number is far more personal and dependent on your own finances, particularly your income level. A solid analysis of your household's monthly budget before you retire should identify any sources of spending that will dissipate in retirement. We encourage folks to leave room for emergencies that may arise, and to be realistic about the amount of "bucket list" items to achieve.

You will need at least 75% of your current annual income to maintain your current standard of living.

It's key to remember that the longer the retirement period, the more affect inflation can have on your spending habits. At an annual rate of 3% inflation, it would only take 20 years before the cost of living will have doubled. This is a major risk for many retirees, and one that must be considered when planning their retirement.

What Sources of Income Are Available?

When thinking about retirement and managing your monthly cash flow, one needs to consider the different sources of income and how they factor into your overall cash flow. As you approach retirement it's important to have reasonably reliable sources of income coming in every month that does not rely on investments.

For most of us, Social Security will play a significant role in supporting our lifestyle in retirement. However, the decision on when to file for social security is far more complex than many may believe. Married couples have a wide variety of options on when & how to file! While the folks at the Social Security administration can help suggest alternative approaches that may maximize your benefits, we encourage retirees to talk with a financial professional who can analyze your specific variables and discuss the different outcomes.

While falling in popularity for new workers, there are still a fair amount of folks who receive a pension. It's important that the retiree understand the beneficiary outcomes when they file for their pension. It's not unusual for a retiree to have a dozen different choices on how to take their pension and what the payouts to beneficiaries will be. Finally, many pensions do not include a cost of living adjustment so it's imperative that one considers inflation's effect on their pensions when planning for a long retirement period.

There are other forms of income that some folks have in retirement, be it from rental properties, the sale of a business or their living benefits from an annuity. Regardless of the type of income that you have, it's important to consider the pros and cons from the income that you plan to receive in retirement.

The two largest factors that most pre-retirees can control – working longer and controlling their spending – can have dramatically positive effects on retirement planning.

How Much Can Be Safely Withdrawn From a Portfolio?

The next big question is how much can you safely withdraw from your portfolio each year in retirement, while ensuring that it is unlikely that you will run out of money. This mindset of converting savings into an additional income stream is essential for many retirees. However, due to the volatile nature of investing, this process can also cause the most worry. Determining how much money can be drawn from retirement savings each year, with an annual adjustment for inflation and minimizing the chances of running out before the end of one's lifetime, is challenging. What each retiree is trying to identify is their "Safe Withdrawal Rate."

Let's start with a clear definition: an initial distribution from your retirement savings is the amount of money you receive during your first year of retirement. It is a percentage of your total savings for retirement. 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 withdrawal rate" as a percentage of assets of somewhere in the range of 3% to 4%. Some research has shown that this number can be increased slightly, depending on the definition of "safe" and the underlying asset allocation. The justification for higher withdrawal rates is based on key assumptions about asset returns going forward. While outside the scope of this whitepaper, we believe that higher historical asset returns may be challenging to achieve, especially within the fixed income allocation of a diversified portfolio.

One key element that we find ourselves discussing with many retirees is that your entrance into retirement is not the end of your investing career. Assuming a couple enjoys thirty years of retirement, in order to support any withdrawal rate with annual adjustments for inflation, one must remain invested in equities to some degree. We find far too often that upon retirement, folks believe that they can become extremely conservative in their investing. We try to impress upon folks that their time horizon is still decades long, and that history has shown that equities are a valuable tool to be used to fight inflation.

Armed with a safe withdrawal rate, one can then convert their retirement savings into an estimated income stream throughout their retirement. 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 a year for retirement spending and expects $35,000 in social security payments, then the initial safe withdrawal of $40,000 (4% times $1,000,000) puts them within their retirement spending goal. Using the safe withdrawal rate of 3% shows that this couple may fall short and changes may need to be taken. The two largest factors that most pre-retirees can control – working longer and controlling their spending – can have dramatically positive effects on retirement planning. If you find yourself with a potential shortfall, it may be time to reevaluate working a few more years, or reducing your spending needs in retirement.

Other Adjustments

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

- A reduced rate of less than 4% may be advised if you would like to leave a legacy to charity or heirs.
- Reduce the rate if your retirement is expected to last longer than the assumed thirty years, this is common in couples with a large gap in age.
- Reduce your withdrawal rate if your tolerance for risk and gyrations in your portfolio are low and as a result your portfolio allocation is more conservative.
- A withdrawal rate of more than 5% is possible under special circumstances such as: if you have a shortened life expectancy; anticipate an inheritance; 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.
- Increasing the withdrawal rate to above 4% 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.

Where Should I Pull My Money From First?

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 can depend on a variety of factors including:

- Your effective tax rate
- Your income needs and the ability to manage your tax bracket
- Whether or not you are currently taking required minimum distributions from your retirement accounts
- The anticipated rates of return on the accounts
- Factor in pensions, annuity income and/or Social Security payments as well as unrealized capital gains
- As part of your withdrawal strategy, consider your estate planning goals for inherited assets

Sequencing Withdrawals

The traditional rule of thumb has been 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, research has shown that for some folks, delaying distributions from retirement accounts leads to higher minimum required distributions once they reach age 73 or 74, depending on when they were born. Again, every retiree should analyze their own personal situation to see if this is something that may affect them. The reality is that sometimes it is better to use a different sequence or a combination of taxable, retirement and non-taxable accounts, such as a Roth IRA.

For some folks, delaying distributions from retirement accounts leads to higher minimum required distributions once they reach age 73 or 74, depending on when they were born.

Example

1. Assume you retire in your sixties, prior to receiving your IRA required minimum distributions (which begins when you turn 73 or 74). 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 12th 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

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 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.)

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), Roth IRAs can be effectively used to manage the retiree's taxes during their lifetime.

Other Keys & Tips!

Before retirement, one common approach is for folks to 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.

One source of savings we have not discussed is the equity in your home. It's not uncommon for retirees to see the equity in their home exceeds their retirement savings. There are a variety of ways for retirees to convert that equity in income or savings, including:

- Downsizing
- Moving to an apartment or other rental property
- Relocate to an area with more modest housing options
- Reverse Mortgages

The key to tapping equity in the home for retirement is to not squander that equity and plan wisely.

Lastly, we've seen more and more Baby Boomers who are choosing to work past traditional retirement age. Just because society says retirement is at age 65 does not mean everyone should feel compelled to retire. We find many folks are working longer, not due to the financial reasons, but because they still find work enjoyable and fulfilling. The financial benefits of working longer can be quantified, but it's just as important to recognize the benefits both mentally and emotionally from working.

The key to tapping equity in the home for retirement is to not squander that equity and plan wisely.

Conclusion

Prudent retirement planning can provide financial security and lower your fears as you reach retirement age. 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.

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