

## Retirement - Now What?

*“Waiting for your retirement party is too late to start planning your [retirement] portfolio.” ~ Richard Wastcoat in the Telegraph*

Difficult challenges in life capture our attention, and given the increased level of focus it takes to meet them, we are often guilty of not putting enough thought into the steps we will follow afterward. Few would argue that retirement is one of the more difficult challenges we face, and far too often investors put off their post-retirement homework and planning until the last minute – the year of their retirement.

In 2011, the first baby boomers will reach age 65. Not surprisingly, we are encountering a higher number of plan participants near retirement who are asking the question “now what” - a question that makes us nervous. We devote our professional lives to helping clients amass a retirement nest egg and meet their retirement goals. However, far too often investors are forced to make life altering decisions related to post-retirement account structuring and asset allocation without the knowledge to do so.

We have maintained our focus on corporate retirement plans since the firm’s inception. For this reason, our educational efforts have always concentrated on the accumulation or pre-retirement side of the equation. When we meet with a participant nearing retirement, we share the various distribution options and wish them the best as they transition to the next step in their retirement journey. However, a recent increase in the number of “now what” inquiries has compelled us to put serious consideration toward enhancing our post-retirement education efforts. This newsletter serves as the kickoff for those efforts and will focus on three critical areas of knowledge building (*i.e.* preparation, account structure and asset allocation).

*We preface this discussion by stating that post-retirement planning can be complex and it is impossible for us to dig too deep into each aspect. We suggest you use this information as a base and build upon it with independent research. In addition, building your knowledge will take you a long way, but having a knowledgeable financial advisor and/or estate planner is necessary for many. With that said, knowledge of these fundamentals will help you make informed decisions and hire professionals that are a good fit given your objectives.*

### **Preparation**

Preparing for retirement involves building your knowledge, reducing your debt, and planning your withdrawals (to ensure you will be able to live throughout your golden years on what you have saved). We have stressed the importance of knowledge building to avoid the potential mistakes that often are the result of a lack of preparation, but finding unbiased information is difficult. A great source of information is the new *Real Life Finance* section of Morningstar’s website ([www.morningstar.com](http://www.morningstar.com)). In particular, we suggest reading the articles and watching the videos posted by Christine Benz, Morningstar’s Director of Personal Finance. Although we do not agree with 100% of her advice, overall she is extremely knowledgeable and presents helpful information without a compensation incentive.

Debt reduction is an important factor in retirement planning for obvious reasons. Fewer expenses reduce withdrawal requirements, which in turn provides greater flexibility for withdrawal planning. Higher expenses increase withdrawal requirements, which in turn increases longevity risk (*i.e.* the risk you will outlive your money). Additionally, a higher withdrawal rate can be especially damaging if your retirement account decreases in value due to market volatility. *We will expand upon this topic later in the newsletter.*

Withdrawal planning involves estimating the amount you will need to withdraw each month to supplement other income sources (*e.g.* Social Security, a part-time job, a pension plan, etc.), projecting your withdrawal window, and forecasting a rate of return for your retirement accounts. Realism and conservatism are necessary when planning for retirement, especially as it relates to this step in the process.

If you are uncertain of the amount you will need each month for living expenses, make a list of projected expenses in today's dollars taking into account every expense (including even minor items such as hair cuts, pet grooming, etc.), then add extra for the unexpected. You will also need to adjust for inflation which increases the cost of living over time. There are a number of tools online to help with this process. On the *Participant Resources* page of our website ([www.veratisadvisors.com](http://www.veratisadvisors.com)), we have a link to additional information on this topic titled "Determining Retirement Income Needs".

Once you have estimated monthly expenses, you will want to estimate monthly income sources to determine the amount you will need to withdraw from your retirement account to make up the difference. With this information you can determine if the amount can be safely withdrawn from your account given your estimated withdrawal window - without prematurely depleting the account. A simple way of looking at this is to start with an assumption that your portfolio's growth rate will match the rate of inflation. If this is the case and you estimate a 25-year withdrawal window (*e.g.* retire at age 65 and live until 90), you will deplete your account at the end of the window by withdrawing 1/25<sup>th</sup> per year - or 4%.

Of course, a rate of return that exceeds inflation would prolong the account's ability to produce income, but again, it is important to be conservative in your estimates throughout this process to make sure that you don't fall short. You may live longer than you expect and the past decade reminds us that there is no certainty as it relates to returns.

There is a generally accepted maximum withdrawal rate used among financial planners to reduce the likelihood of premature account depletion. The rate is 4% of the total retirement nest egg at the beginning of the withdrawal window, not 4% of the account value at the end of each year. In other words, a \$1 million nest egg should be able to support \$40,000 in annual withdrawals adjusted for inflation. It is important to recognize that this general rule of 4% is just that, a general rule. The maximum rate may be quite different for your unique circumstances at retirement.

### **Structuring Your Accounts**

The process of structuring your retirement accounts can be as simple as rolling your 401(k) into an IRA and setting up a systematic withdrawal program or as complex as establishing trusts. There are options on top of options, even for Social Security, so a little bit of knowledge and a good advisor or financial planner (if you need help) can go a long way toward ensuring your accounts meet your objectives.

In general, most retirees will want to streamline by reducing the number of accounts they manage, simplifying the process of monitoring investments and making withdrawals. In



consideration of taxes, most retirees will want to postpone withdrawals from tax deferred accounts (if they have both taxable and tax deferred accounts), thereby allowing continued growth without the yearly drag of tax payments on dividends and any realized capital gains.

Another consideration is whether you are willing to give up a portion of your long-term growth or nest egg to insure (*as in insurance*) your stream of income with an annuity. Of course, there are numerous varieties and a multitude of products available within each variety for those who choose this route. *It is critically important that you do your homework prior to purchasing an annuity – making sure information is coming from unbiased sources since some annuities pay high commissions.*

Typical account structuring considerations include how many accounts you should have, the process for withdrawing money, when you should start taking Social Security, whether you should roll your 401(k) into an IRA, whether you should convert your IRA into a Roth IRA, how you can increase tax efficiency, how you can reduce estate taxes for your heirs, and as mentioned, whether you should buy an annuity. These are all questions that relate to this step of the post-retirement planning process where guidance is often needed due to the complexity of the decisions and sheer volume of available options. There is a wealth of information available on the internet for those who are willing to do a little research.

### **Asset Allocation**

Investment losses are painful when accumulating for retirement, but the pain is magnified when an investor is forced to realize those losses by making withdrawals. A retiree who needs \$40,000 per year to live spends 4% of a \$1 million account and 8% if that account falls to \$500,000 in value. To generate the \$40,000, a certain number of shares must be sold. If the shares drop in value, additional shares must be sold to generate the necessary income. Unfortunately, these shares will not be around when the investment recovers in value – creating long-term damage to the account.

Retirees are often caught between the need to obtain growth to offset underfunded retirement accounts and the damage and emotion caused by volatility. Fortunately, there is a way to gain exposure to growth oriented investments, while maintaining an appropriate level of short-term protection. This is obtained through diversification across asset classes, appropriately laddered based upon probability of loss. Safe investments are used for near-term income needs, moderately safe investments for medium-term needs, and growth oriented investments for income needs farther out. This creates a diversified portfolio with both protection and growth characteristics. However, the right answer as it relates to the allocation percentages is dependent upon the retiree's goals, risk tolerance, withdrawal window (*i.e.* time horizon), and withdrawal rate. Sound familiar? *One thing to keep in mind is the likelihood of a financial surprise. As we age, the risk of unexpected medical expenses obviously increases – so a little extra cash on the sidelines is prudent for this purpose.*

When constructing an allocation, the degree of complexity is up to the retiree. The allocation decision can be as simple as maintaining a few years of income *plus* money to cover unexpected expenses in cash, allocating assets earmarked for medium-term funding needs to bonds, and using stocks to obtain long-term growth. Those who want to ramp up the complexity can include additional investment categories or asset classes such as short-term high quality bonds, inflation-protected bonds, balanced funds, and commodities.

As it relates to post-retirement asset allocation, it is important that retirees gain their exposure to asset classes through separate investments. If you lump your cash, bonds and stocks into one investment, such as a target date fund, a downturn in the stock or bond portion of the fund may pull down the entire investment. This would mean you would have



to sell the investment while its share price is down in order to meet income needs. However, if you keep your investments separate, you have the flexibility to tactically make sells to fund income needs, avoiding the sale of an investment at a depressed price. Many retirees make their monthly withdrawals from the cash portion of their allocation and tactically replenish the cash from bond and stock allocations. *A properly designed target date fund/portfolio can be a fantastic tool for accumulation. However, for retirees separation of asset classes is often optimal.*

### **Conclusion**

We are committed to the long-term financial success of our clients. As a retirement plan firm, our focus must remain on the accumulation side of retirement journey. However, we are bolstering our efforts as it relates to post-retirement education. Should you have any questions related to this topic, please do not hesitate to give us a call.

### **Market Comments**

Improvement in a number of areas of the economy resulted in an increase in the confidence of investors during the quarter. As a result, the stock market continued the strong run it began in the 3<sup>rd</sup> quarter with the Russell 3000 Index gaining 11.6% for the period. *The index is now 12% off the highs it set in October 2007.* Economic improvement was widespread, but of particular importance was the improved spending appetite of consumers. After anemic spending during the recession and much of the recovery, the consumer came to life late in 2010. *Consumption is a key contributor to the overall economic cycle.*

Housing and unemployment continue to be areas of concern, although many economists forecast improvements to both in 2011 and 2012. In addition, consumer and government debt concerns continue to unnerve investors. However, consumers do seem to be improving their balance sheets. The Financial Obligations Ratio, a measure of key consumer payments such as mortgage, rent, auto, and credit card payments, dropped from its peak in 2007 of 18.9% to 16.8% of income at the end of the 3<sup>rd</sup> quarter. The 30-year average is 17.2%.

During the quarter, a rotation in investor demand out of bonds occurred. The Barcap Aggregate Bond Index lost 1.3% for the quarter. After a period where bond returns were boosted by strong demand (due to frustration with historically low money market rates and disappointing stock returns), investors seemed to come to the realization that the party will not last forever and began to exit the asset class. *Please avoid the temptation to market time, the improvement in economic conditions and potential for higher rates may make bonds look unattractive, but stocks didn't look all that unattractive in 2007 – prior to the 50% drop.*

Sources: Morningstar Principia and [www.federalreserve.gov](http://www.federalreserve.gov)

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