

SEC's Third Annual Senior Summit

*Managing Your
Income in Retirement*

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Step 1: Withdraw the Right Amount

Q: If you want to be reasonably certain your retirement nest egg will survive for 30 years, during the worst stock and bond markets in modern history, and you want to increase your withdrawal to keep up with inflation, how much can you withdraw from a diversified retirement portfolio?

A: Approximately 4%.

A Portfolio's Longevity

Historical Survivability							
60% S&P500/40% Fixed-Income Portfolio							
Payout Period	Initial Inflation-Adjusted Withdrawal Rate						
	3.0%	3.5%	4.0%	4.5%	5.0%	5.5%	6.0%
20 years	100%	100%	100%	100%	99%	93%	79%
30 years	100%	100%	100%	92%	74%	60%	48%
40 years	100%	100%	97%	78%	64%	45%	37%
50 years	100%	99%	87%	68%	52%	40%	32%

Source: Safe Withdrawal Calculator at Retire Early Home Page (www.retireearlyhomepage.com)

Managing Three Risks

1. Protection from really, really bad investment markets.
2. Protection from outliving your assets by having a large allocation to stocks and a 30-year time frame.
3. Protection from retirement income not keeping up with rising prices by allowing for inflation-adjusted withdrawals.

How to Make Withdrawals

- Multiply the value of all your investments by 4%. That's amount you can spend this year.
- One year later, multiply that amount by the rate of inflation.

For example, if your portfolio is worth \$100,000, you would withdraw \$4,000 this year. Assuming an inflation rate of 5%, the following year you would withdraw \$4,200.

Make Regular Adjustments

If your investments perform poorly, consider reducing withdrawals or not adjusting for inflation.

If your investments perform well, re-set your withdrawal amount and take out more money

Step 2: Diversify, Diversify, Diversify

- **Q:** From 1926-2007, large-cap stocks returned an annual compound average of 10.4%, according to Ibbotson Associates. In how many of those 82 years did large-cap stocks post a return between 10.0% and 10.9%?
- **A:** Just once: In 2004, large-cap stocks returned 10.8%. In fact, large-cap stocks have returned between 8% and 12% in just five years (1926, 1959, 1968, 1993, 2004).

The Wild Ride: 1926-2007

Range of Returns	No. of Years Per Range
-50% to -40%	1
-30% to -40%	1
-20% to -30%	3
-20% to -10%	5
-10% to 0	13
0 to 10%	13
10% to 20%	15
20% to 30%	13
30% to 40%	13
40% to 50%	3
50% to 60%	2

The Price of Volatility

Year	A	B	C
1	8%	4%	-8%
2	8%	12%	24%
3	8%	4%	-8%
4	8%	12%	24%
5	8%	4%	-8%
6	8%	12%	24%
7	8%	4%	-8%
8	8%	12%	24%
9	8%	4%	-8%
10	8%	12%	24%

•\$100,000
starting value

•Start with 4%
withdrawal
rate

•Adjust
withdrawals
annually for
3% inflation

After 10 Years...

Portfolio A (no volatility) is worth \$145,476

Portfolio B (moderate volatility) is worth
\$142,990

Portfolio C (high volatility) is worth \$122,008

Withdrawals From a Portfolio of Only Large-Cap U.S. Stocks

- Start with \$100,000

- Make annual inflation-adjusted withdrawals

- Initial withdrawal rate of 4%

- Rebalance annually

Year	Year-End Value	Annual % change
2000	\$87,254	-12.7%
2001	\$73,236	-16.1%
2002	\$53,779	-26.6%
2003	\$63,680	18.4%
2004	\$65,746	3.2%
2005	\$64,222	-2.3%
2006	\$68,952	7.4%
2007	\$67,684	-1.8%

Stocks *and* Bonds

Now, let's change the portfolio to 60% large U.S. stocks and 40% intermediate government bonds.

Year	Year-End Value	Annual % Change
2000	\$95,587	-4.4%
2001	\$87,715	-8.2%
2002	\$76,760	-12.5%
2003	\$85,634	11.6%
2004	\$87,284	1.9%
2005	\$85,644	-1.9%
2006	\$89,659	4.7%
2007	\$91,074	1.6%

All Kinds of Stocks and Bonds

Change stock allocation to 15% large caps, 15% small caps, 15% international stocks, and 15% real estate investment trusts (REITs).

Year	Year-End Value	Annual % Change
2000	\$100,790	0.8%
2001	\$100,122	-0.7%
2002	\$94,088	-6.0%
2003	\$112,969	20.1%
2004	\$122,844	8.7%
2005	\$125,490	2.2%
2006	\$139,065	10.8%
2007	\$138,437	-0.5%

Step 3: Create an Income Cushion

Q: From 1871 to 2006, in what percentage of five-year periods did stocks beat bonds?

A: 71.3%, according to *Stocks for the Long Run* by Dr. Jeremy Siegel.

How to Create Your Cushion

1. Estimate your annual expenditures.
2. Subtract annual Social Security benefit, defined-benefit income, and any other sources of income (e.g., part-time employment).
3. Multiply by five.

Income Cushion Example

1. A retiree needs \$40,000 income.
2. She receives \$18,000 a year from Social Security, \$5,000 from a pension, and \$5,000 from an annuity, for a total of \$28,000.
3. Subtract \$28,000 from \$40,000, and you get \$12,000. Multiply that by five, and the result is that this retiree should have \$60,000 in cash, CDs, or short-term bonds.

Step 4: Practice Smart Asset “Location”

Q: How much after-tax wealth can you add to your portfolio by knowing which assets to put in your retirement accounts, and which to keep out?

- A. 5%
- B. 10%
- C. 15%
- D. 20%

A: C. 15% after-tax wealth

Source: Robert Dammon, Chester Spatt, and Harold Zhang, "Optimal Asset Location and Allocation With Taxable and Tax-Deferred Investing"

The Taxation of Accounts

- Withdrawals from traditional IRAs and employer-sponsored retirement accounts (e.g., 401(k)s) are taxed as ordinary income – the highest rate possible.
- Qualified withdrawals from Roth accounts are tax-free.
- Interest, dividends, and capital gains in non-retirement accounts have more specialized tax rules.

Qualified Stock Dividends

- Dividends distributed by stocks held for more than 60 days during a 121-day period that begins 60 days before the fund's ex-dividend date.
- Qualified dividends are taxed at a rate of 0% or 15%.

If you rely on dividends for income, keep the stocks outside of traditional retirement accounts.

Interest From Corporate Issuers

- Interest from corporate bonds, certificates of deposit, and money markets are taxed as ordinary income.
- If you spend the income, the type of account doesn't matter.
- If you're reinvesting the income – e.g., reinvesting interest from a taxable bond fund – hold the investment in a retirement account.

Interest From Government Issuers

- Interest from Treasuries is free of state income tax.
- Interest from municipal bonds is free of federal income tax and usually free of state income tax to residents of the issuer.

Government-issued bonds should be held outside retirement accounts.

One exception: Treasury inflation-protected securities (TIPS)

Capital Gains From Stocks

- Gains from stocks held less than a year are considered short term and taxed as ordinary income.
- Gains from stocks held for more than a year are taxed at a rate of 0% or 15%.

Investment strategies that result in short-term gains should be held in retirement accounts. Buy-and-hold stocks might be better held outside of retirement accounts.

Step 5: Be Smart With Withdrawals

Q: If a retiree has investments in a Traditional IRA, a Roth IRA, and a taxable, non-retirement account, from which account should withdrawals be made first?

A: Start with the taxable account, then empty the traditional IRA next, and save the Roth IRA for last.

Ordering Your Withdrawals

Extend the tax advantages of your retirement accounts by depleting taxable accounts first, then tax-advantaged accounts. However...

- If you're 70 ½ or older, you must make required minimum distributions from traditional tax-deferred retirement accounts (or pay a 50% penalty).
- If want your heirs to inherit more after-tax wealth, spend down traditional IRAs and other tax-deferred accounts.

What to Sell?

- Rebalance portfolio by selling investments that have become too big a part of your portfolio.
- When selling assets in taxable, non-retirement accounts, consider the tax basis.

Example: You bought a stock at \$25 a share and additional shares at \$50 a share a year later. It's now worth \$35. Selling one lot results in a \$10 per share capital gain, the other a \$15 per share capital loss.

Step 6: Monitor Costs and Performance

- **Q:** Of the 50 best-performing large-cap U.S. stock mutual funds over the past decade, how many charge above-average fees?
- **A:** Just three.

Costs Matter

- The studies of safe withdrawal rates assumed the use of low-cost index funds, which charge 0.2% a year. However, the average mutual fund charges 1.4%.
- The safe withdrawal rate for a retiree who pays 2.5% in fees and investment costs is less than 3%.

Monitor Cost and Performance

- Over the long term, most mutual funds under-perform index funds.
- Compare your funds to relevant benchmarks to make sure yours are among the winners.
- If you pick your own stocks, keep yourself honest.

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