ProVest Wealth Advisors

How to Make Your Assets Last a Lifetime

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The years leading up to retirement are about accumulating and saving assets. As the day nears, most discussions about retirement planning still focus on income, making sure your assets can fund the retirement you envision. Once you're retired, the conversation shifts. The focus moves to *spending* and cash flow – and how to make your assets last a lifetime.

'The 4 percent rule'

To be confident that your money will last as long as you do, you'll need a good idea of how much you have to save and how much you can afford to spend each year in retirement. The "4 Percent Rule" was introduced by financial advisor Bill Bengen in 1994 as a guide for how much money a retiree could withdraw from her nest egg each year and still feel confident that she would not run out of money. The rule states that you can withdraw 4 percent of your savings in the first year of retirement. In future years, the 4 percent base is adjusted for inflation on an annual basis.

Let's say Sara has $1 million in savings when she retires next month. In the first year, the rule says Sara can withdraw $40,000 ($1,000,000 X .04). In year two, if inflation is at 3 percent, she can withdraw $41,200 ($40,000 X 1.03). But when inflation drops to 1 percent in Year Three, her withdrawal would be $41,612 ($41,200 X 1.01).

Assuming you know how much money you'll need on an annual basis, the 4 Percent Rule can also be used to determine how much you need to save to reach that goal. Let's use Fred as an example. Fred has determined that he'll need $100,000 per year in retirement. Half of that amount will come from a combination of Social Security and his pension, meaning $50,000 per year has to come from his savings. To generate $50,000/year for the next 30 years, the 4 Percent Rule says Fred will need $1,250,000 in savings when he retires ($50,000 divided by .04).

The 4 Percent Rule worked well for over a decade, but a lot has changed since 1994. Back then, interest rates were higher and bond investments were generating more income. Unfortunately, since the Great Recession we've been mired in a low-return environment in which bonds are unable to replenish the funds that are withdrawn each year.

Americans are living longer than ever before, putting additional pressure on the 4 Percent Rule, which was designed only to make funds last 30 years. According to the Social Security Administration, 25 percent of today's 65-year-olds will live past age 90 and one in ten will live past 95. So, if you plan on retiring at 62 and expect to live well into your 90s, those last few years could be a struggle, financially.

The 4 Percent is based on a balanced portfolio of stocks and bonds. Any deviance from that mix renders the rule less effective. The portfolio – and the reliability of the 4 Percent Rule – can also be impacted by volatility on Wall Street. For example, Barbara was planning to retire in 2009 with $300,000 (60 percent) of her $500,000 nest egg invested in S&P 500 stocks. But in 2008 the S&P tanked, losing 37 percent of its value. On the verge of retiring, Barbara discovered her savings had dropped $111,000 ($300,000 X .37) to $389,000. Using the 4 Percent Rule, her annual income from savings in the first year of retirement dropped from $20,000 to $15,560 ($389,000 X .04).

All that said, many financial advisors believe the 4 Percent Rule can still be used as a general guideline, especially if you build some flexibility into your plan. Selena Maranjian, writing for the Motley Fool, suggests "you can address the stock market volatility issue by being flexible. Withdraw less than 4 percent in bear markets and more than 4 percent in bull markets."

Flexibility also means being prepared to cut back on expenses in bad years, even if it means adjusting your lifestyle, leaving more money in savings to grow when the inevitable upturn occurs. Even small expense cuts can make a big difference. According to Dan Caplinger of the Motley Fool, cutting expenditures just 5 to 10 percent in down years, can increase the safe withdrawal rate to 5 – 6 percent in "normal" years.

Alternatives to the 4 percent rule

With increased longevity and the current low-return environment in mind, R. Evans Ingles, senior vice president of Nuveen Asset Management and a fellow of the Society of Actuaries, generally recommends spending only 3 percent of savings per year with no adjustment for inflation. Because it is not adjusted for inflation, the withdrawal rate is based on the portfolio's value each year, making it safer than the 4 Percent Rule.

Maranjian also recommends taking your personal life expectancy into account when using the 4 Percent Rule. "If you think you stand a decent chance of living more than 30 years in retirement, you can be more conservative, perhaps using a 3 percent or 3 ½ percent withdrawal rate – at least in your initial years."

Other advisors are more critical of the 4 Percent Rule and recommend retirees use caution when applying it. They argue that today's prevailing interest rates are too low to support the 4 Percent Rule. The federal fund rate, for example, was in the 6 percent range in the 1990s, compared to today's 0.75 percent rate. Back then, "a retirement portfolio could generate most or all of the money necessary to fund withdrawals solely from interest payments," says Caplinger. "In that light, even modest dividend payments were adequate to hit the withdrawal target without having to sell off any investments or tap into principal."

Also writing for the Motley Fool, Asit Sharma points out that the linear nature of the 4 Percent Rule underscores a weakness in its application. The 4 Percent Rule is based on withdrawing the *same amount* (adjusted for inflation) every single year. History shows that barring a major unexpected expense, retirees spend more in the first few years after they stop working than they do later on. "The 4 Percent Rule doesn't really address the greater need for funds by the relatively young retiree – say, a 65-year-old – versus an older retiree who may be more content with a fixed monthly income," says Sharma.

David Blanchett, Head of Retirement Research at Mornngstar Investment Management, agrees. His research confirms that retirees spend more in their first years of retirement when the extra leisure time is new and their health is at its best. Spending declines with age, with only 75-80 percent of initial retirement expenses increasing with inflation. According to The Experts, a blog in the Wall Street Journal, “Blanchett finds that households spending $50,000 at age 65 decrease their real spending by about 15 percent by age 80; the drop hits 20 percent by age 85. For those spending $100,000, it’s 20 percent by 80 and nearly 30 percent by 85.” If you accept Blanchett’s data, Americans could be working longer than necessary, saving more than they need, and living more conservatively in retirement than they can actually afford.

Required Minimum Distributions

The good news when you retire is that you finally get to spend the money you’ve been saving all those years. The bad news is that Uncle Sam will have his hand out when you do.

By law, you are required to begin taking minimum distributions annually from your 401(k), IRA, SEP IRA, SIMPLE IRA and other types of tax-deferred saving accounts by April 1 of the year after you turn 73. After Year One, withdrawals must be made by December 31 of each year. If you delay the first RMD until the following year, you’ll find yourself making two payments in the same calendar year – the one you delayed and the one that would be due for Year Two. Because they were not taxed previously, you will have to pay income tax on those withdrawals. Failing to take an RMD each year will result in a 25 percent penalty on what should have been withdrawn, in addition to the taxes owed on the RMD.

The amount you must withdraw each year is determined by an Internal Revenue Service formula that is based on life expectancy. Your RMD is calculated by dividing the total amount of money in your tax-deferred accounts by your life expectancy (25.6 for 72-year-olds).

Unless the tax-deferred accounts are depleted over time, the RMDs will increase with age.

Although the RMD is based on the total of all tax-deferred accounts, you are not required to take withdrawals from each account. As long as you are withdrawing at least the minimum required, you can take the distributions from one account or any combination of accounts. By the way, withdrawing more than the minimum has no impact on RMDs in future years.

The rules regarding 401(k)s are slightly different. Franklin explains that “if you are still working at 70 ½ (and are less than a 5 percent owner in the company) you don’t have to take a distribution from your current employer’s 401(k) plan until you leave your job.” And unlike an IRA, even after you turn 70 ½ you can continue to fund a 401(k) plan as long as you keep working. Another difference between IRAs and 401(k)s is that “if you have multiple 401(k) plans, you must calculate a separate required minimum distribution from each employer plan and you must take a distribution from each plan once you turn 73.” says Franklin.

Tax Strategies

One of the best ways to maximize withdrawals is to minimize the income taxes you owe on them. For the best tax outcome it is essential to coordinate withdrawals between taxable brokerage accounts and pre-tax accounts such as IRAs and 401(k)s.

Conventional wisdom suggests that taxable investment accounts should be exhausted first, then tax-deferred accounts, and finally tax-free accounts. That strategy allows tax-deferred and tax-free accounts to continue to grow. In his blog, financial planner Michael Kitces warns that there could be a downside to the traditional approach.

For example, he cautions that “being too good at tax deferral” could result in the IRA growing so large that future withdrawals could actually drive the retiree into a higher tax bracket. Instead, Kitces suggests “the optimal approach is actually to preserve the tax-preference value of retirement accounts *and* to fill the tax brackets early on, by funding retirement *spending* from taxable investment accounts but doing systematic partial Roth conversions of the pre-tax IRA to fill tax brackets in the early years.” Kitces explains that if withdrawals are taken simultaneously *from both* types of accounts a retiree’s savings will last longer. “By taking only partial distributions from the IRA each year, the distributions can occur at ‘only’ the 15 percent bracket without ever reaching the 25 percent bracket,” says Kitces. “Yet by taking at least some withdrawals from the IRA every year, the brokerage account lasts longer.”

Kevin Reardon of Shakespeare Wealth Management advises many clients between the ages of 59 ½ and 70 ½ to systematically convert portions of their traditional IRAs into Roth IRAs prior to retirement. Reardon’s goal is to prevent his clients from being pushed into higher tax brackets when they begin taking RMDs by paying Roth IRA taxes now rather than traditional IRA taxes later when they may be in a higher tax bracket. For example, if someone in the 15 percent tax bracket converts $50,000 from a traditional IRA to a Roth IRA before retiring, they will owe $7,500 in taxes. If the conversion is not done until later and the RMD pushes that person into the 25 percent tax bracket, they will owe $12,500 if $50,000 is withdrawn.

On the other hand, retirees who continue to work at least part-time “may want to withdraw funds from their Roth IRA account because their income now is presumably higher than it will be when they aren’t working at all and subject to a higher income tax rate,” says Vanguard investment strategist Colleen Jaconetti.

Minimizing an heir's tax bill

Retirees wishing to pass along their assets to heirs have additional tax consequences to consider. In those situations, Jaconetti suggests delaying withdrawals from a Roth IRA because those funds would pass to heirs tax-free. "Other inherited assets such as those from a 401(k) or rollover IRA are taxable to the heirs whose tax rates may be higher than that of the retiree," says Jaconetti. "In that case, the retiree many want to spend down his or her tax-deferred assets to remove them from the estate."

Retirees wanting to minimize the tax burdens faced by heirs should also look at deferring withdrawals from taxable assets with large capital gains. Those assets, such as individual stocks, will get a step-up in value prior to the tax bill being determined. The result, explains Jaconetti, is that heirs "will pay a much lower tax on capital gains than the retiree because the basis of those gains will be the value of the asset when the retiree died, not when they were first purchased."

You can also reduce or avoid paying taxes on RMDs by donating a portion of the RMDs, up to $100,000, directly to a public charity. Franklin explains that "although the direct-IRA donations do not qualify for a charitable donation, the money is excluded from taxable income."

Help is available

The tax consequences – and options for minimizing them – are complex and can be hard to understand. The rules are also fluid and can change at any time. The right strategy depends on a variety of factors, including your age, the value of your accounts and the components of your estate.

For example, converting funds from a traditional IRA to a Roth IRA could save one person money on her taxes but actually increase the taxes owed by someone else. Proper sequencing of withdrawals – which accounts to tap and in what order – is also crucial to maximizing your savings but can be complicated and difficult to execute. The wrong choices can profoundly impact your financial future, as well as those of your heirs.

Before making any significant decisions about spending in retirement, you may want to work with your financial advisor and/or tax specialist before you begin taking withdrawals from your savings. And the earlier you put a plan in place, the greater the likelihood of it succeeding.

To get a second opinion on your retirement outlook and portfolio, give us a call at 800-277-0025 or send an email to asknoel@theprovestperspective.com.

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