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How to Generate a Retirement Paycheck

A Guide to Tax Efficient Distribution Planning

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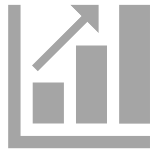
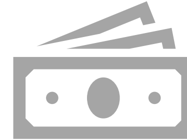
The Basics of Distribution Planning:



The challenge is to sustain inflation adjusted retirement distributions over time

The challenge is made harder when market volatility is added



It is important to avoid an adverse sequence of returns that could permanently affect the retirement cash flow into the future

With different accounts, rules and volatility –
it gets complicated

Create a Retirement Paycheck From a Portfolio of Assets

- Profound change as we transition from the accumulation phase of life where we are working, saving and reinvesting to the de-accumulation phase where earned income and paychecks stop

- The shift is tricky, emotional and easy to get wrong

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Two Components of Total Return: Income (Dividends/Interest) and Capital Gains (Loss)

- Most portfolios are invested in a combination of stocks and bonds

- It would be nice if income was sufficient to equal the spending need for the investor, but rarely is that the case

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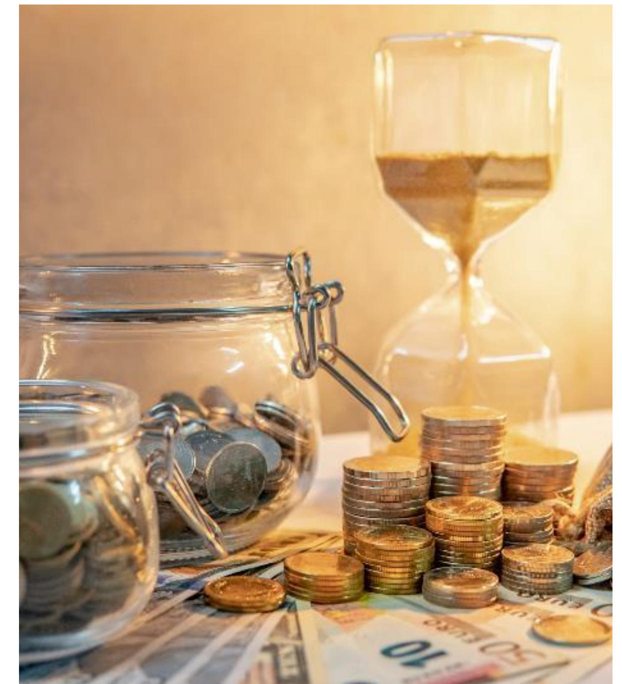
For Most, Spending Starts with Dividends and Interest But Needs Topping Up with Periodic Liquidations of Principal

- Today's dividend and interest payments are 2-3% of portfolio*
- Most investors do not have the size portfolio to just spend the income
- One has to carefully consider how to handle these principal liquidations in various up and down markets



*SOURCE: 2019 Morningstar/Ibbotson, based on a blended portfolio of large-cap stocks, small-cap stocks and US investment-grade bonds.

Three Main Considerations:

1

What is the frequency of distributions?

2

What types of accounts are the source of distributions?
(IRA, Roth IRA, taxable securities portfolio, etc.)

3

How are distributions coordinated and taxed when combined with the rest of a retiree's retirement income picture?
(Social security, pension, rental property, etc.)

Today's Low Interest Rates Make Income Replacement Difficult

- Dividends are a good option …
  - But when introducing equities we have to deal with market volatility and uneven nature of total returns in the short and intermediate term

- Capital gains are not stable and consistent like interest/dividends
  - In some years there are sizable gains and none or outright losses in others
  - Periodic principal liquidations can cause anxiety

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What is a Sustainable Withdrawal Rate (SWR)?

Depends on a few factors, such as:

- ✓Length of retirement
- ✓When you retire
- ✓What is your life expectancy
- ✓Your desire to leave a legacy to others

4%

SWR for most retirement time frames

Objective Is to Withdraw 4% from a Balanced Portfolio of 60-80% Stocks and 20-40% Bonds

6-8%

Expected long-term total returns*

2-4%

Expected long-term portfolio growth rate*

NOTE: It is critical to account for inflation. It has historically averaged 2.5-3.5%*. By spending a percentage of the portfolio that is growing with inflation, the spending will also grow with inflation.

*SOURCE: 2019 Morningstar/Ibbotson. Long-term total returns are based on a blended portfolio of large-cap stocks, small-cap stocks and US investment-grade bonds. Long-term portfolio growth rate refers to the long-term total returns after 4% annual withdrawals.

Four Factors to Determine Sustainable Withdrawal Rate (SWR):

1. Age and health of investor
2. Desire to leave a legacy or inheritance
3. Rules-based spending decisions can help to optimize SWR (for example: capping)
4. Spending at **6%** in a bear market and allowing inflation adjustments only after positive years

Portfolio Yield (Dividend and Interest) vs. 4% Sustainable Withdrawal Rate

- **The need to rely on principal in years where capital gains do not occur requires a plan**
  - How to generate this spending ability when they do not have the full 4% from capital gains and income

- **Tapping principal may or may not be taxable income depending on whether it is from an IRA**
  - We must make the distinction because income for tax purpose is different from retirement cash flows to cover spending

What to do When the Stock Market is Negative:

- Start accumulating the 4% spending from dividends and interest first
- “Top up” to generate the rest by rebalancing
    - Sell from whatever investment was recently up the most
- In the event the whole stock market is negative and there is nothing “up” to rebalance you would sell from short-term bonds or cash to avoid liquidating equities when they are down

When Spending a Portion of Principal …

Stock market **up** 3% or more

Take from equity allocation

Stock market **down** 3% or more

Take from bond allocation

Stock market **up** 10% or more

Replenish bonds and bring forward discretionary spending

Create an Investment Policy Statement

- Having rules help when the situation is fluid and markets are down

- Being objective and having a plan of action is necessary to avoid making an ill-timed decision

- Such rules need to address:
  - Liquidations
  - Cash reserve
  - Frequency of distributions
  - What kinds of accounts
  - The coordination of other cash flows such as social security and pensions

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Follow the Three Bucket Strategy:

Cash and short-term bonds in an amount sufficient to cover 2-3 years of anticipated cash flow need

Should be invested in various fixed income asset classes and should approximate 3-9 years of spending

Funds not needed for 10 years should be invested in dividend paying stocks

How Account Types Affect the Distributions

- Taxation is the biggest factor
- Evaluate the ratio of taxable account assets to tax-deferred and tax-free account assets
- If everything is in tax-deferred, it is straight-forward and everything will be taxed as ordinary income upon withdrawal
- If there is a mix of account types, tax planning becomes more important

Withdrawal Strategy for Various Account Types:

- **IRA or 401(k):** Generally we do not recommend withdrawing money right away (especially if under age 59½)
- **Roth IRA:** We do not generally recommend withdrawing funds for as long as possible
  - This allows the tax-free accounts to benefit most from the time value of money
- NOTE: Be mindful to keep a reasonable balance between the different types of accounts as it could hurt you later in life

Diversify Between Account Types

- Taxable accounts and cash means you are likely to pay less income tax in early retirement
- You could be left with a portfolio that only consists of IRAs toward the end of retirement
- That could mean years of unpleasant tax bills or a faster drawdown rate later in retirement

How Does an IRA Affect Distributions?

- At 70½ years old you are required to take a **required minimum distribution (RMD)** from your IRA
- The RMD is taxed as ordinary income, but can be directed to a non-profit via qualified charitable distribution (QCD) rules to help avoid tax
- It may make sense to withdraw before required to do so by calculating your tax bracket now and comparing it to what it is projected to be in your seventies

Stay Flexible

- Market conditions change
- Tax laws change
- Cash flow needs change
- There is no “set it and forget it”

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Note: Thank you to Michael Kitces (Kitces.com) for his thought leadership that we leveraged in this presentation.