



GET A TAX-SMART PLAN FOR IN-RETIREMENT WITHDRAWALS

There isn't a cookie-cutter answer to deciding which accounts to pull from first because an investor's strategy will be determined by age and tax rate when taking the withdrawal. A key focus when developing your withdrawal strategy should be preserving the tax-saving benefits of your tax-sheltered investments for as long as you possibly can.

As long as a retiree has both taxable and tax-advantaged assets like IRAs and company retirement plans, it's usually best to hold on to the accounts with the most generous tax treatment while spending down less tax-efficient assets.

The following sequence will make sense for many retirees.

1) If you're older than 70½, your first stop for withdrawals are those accounts that carry required minimum distributions, or RMDs, such as traditional IRAs and company retirement plans. (You'll pay penalties if you don't take these distributions on time.)

2) If you're not required to take RMDs or you've taken your RMDs and still need cash, turn to your taxable assets. Start by selling assets with the highest cost basis first and then move on to those assets where your cost basis is lower (and your tax hit is higher). Relative to tax-deferred or tax-free assets, these assets have the highest costs associated with them while you own them. However, taxable assets could also be valuable to tap in your later retirement years because you'll pay taxes on withdrawals at your capital gains rate, which is lower than your ordinary income tax rate.

3) Finally, tap company retirement-plan accounts and IRAs. Save Roth IRA assets for last.

For more on this topic, see: www.morningstar.com/now/lifestage

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Those who lived through the 1970s and '80s no doubt find their photographs from those decades to be cringe-worthy. But while few may wish to repeat a fashion era marked by pastel-colored suits and big hair, one aspect of those bygone decades is appealing — substantially higher interest rates than those that prevail today. The average interest rate on a six-month certificate of deposit was 9.1 percent in 1970 and 13.4 percent in 1980. Of course, inflation was high then, too, but those higher rates, plus the prevalence of pensions, allowed many retirees to generate livable income streams without invading their principal or taking risks in stocks.

But three decades' worth of declining interest rates have dragged yields way down, dramatically compounding the challenge for retirees. With infinitesimal yields on money market accounts and high-quality bonds, retirees' choices are stark: To be able to afford retirement, they can plan to delay the date, save more, reduce their standards of living or take more risks with their portfolios.

The "Bucket Approach" to retirement-portfolio management, pioneered by financial planning guru Harold Evensky, aims to meet those challenges, effectively helping retirees create a paycheck from their investment assets. Whereas some retirees have stuck with an income-centric approach but have been forced into ever-riskier securities, the bucket concept is anchored on the basic premise that assets needed to fund near-term living expenses ought to remain in cash, dinky yields and all. Assets that won't be needed for several years or more can be parked in a diversified pool of long-term holdings, with the cash buffer providing the peace of mind to ride out periodic downturns in the long-term portfolio.

(The all-important) Bucket 1

The linchpin of any bucket framework is a highly liquid component to meet near-term living expenses for one year or more. With money market yields close to zero currently, Bucket 1 is close to dead money, but the goal of this portfolio sleeve is to stabilize principal to meet income needs not covered by other income sources. To arrive at the amount of money to hold in Bucket 1, start by sketching out spending needs on an annual basis. Subtract from that amount any certain, nonportfolio sources of income such as Social Security or pension payments. The amount left over is the starting point for Bucket 1: That's the amount of annual income Bucket 1 will need to supply.

More conservative investors will want to multiply that figure by 2 or more to determine their cash holdings. Alternatively, investors concerned about the opportunity cost of so much cash might consider building a two-part liquidity pool — one year's worth of living expenses in true cash and one or more years' worth of living expenses in a slightly higher-yielding alternative holding, such as a short-term bond fund. A retiree also might consider including an emergency fund within Bucket 1 to defray unanticipated expenses such as car repairs, additional health-care costs and so on.

Bucket 2

Under our framework, this portfolio segment contains five or more years' worth of living expenses, with a goal of income production and stability. Thus, it's dominated by high-quality bond exposure, though it might also include a small share of high-quality dividend-paying stocks and other yield-rich securities such as master limited partnerships. Balanced or conservative- and moderate-allocation funds would also be appropriate in this part of the portfolio.

Income distributions from this portion of

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the portfolio can be used to refill Bucket 1 as those assets are depleted. Why not simply spend the income proceeds directly and skip Bucket 1 altogether? Because most retirees desire a reasonably consistent income stream to help meet their income needs. If yields are low, the retiree can maintain a consistent standard of living by looking to other portfolio sources, such as rebalancing proceeds from Bucket 2 and 3, to refill Bucket 1.

Bucket 3

The longest-term portion of the portfolio, Bucket 3 is dominated by stocks and more volatile bond types such as junk bonds. Because this portion of the portfolio is likely to deliver the best long-term performance, it will require periodic trimming. By the same token, this portion of the portfolio will also have much greater loss potential than Bucket 1 and 2. Those portfolio components are in place to prevent the investor from tapping Bucket 3 when it's in a slump, which would otherwise turn paper losses into real ones.

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■ RETIREES: Road Map

Even retirees who are seasoned investors will tell you that transitioning from accumulating to spending from their portfolios is a challenge. The "right" withdrawal rate and strategy seems to be a moving target.

Devising an asset allocation plan that balances safety and liquidity with long-term growth is no mean feat, either, especially given today's high(ish) equity valuations and still low yields on bonds and cash. There are also psychological hurdles to jump over: After years of saving, transitioning into drawdown mode can feel a little bit scary.

Because mapping out a durable in-retirement investment plan can be so complicated, it's crucial to do your homework. Above all, keep in mind that your in-retirement portfolio is a work in progress: The most successful retirement plans, while not overly complicated, need to change with the times and be responsive to changes in your own situation.

As you plot out your in-retirement financial and retirement plan, here are the key tasks to tackle.

Project and adjust your expenses

As you enter retirement, it's valuable to compare your in-retirement budget with your ledger when you were working. If you were a heavy saver while in accumulation mode, taking savings off the table means that you're apt to need a much smaller sum than you did while you were working. For this reason, Morningstar's David Blanchett has found that higher-income workers' income-replacement rates in retirement are much lower than their lower-income counterparts! Of course, your spending may rise in other categories, such as travel and healthcare, but it may be offset through lower expenditures on categories such as work transport and eating lunches out.

A budget is as valuable in retirement as it is while you're working and saving, but it requires some discipline and a bit of artfulness: Aim to strike the right balance between minding expenses and counting every penny.

Take stock of and maximize your sources of lifetime income

For most retirees, Social Security will be their key source of guaranteed lifetime in-

come; a small (and shrinking) share of the population will be able to rely on pensions that can be annuitized during retirement.

Obviously, the greater the certain sources of lifetime income that you'll bring into retirement, the less you'll need to tap your investment portfolio (and the better its odds of lasting). Ideally, those certain sources of income will cover your baseline living expenses — housing, food, utilities, and healthcare/insurance costs. That underscores the virtue of maximizing those income sources.

Delaying Social Security, while not the right answer in every situation, is well worth considering. For every year that you're able to delay past your full retirement age, you can pick up a roughly 8 percent increase in your benefits — an advantage that will be with you for the rest of your life. And if you have a pension, give due consideration to taking benefits as an annuity rather than a lump sum.

Don't rule out some type of work

The complexion of "retirement" is changing before our very eyes. Thanks to improvements in healthcare, many retirees are healthier and more active than

their forebears. Moreover, many "retirees" aren't fully retired at all, but instead continue to work in some fashion into retirement.

Working longer can be a win-win-win from a financial standpoint, reducing portfolio withdrawals and improving portfolio longevity, allowing for other financially beneficial decisions like delayed Social Security, and even enabling additional retirement-plan contributions later in life. Yet even as working longer is a worthwhile aspiration, the data show a disconnect between the percentage of pre-retirees who say they plan to continue working in some fashion through retirement and the percentage who actually do so. While a third of the workers in a 2014 Employee Benefits Research Institute survey said they planned to work past age 65, just 16 percent of retirees said they had retired post-age 65.

Health issues — for the older worker, spouse, or parents — and/or untenable physical demands of the job can derail a goal to work longer, for example. Thus, it's crucial to ensure that "working longer" isn't central to the viability of your financial plan.

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