

Retirement Distributions: Creating a Limitless Income Stream for an 'Unknowable Longevity'

by Nancy Opiela

The U.S. Census Bureau projects that by 2040 the number of Americans over age 65 will double to 77 million, making that age group 20 percent of the country's population. Sure, you may be retired yourself by the time retirement distribution planning is catapulted into the limelight, but there are plenty of people who could use your help today. A 2003 study by LIMRA International Inc., a life insurance marketing research organization, found that only one in five retirees or pre-retirees has any formal, written plan for managing income, assets and expenses in retirement.

At a time in life when they can least afford to take on risk, American retirees seem content to wing it. Added to the lack of planning are the bursting of the technology bubble, historically low interest rates and increasing longevity; as a result, the challenge of managing the retirement income stream for today's retirees rivals the challenges of building the nest egg in the first place. Here, planners share their current thinking on issues from asset allocation and withdrawal rates to how tax law changes have altered strategies.

Stocks, Bonds, a Cash Pool and Proper Withdrawal Rate

Not so long ago, common wisdom held that the onset of retirement was the time to begin moving out of equities and into bonds. "In the 1950s, when life expectancy was much less, retirement might have lasted ten years, so asset allocation didn't make as much difference," says William Bengen, CFP®, of Bengen Financial Services in El Cajon, California. "But with people now living perhaps 30 years in retirement, we have to look at optimizing withdrawals."

And that means equities. Says Bengen: "If you are investing for long periods of time, and planning to withdraw money for long periods of time, you should not have less than 50 percent equities, and no more than 75 percent. Less than 50 percent is not enough return to give you an optimal rate of withdrawal and more than 75 percent introduces too much volatility, and that affects withdrawals."

Bengen's opinion is based on his extensive research, more than 2,000 hours, published in a series of articles on sustainable portfolio withdrawal rates. The first of his four-part series was published in this journal in 1994 ("Determining Withdrawal Rates Using Historical Data," [October 1994](#)). Bengen explains, "It was fascinating to see unexpected patterns emerge. First, anything in the 50 percent to 75 percent range for equities supports the same withdrawal rate. It's sort of like a mesa, a plateau. It's flat on top and everything drops off to the sides. Small-caps had higher returns, but they are incredibly volatile. They have a completely different-looking chart. You don't get a nice plateau—just a mountaintop. That scared me, so I tend not to include small-caps in my portfolios. Also, I thought long-term bonds would help with a higher rate of return, but they don't. Intermediate bonds' lesser volatility offsets the higher interest rates of long-term bonds."

Bengen's research used the actual rates of return for each year and the inflation rates to identify what's now the fairly well accepted four percent safe withdrawal rate. While planners quoted withdrawal rates from three percent to six percent, depending on how aggressive the portfolio is and the client's age, a common complaint is that retirees took more than they needed in the boom of the 1990s.

No Longer Safe

Kathleen P. Day, CFP®, CFA, of The Enrichment Group in Miami, Florida, notes that a withdrawal rate that seemed safe a few years ago may not be safe any longer. "Portfolios are down and we anticipate lower returns,"

she says. “Although we used distribution levels of five percent to six percent, at this point we’re cutting back to five percent as absolute top level, but we are much more comfortable with three percent. Of course that all depends on the age and health of the clients and their wishes—whether they are trying to preserve capital for the next generation or if they are willing to consume capital.”

In fact, the down market was a test and ultimately justification of Bengen’s recommendation. “A market decline is just the kind of situation my methods have been designed for,” he says. “People taking four percent now know why they were taking four percent. With three consecutive years of negatives, if you continued to take six percent or seven percent, you really harmed your portfolio. In the 1990s, it looked like retirees could take more. Some did and they’ve learned a painful lesson.”

In fact, after three years of negative returns, many planners are tinkering with asset allocation. Whether they’d agree the former baseline for an average portfolio was 60 percent stocks and 40 percent fixed income, or 40 percent equities and 60 percent fixed income, many planners are looking for greater protection of principal. The bottom line, says Michael Finer, CFP®, CPA, CLU, PFS, of Major League Investments in Salem, Massachusetts, is that many retirees have less than they expected at this point. “Some shifted a little too much into equities in the 1990s. Others have a fixed income strategy, but money is rolling out of six percent to eight percent instruments and they can’t replace that today. Also, when they started planning for retirement, maybe they weren’t planning to live as long,” he explains.

Finer’s suggestion is to diversify into additional asset classes. “Stocks and bonds don’t provide enough balance,” he says. “We’re adding commodities, real estate, hard assets that, should the market go through floor, would offer some protection.”

In his search for income, Finer finds himself going out further on the yield curve. “We may go out to 20 years to capture better interest rates,” he says. “Additionally, if a client needs to increase income and owns a condo in Florida and a house in New England, in some cases we’re selling the New England home. In these situations, we can create more income by adding principal that we diversify with bonds, equities and REITs.”

A “general asset allocation” for Finer’s conservative portfolio—again with the caveat that it depends on age and risk tolerance—would be 60 percent bonds, 20 percent equities (largely dividend-producing stocks), 10 percent commodities and 10 percent real estate.

He adds, “I have a tough time recommending mutual funds for clients in retirement because we don’t know exactly what they own or what they are going to produce in the way of distributions.”

Planners have long held that keeping two to five years’ worth of expenses in a cash pool alleviates anxiety and ensures clients won’t be selling investments that are down in order to meet expenses. While the market crash proved the wisdom of this advice, today’s low interest rates make the plan difficult for many clients to accept.

Bryan Lee, CFP®, of Strategic Financial Planning in Plano, Texas, says he likes to keep clients’ money invested and earning as much as possible, for as long as possible. “I can’t justify leaving a lot of money in a money market that’s earning next to nothing. If we have no-load, no-transaction-fee mutual funds, I don’t see anything wrong with leaving money there and pulling out what you need on a monthly basis. The risk of pulling out of a fund at a time when the market is down is much lower than the risk that inflation will be greater than the half-percent you’re earning in a money market.”

Finer adds that part of a client’s cash pool could be stocks that tend to do well in a market downturn, like Philip Morris. And he adds that in today’s environment when his client needs cash, he doesn’t automatically look to the short part of a bond ladder. Rather, he might look for a loss to harvest in equities.

Tools to Model Scenarios

Lee says that using Monte Carlo simulation is a must for today's planner. "A lot of planners are still using software that assumes a linear growth rate, but I think planners not using Monte Carlo in their analysis are leaving themselves open to liability," he says. Lee often discusses his Monte Carlo analysis with his clients. "If you're having back surgery, you just assume your surgeon will use the best tools and techniques. You don't need to discuss the scalpel," he says. "I don't go into a lot of detail about Monte Carlo, but at the same time I think there are a lot of planners out there not using it who should be—and I want to distinguish myself."

Martin F. Kurtz, CFP®, of the Planning Center in Moline, Illinois, uses Monte Carlo simulation and uses Financeware to make the analysis available online for his clients. "Clients love it," he reports. "Showing them the parameters of a plan in an interactive way is so much more effective than doing it on paper. I make changes, hit "refresh" and they can clearly see how changes in returns or interest rates could affect them personally."

Kathleen Day also uses Monte Carlo, but prefers what she calls "scenario analysis." She explains, "Clients understand there is variability of returns, that they could get good or bad returns up front, and that it affects the portfolio. As helpful as this analysis is, you can't build in changes in tax laws, the early retirement you didn't expect, or the grandchild who needs extra help. You can model some things, but you can't model everything. Monte Carlo models investment returns, but changes in tax laws or major life changes can throw the model off. We look at best- and worst-case scenarios and something in the middle. We can't predict the future, but what we can do is be prepared to make small adjustments year to year that will help clients deal with changes."

Have New Tax Laws Changed Standard Thinking?

Come age 59 1/2: Is the standard advice of making withdrawals from taxable assets before tax-deferred assets still standard? Says Bengen: "With capital gains rates coming down, it makes sense to avoid building up a huge tax-deferred liability at future ordinary income rates in IRAs."

To decide which account to withdraw from first, Day first determines if Social Security is going to be taxable. She explains, "If Social Security isn't taxable, then we play a game to see at what level it will become taxable. What leeway do we have? We do multiple scenario modeling to determine at what point it's more efficient to start taking non-taxable dollars versus taxable dollars."

Day also notes that the new lower tax rates on dividends enables clients to invest in dividend-paying stocks outside of the IRA. "The new tax laws have changed the character of the income that we would hold outside and inside IRAs," she says. "With lower dividend rates and capital gains, it's a more complex decision about where the money should come from. Every year it will be a little different, depending on the character of the account, what the inside and outside assets are, what the capital gains are, and whether there are capital losses. This year, we have capital losses carried forward in many cases, so we'll take income from outside assets before we take it from inside assets."

This multi-year issue is complicated when income varies, and that happens more and more with retirees working part-time. Says Day, "We have clients who will work one year and we have to tell them to stop at a certain point so they don't come out dollars behind. Tax-managing withdrawals is one of the more challenging things we do."

Kurtz adds that the new tax laws enhance opportunities his firm was already promoting. "We've always insisted that clients invest inside and outside of qualified plans, and these tax law changes give us more reasons to do this. With taxes on dividends and capital gains rates going down, it's all the more important to go into retirement

with money in both pots. Tax laws will always change. The only way you can take advantage of those changes is if you have assets inside and outside of qualified plans.”

Adds Bryan Lee, “With more parity in tax rates, we have more freedom in terms of what investments we choose to cash in. Rather than let the tax tail wag the dog, we can base our approach more on what would be the best vehicle for that client to sell. Taxes are no longer an inordinate factor in deciding what asset we are going to use first.”

Finer stresses that multi-year tax analysis becomes more important once distributions start. “I have one client who has income from several sources and this year he has no income, and no gains,” says Finer. He’s used most of his liquid cash and wants to take money from his IRA. I’m suggesting that he take more than he needs from the IRA this year so he doesn’t have to take any in the years when he has other income and will pay a higher tax. However, clients are often leery about taking a withdrawal they don’t need and paying tax because they think that the tax situation may be better in the future.”

Finer works with clients to estimate their three-year cash flow needs and sources of income as a way to average out the tax burden. “In general, we try to keep everyone below \$40,000 in distributions because we know that keeps you in the low tax bracket,” he says. “If you never touch your IRA and leave it for your children, great. However, that’s the top few percent of clients who don’t need the money. You don’t wait until the end when it’s your last asset and only choice.”

When and Where

In terms of timing, planners also mention that clients in a low tax bracket may want to withdraw just enough from their deferred accounts (with the exception of Roth IRAs that have no required distributions) to take them to the top of the 15 percent income tax bracket. By withdrawing some money before age 70 1/2, they will have smaller required minimum distributions down the road.

Day works with a number of clients who were given early retirement packages from their company and are taking distributions through the exception to the 72(t) rule, substantially equal periodic payments. She explains, “Previously, once you initiated the distribution, you couldn’t change the pattern. If you did change the pattern, every distribution was subject to penalties and interest. However, the 2003 tax law gave us the opportunity to reset assumptions we made before the market crash.

“Prior to the new tax law, we could choose what reasonable return assumptions we wanted to use, so we varied our return assumptions based on the portfolio composition. If we had a very conservative portfolio, we might use 6 percent and for a very aggressive portfolio, we might use 7.5 percent. Now, if we choose to reset, the return assumptions are set for us. For the fixed amortization method, the 2002 guidelines say that the interest rate may not exceed 120 percent of the federal mid-term rate for either of the two months immediately preceding the month in which the distribution begins. In December 2003, 120 percent of the federal mid-term rate was 4.26 percent.”

Rather than go on old assumptions that were aggressive compared with the current market to new, fixed assumptions that are super conservative, Kathleen Day and her clients are staying with their old schedule, but trying to “cut back to capture those distribution dollars we now feel are excessive. We either have the distributions deposited into two accounts—the client’s checking account and one savings account—or make one deposit into their checking account with an immediate withdrawal to fund the other account.”

Another strategy to guard against penalties in distribution is to split an IRA so you have a distributing IRA and a nondistributing IRA. Explains Day, “Let’s say you have a \$1 million IRA. You might put \$900,000 in a distributing

IRA and \$100,000 in a nondistributing IRA. That way, you have a fallback position for emergencies. If you had to take an unplanned distribution, you'd take it from the nondistributing IRA and pay the penalty only on that distribution—not on all the distributions you've taken from the distributing IRA.”

David Maurice, CFP®, of Gilbert Carrier Maurice Benzer in Johnson City, Tennessee, says that wherever the money comes from, it's important for planners to let clients know the origin of every distribution check. “We talk about distribution every time clients come in,” he says. “In 2001, my reviews with those taking income took about half as long as someone not taking income. That seems counterintuitive, but it's because we had done such a good job educating people about their distributions and how the mechanics work inside their portfolio. I shared this fact with pre-retirees to ease fears, to let them know that those who were taking distributions were confident.”

Numbers Are Just Numbers

Lois Carrier, CFP®, also of Gilbert Carrier Maurice Benzer, notes that it's increasingly important for planners to help their clients deal with the emotions of the transition to retirement.

Explains Carrier, “I remember talking with a group of people who had been laid off from a local company. When it came to managing their retirement, they were interviewing planners and shopping for returns. Their attitude was, ‘Here's my retirement, what will you pay me for it?’ These people were equating their future lifestyle and happiness with the return we'd get them on their money. They were focused so much on products and return, and were ignoring the emotional side—the heart-and-soul part of money.”

Carrier continues: “Retirement is such a big life transition, and people are spending more time in retirement than ever before. It's important that planners be well versed in the emotional side of money to help clients untangle the emotions that come along with retirement. That can range from great expectations to the pain of having to leave a job held for 35 years.”

Kurtz notes that financial planners are just beginning to understand how to help people through the emotional issues that surface during the transition to retirement. “These are big changes and we need to be perceptive enough to help our clients sort through the issues,” he says. “Whether we meet quarterly or annually, it's important to view these meetings as more than an opportunity to review the numbers, because they are just numbers. What's important and therapeutic is the ongoing personal connection we enjoy with clients.”

The planner's task is substantial, as Maurice describes, “creating an inexhaustible stream of income for an unknowable longevity.”

Concludes Kurtz, “We live in a chaotic world, but in our business we see ourselves as purveyors of order and value. We work with clients to establish some kind of order, even though we understand that anything can happen. With retirement planning, the best we can do is to create a situation where we can sleep at night, knowing we've done all we can, and accept there's plenty we have no control over.”

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