Retirement Income, Part 5

By Gary Case

A 2003 study by the Life Insurance Marketing Association International, Inc., found that only about one in five retirees had any formal, written plan for managing income, assets and expenses during retirement. Many who do have plans use incorrect assumptions, and most are simply “playing it by ear” – at serious risk to their long-term financial health.

Some basic investing principles carry over into retirement. For example, based on historical measures, stocks deliver good long-term returns, and should be held in a retirement portfolio to finance income needs later in retirement, which may be twenty, thirty, or even more years into retirement.

But some savings and investment tactics change when moving from accumulation to drawdown. Tax efficient withdrawal strategies are an important consideration. Most retirees benefit by drawing on taxable assets first, leaving tax-sheltered savings for last—drawing on them only after other, non-sheltered savings are exhausted. This strategy can add extra years of income. For an initial pool of $500,000 equally divided between taxable and tax-sheltered holdings, drawing down the taxable elements first can lengthen the portfolio’s life by more than five years (assuming annual withdrawals of $20,000 increased by 3% annually for inflation—7% average annual investment return—35% income tax rate on tax-deferred distributions and 28% on taxable investments). * It should be noted that individual circumstances may vary and you could benefit from taking tax-sheltered holding ahead of taxable.

There are other key differences between the accumulation and distribution phases. While young savers can monitor progress using long-term average returns as a benchmark, retirees must meet their expenses from real, current returns on their assets. These returns fluctuate substantially and unpredictably each year.

While younger savers can aim at a somewhat predictable and controllable retirement date, retirees simply don’t know how long they themselves or their spouses will live. Thus, they cannot forecast with much certainty how long their financial resources need to last.

The five key risks that everyone should address in retirement planning include:

- Longevity risk, the risk of living well beyond their theoretical life expectancy
- Withdrawal risk, the potential of drawing down their savings to rapidly
- Inflation risk
- Asset Allocation risk, specifically, being too “aggressive” or “conservative”
- Health Care Cost risk, the risk of not having set aside enough money to cover future health care expenses.

Some of these risks are more complex than those faced during the accumulation phase, and mistakes in managing post-retirement risks are more difficult, sometimes impossible, to correct. Yet all of these retirement income risks can be met, and potentially overcome, provided people understand them and take action. Guidance from a trusted financial advisor can be extremely valuable in this process. Next week I'll begin a discussion of the risks outlined above.

*These assumptions are do not imply actual performance of any particular investment. Your portfolio might earn more or less than the example

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