

Tools and Pools: Strategies for Increasing Retirement Cash Flow and Creating a Retirement Plan

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In Part I of this two-part article, Robert Kreitler discusses tools for increasing a retiree's cash flow while considering uncertainties in portfolio performance, inflation, market structure changes and life expectancy. Part II addresses a strategy to create different investment pools, each with its own purpose. These pools form the basis for the entire retirement plan and allow the retiree to clarify his retirement objectives.

Part I. Tools for Increasing Retirees' Cash Flow

Introduction

How much money retirees can take from their portfolios depends upon how the portfolios will perform in the future. Yet, future performance is unknown. We do not know how stock markets will behave. We do not know what interest rates will do. Investment vehicles and the structure of markets may change. Inflation may increase or decrease. Government policies will affect taxes and the value of the dollar. Most importantly, retirees do not know how long they will live and need income.

Retirees must adopt strategies that account for these uncertain-

ties. The strategies should have close to a 100-percent chance of working, not the 90- or 95-percent chance generated by simulation models frequently discussed in professional journals.

Monte Carlo and other simulation models provide useful information about how much investors need to save for retirement. However, they are not useful tools for managing withdrawals during retirement. These simulation mod-

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els typically conclude that retirees should not withdraw more than four to five percent plus inflation from a portfolio. They warn that exceeding these rates increases the odds of exhausting capital before death between five and 10 percent.

Many advisors accept the results of these simulation models and advise their clients to limit withdrawals to four to five percent. Limiting lifetime withdrawals increases the amount that will likely be left for heirs. However, if retirees prefer to maximize lifetime income, this cash flow strategy will not be consistent with their objectives.

Clients can have many objectives. These may include assuring lifetime income, maximizing income, protecting against inflation, keeping a pool for emergencies, maintaining flexibility and leaving assets to heirs.

The purpose of the first part of this article is to provide advisors tools so they can increase cash flow income to clients who are planning for retirement without risking exhaustion of capital. For some retirees, the result will be as simple as increasing the monthly check in the mail with assurance that they will not exhaust their capital before they die. Some retirees need increased cash flow to meet critical expenses such as rent, food or medical bills. Retirees with significant assets will be able to safely increase spending while living and reduce the amount left to be controlled by estate plans. They will be able to spend more on hobbies, improve their standard of living, indulge in more travel or enjoy gifting to relatives or charities. Retirement planning becomes more important while estate planning becomes less important.

Overview of Cash Flow Sources
I split retirees' cash flow into two major categories. The first is from income sources that are guaranteed for life with the principal consumed and nothing left for heirs. Frequently, not only the payment is guaranteed for life, but also the amount of that payment is guaranteed. Typical examples include Social Security, pensions and immediate annuities. The retiree has relatively little flexibility to modify the cash flow once he or she has chosen a course of action.

The second category is cash flow generated from a portfolio. Typically, the retiree does not intend to consume this capital and plans to pass whatever is left to heirs. The cash distribution is generated from dividends, interest, consumption of capital or growth of capital. To assure that capital is not consumed before the retiree dies, since the date of death is unknown, cash flow from a portfolio is typically held at low levels.

Retirees can increase lifetime cash flow by using assets from the second category (portfolios) to purchase immediate annuities (guaranteed lifetime income). They can also increase spendable income by identifying and consuming surplus funds.

Guaranteed Lifetime Cash Flow

For most retirees, income from Social Security, pensions and immediate annuities provides the foundation of their cash flow. This income not only lasts for retirees' entire lives but also for their spouses' entire lives. It is income they cannot outlive. Most retirees are unaware that capital is being consumed to provide their guaranteed payments.

With all of these options, the retiree shifts the risk of living too

long to a third party. Insurance companies (pensions and annuities) are uniquely qualified to assume this risk by spreading it among many individuals. The same is true for the federal government (Social Security). Only the very wealthy can self-insure against the risk of living too long.

Fortunately, these income sources are relatively secure. There is a very low probability that politicians will significantly change Social Security benefits for retirees or individuals who plan to retire in the next several years. What could change, however, are the annual inflation adjustments and the taxation of Social Security payments.

Company pensions are typically insured by the Pension Benefit Guarantee Corporation. Retirees should consider this income guaranteed. Income from nonqualified company sponsored retirement plans, such as top hat plans or supplemental executive retirement plans (SERPs) are only as secure as the underlying company offering the plan. Retirees must consider the risk of the company providing the nonqualified plan in deciding how to rate the security of these plans.

Immediate annuities can either be fixed or variable. The payment from an immediate fixed annuity is only as good as the underlying insurance company, but because of state insurance industry oversight, payment is relatively secure. Purchasing immediate annuities from high-quality insurance companies and then diversifying by purchasing annuities from multiple companies can reduce the risk of default.

With immediate fixed annuities, the insurance company assumes both the investment risk and the risk of living too long.

With immediate variable annuities, the insurance company assumes the risk of living too long, but the owner invests in a number of sub-accounts and assumes the investment risk. Retirees must decide, of course, how much investment risk they are willing to assume. Immediate variable annuities are a relatively new product. As the demand for these increases, competition will likely force insurance companies to reduce the internal costs, which are currently relatively high. (Please read the prospectus before recommending to clients.) Other types of immediate annuities include charitable remainder trusts and private annuities. This article does not specifically address their use, but the basic principals apply to them as well.

The common characteristics of Social Security, pensions and immediate annuities are that income is guaranteed for life and nothing is left for heirs. Since capital is consumed, retirees receive a greater cash flow than if they had to preserve capital to protect themselves against the possibility of living beyond life expectancy. The downside is the loss of flexibility. Cash flow cannot be adjusted to meet changing needs. Capital cannot be shifted to new investment opportunities. Once capital is committed to these investment vehicles, little can be changed.

Portfolio Income

Portfolios are the other primary source of income for retirees. Traditional investments include stocks, bonds, real estate and cash. To simplify the discussion, only stocks and bonds are discussed in this article. One of the characteristics of a portfolio is that the retirees maintain ownership.

They have the flexibility to change investments or adjust the income stream to meet future needs.

In order to create cash flow, a retiree can either remove earnings from a portfolio or liquidate capital. Retirees who consume a portion of their original capital typically do not plan to consume all of their capital before dying (the exception being those planning to bankrupt themselves and go on Medicaid). Because the date of death is unknown, it is impossible to schedule withdrawals to maximize income while assuring that principal is not exhausted.

Retirees focus on a variety of parameters as they decide how much income to take from their portfolios. Some focus only on dividends and interest. Others look at total return, which includes dividends, interest, realized gains and losses and unrealized gains and losses. Retirees usually treat cash distributions from nonqualified and qualified sources differently. With IRAs, retirees have a greater tendency to focus on total return. With

nonqualified funds, they are more likely to focus on cash distributions such as interest and dividends. The next section discusses seven cash distribution options retirees can use.

Option 1—Live off Interest and Dividends. This is the traditional approach used by many retirees. They are comfortable with it as it assures that they will not dip into their capital, which of course, assures that they will not run out of capital before they die. If interest

rates are about five percent and dividends are two percent, a portfolio's return will provide between two and five percent depending on the balance between stocks and bonds. Annual distributions will vary based on many factors, but compared to some of the other options discussed below, cash flow is likely to be relatively stable and predictable. Over time, if stock appreciation increases the portfolio's value, the retiree would expect to receive an increasing cash flow as dividends increase and through increased interest after rebalancing to bonds.

The benefits of this approach are that the retiree is virtually guaranteed he or she will never deplete capital and cash flow will be relatively stable. Interest and dividends are more stable than stock or bond prices. Other ben-

Retirees willing to adjust their cash distributions to reflect portfolio performance can safely receive higher levels of distributions over time while avoiding the risk that they will prematurely exhaust their capital.

efits include the built-in bias for long-term appreciation of the portfolio and the ease of understanding. This option is a natural choice for many retirees.

The primary disadvantage is that annual cash flow is likely to be significantly lower than other options, and heirs may be left with a great deal more than they would receive under other options. For many retirees, high levels of cash flow are very important. Another disadvantage is that to generate

more current cash flow, retirees may overweight bonds, which, over longer periods historically, have provided lower rates of return than stocks. This overweighting will drag down long-term portfolio returns and hurt the retiree.

Options 2—Take What I Need. Under this option, retirees take what they need without regard to the ability of the portfolio to generate cash flow. This approach is entirely without a plan. It may work well for retirees whose portfolio's total return far exceeds their income needs (the very wealthy). Others are likely to spend high levels early in retirement, leaving them impoverished in later years. I suspect that many who think they are following this approach are really holding back their expenses to protect capital, and in actual practice, may spend less than they could if they followed other options.

Option 3—Take a Fixed Dollar Amount in Good Markets and Bad. Under this option, a person may decide to withdraw a fixed amount. For example, a retiree might decide to take \$25,000 a year from a \$500,000 portfolio. Once set, the amount is unchanged for many years. Because individuals frequently have greater trouble making decisions as they grow older, adjusting this number up or down is difficult to do later in life.

The advantages of this approach however, are that it is simple to administer and easy to budget, attributes most retirees favor. The disadvantages are that because future returns are unknown, retirees will take out either less than the portfolio will sustain, increasing inheritances to heirs, or they will take out too much and face a severe cut in

income in the future. In my experience, most people take out too little. Playing it safe, they spend less in retirement than they can afford which means leaving more to their heirs.

Option 4—Establish an Initial Amount to Take, Then Increase Distributions Annually with Inflation. This option is frequently written about in retirement planning literature and relies on using Monte Carlo simulations to determine how much should be saved for retirement. The authors suggest that a retiree who withdraws four to five percent from his or her portfolio and increases that amount with inflation has a 90- to 95-percent chance of not running out of money. Although this option is frequently discussed in professional journals, I believe retirees rarely use it.

The benefit is clear. Income increases to offset inflation.

Options 2 through 4 are flawed in that cash flow is not adjusted based on actual portfolio performance. Because future returns are unknown, locking in a cash flow schedule that is not adjusted to reflect actual portfolio performance virtually assures retirees will either:

- receive lower levels of income than the portfolio can generate and increase assets going to heirs, or
- spend too much in early years and have a shortage in later years. If retirees are going to accept the risks of the markets and if they want to maximize cash flow, they must be willing to adjust their cash distributions to reflect actual performance.

Option 5—Take a Constant Percent of the Portfolio (Four to Six Percent) with Payment Adjusted

as the Value of the Portfolio Changes. This option differs from Option 4 in that dollar distributions vary based on how a portfolio does over time. Typically, the distributions are greater than in Option 1, as total portfolio return is taken into account in calculating the distribution.

The advantage of this option is that it is easy to administer and the annual cash flow adjusts to reflect actual total portfolio performance. The strategy adjusts distributions to reflect market performance. If the annual distribution exceeds total performance, the value of the portfolio drops and the following year's distribution is decreased. Likewise, if total portfolio performance exceeds the distribution rate, the distribution will increase the following year. A retiree can choose a distribution rate below the expected total return with the expectation that the portfolio will grow over time, also increasing the distribution rate. This might be used as a way to offset the expected effect of inflation. Because of the self-correcting nature of this strategy, it is virtually impossible to exhaust capital although annual income distributions could significantly drop if the portfolio value drops dramatically.

The major problem with this approach is that it is impossible to determine the optimum distribution rate. Choosing a rate that is too low restricts current income and increases the assets passed to heirs. Choosing a rate that is too high means excess distributions that will reduce principal causing lower payouts in future years. These problems are solved by Option 7.

Option 6—Follow the IRS Required Minimum Distribution Rate. As another option, retirees

may use the IRS Minimum Distribution Rules to set withdrawals. The new regulation dramatically reduces the amount retirees must take from their IRAs. Taking only the minimum required distributions almost assures that retirees will not exhaust capital during their lifetimes.

Assume, for example, that with a \$1 million IRA, a husband and wife begin taking \$36,496 at age 70 1/2. If their portfolio returns eight percent, by age 80 this amount increases to \$71,200 and at age 90 it will be \$145,604 (see Chart 1).

Because of the low distribution rate in early years, the value of the IRA would grow to a maximum of \$1,647,073 at age 88 before beginning to drop (see Chart 2).

This strategy will not be ideal for all retirees. Many will prefer a distribution pattern different from what the IRS sets as a minimum. They may want higher distributions in earlier years, lower in later years. Retirees with other financial assets may want to accelerate distributions from nonqualified assets in early years and rely on IRA assets in later years. This maximizes the tax deferral benefits of the IRA.

Option 7—Take an Amount Based on Portfolio Performance. Retirees willing to adjust their cash distributions to reflect portfolio performance can safely receive higher levels of distributions over time while still avoiding the risk that they will prematurely exhaust their capital.

One way of doing this is to set up two separate distributions. The first, a base distribution, is an amount that the portfolio can safely produce even in bad times and, therefore, is quite secure. The second, a performance distribution, is made whenever portfolio

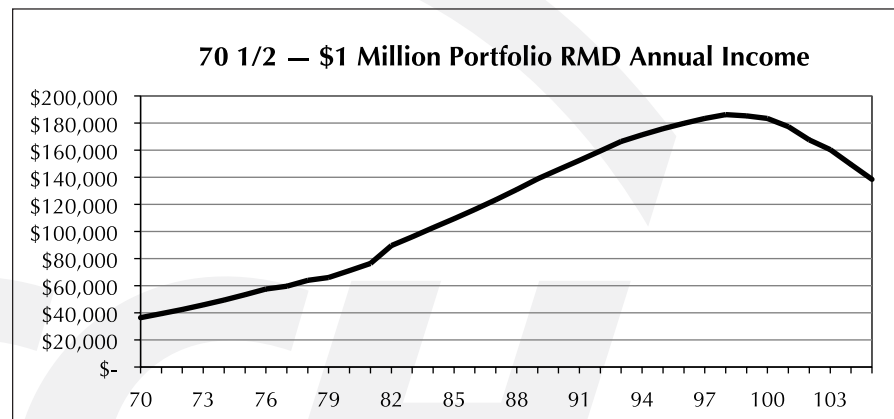
returns rise above a certain predetermined level. The performance distribution is increased in good years and cut back or eliminated in bad years. To simplify administration, the performance distribution can lag by a year and be based on prior year performance. If there are multiple good years and the portfolio grows, the base distribution can be increased.

As an example, a retiree with a \$500,000 portfolio sets the base distribution at \$20,000 per year, or four percent. The retiree then budgets his fixed living expenses

of the annual return above the four percent base amount. Retirees would use performance distributions for discretionary expenses such as the purchase of a new car, travel or gifts to children or charity. These expenses can be added or cut out depending on how the portfolio performs. The remaining 50 percent is used to build capital or to restore it after several years of low performance.

In the above example, if the total return on the \$500,000 portfolio were 10 percent, the performance distribution would

Chart 1

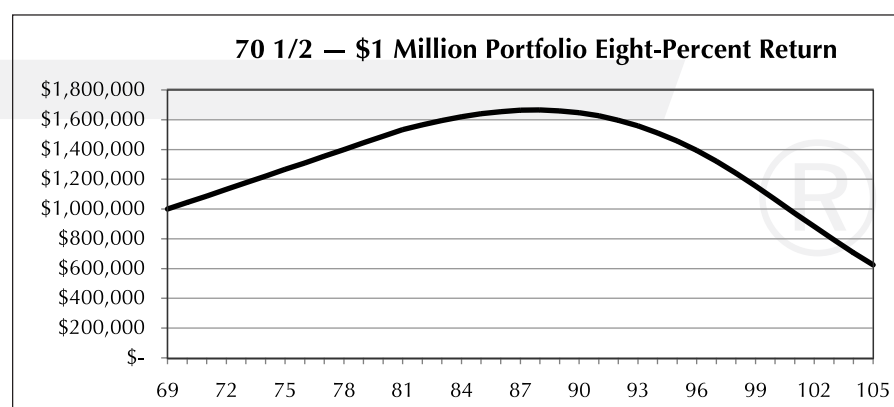


within this amount. In bad markets, he could ride through the difficult times without reducing his living standard.

There are many ways to set up a performance distribution. One option is to distribute 50 percent

of the annual return above the four percent base amount. Retirees would use performance distributions for discretionary expenses such as the purchase of a new car, travel or gifts to children or charity. These expenses can be added or cut out depending on how the portfolio performs. The remaining 50 percent is used to build capital or to restore it after several years of low performance.

Chart 2



advisors would typically consider prudent.

The benefit of performance-based distributions is that if the retiree is willing to cut back spending in bad years, the distributions can be greater over time. The problem of taking large distributions in bad years, which destroys capital, is solved. The odds of exhausting capital are very low. Because the retiree is willing to be flexible, distributions over time typically will be safely higher than the other options discussed above.

There are two disadvantages with this approach. First, it is complex. Many seniors, particularly as they grow older, may be unable to understand the need to make annual adjustments. Second, if retirees become accustomed to higher levels of expenditures, they may be unwilling to cut back after bad years.

Increasing Cash Flow by Consuming Capital

Retirees wishing to increase income can do this by consuming capital. The challenge is to do this without prematurely exhausting capital. This section discusses two options. The first moves portfolio capital into immediate annuities to provide additional income that is guaranteed for life. The second, after putting a plan in place that provides adequate lifetime cash flow, identifies capital that is truly surplus and that retirees can safely spend down. These two options, while both consuming capital, serve completely different objectives.

Guaranteed Lifetime Cash Flow When Capital Is Consumed

Immediate Annuities. An immediate annuity increases lifetime cash flow but exhausts capital on the date of death. The cash flow is

higher than other lifetime payout options because the capital is intentionally consumed. Because of the uncertainty of when death will occur, an immediate lifetime annuity is the only investment vehicle that assures capital is exhausted on death (not before or after). Few people can self-insure for this risk. Because insurance companies spread the uncertainty of death over many individuals, they are uniquely qualified to sponsor such products. The immediate annuity is the reverse of life insurance.

The increase in income from an immediate annuity is meaningful. Chart 3 compares the cash flow from an immediate fixed annuity with a government bond (an immediate fixed annuity is chosen here for simplicity of comparison). The annuity for a couple aged 65 provides 45 percent greater income than the government bond.

At age 80, the couple receives over a 100-percent increase in income. The older a retiree is when he or she starts receiving income from an immediate annuity, the greater the payment will be because life expectancy is shorter. (I usually figure age 65 is the youngest someone should be before using an immediate annuity.) Lower interest rates reduce the monthly payments but they also

reduce the returns on competitive investment vehicles. At lower interest rates, the return of capital represents a larger proportion of the monthly payment, and thus, the immediate fixed annuity improves its competitive position versus government bonds.

There are two types of immediate annuities—fixed and variable.

Immediate Fixed Annuities. With an immediate fixed annuity, which was used in the prior example, insurance companies set and guarantee the amount of the retiree’s monthly payment for life.

The insurance company manages the funds and assumes both the investment risk and that the retiree will outlive the capital. Payment is an obligation of the insurance company and cannot change no matter how much interest rates vary. The insurance companies are governed by state insurance regulators who also would manage any bankruptcy situations. Choosing a highly rated insurance company is important and, typically, the rating of the company does not influence the level of monthly payment. So choosing quality companies will not reduce income. By purchasing multiple policies from different companies, retirees can provide additional protection.¹

Chart 3
Comparison of Income from an Immediate Fixed Annuity and a Treasury Bond

\$100,000 Investment				
Joint Survivor with Husband and Wife, Life Certain				
Current 30-Year Treasury Bond is Five Percent				
<small>All Data Obtained August 27, 2002</small>				
Age	Annuity Monthly	Annuity Annual	Treasury Annual	% Increase Income
65	\$604.16	\$ 7,249.92	\$ 5,000	45%
70	\$656.18	\$ 7,874.16	\$ 5,000	57%
75	\$737.99	\$ 8,855.88	\$ 5,000	77%
80	\$866.99	\$ 10,403.88	\$ 5,000	108%
85	\$1,059.89	\$ 12,718.68	\$ 5,000	154%

Immediate Variable Annuities.

With an immediate variable annuity, the policyholder selects between a number of investment options offered by the insurance company. The performance of the selected investments determines the future annuity payouts. Even though the retiree assumes the investment risk, the insurance company is still insuring the risk that the retiree will outlive the capital, so quality companies should be used.

Immediate variable annuities were developed to provide the potential for an increasing payout as an alternative to the level payout of immediate fixed annuities. Because the investor typically selects some stock funds as an investment option and because stocks historically have outperformed bonds over the long term, the total return of the underlying portfolio of immediate variable annuities should be higher than the return from an equivalent amount used to purchase immediate fixed annuities. However, immediate variable annuities also carry significantly more investment risk. If retirees want the underlying portfolio invested in bonds, they should probably use an immediate fixed annuity instead with its lower costs and lower risks.

Because of limits that insurance companies place on the initial choice of payouts, the early payout of immediate variable annuities is lower than that of immediate fixed annuities. Though not guaranteed, the payout of an immediate variable annuity is designed to grow over time. This is because the assumed investment return (AIR) that may be selected is conservative and, hopefully, below the actual return.

The requirement that the assumed investment return be conservative (lower than the expected return of the portfolio)—typically four to six percent—penalizes owners who die early and helps those who live longer. This causes immediate variable annuities to carry more mortality risk than immediate fixed annuities.² A retiree should generally use immediate fixed annuities before using immediate variable annuities.

Insurance companies tend to make immediate variable annuities relatively complex products with higher internal charges. Pricing comparisons between various providers and their myriad of contract options is more difficult than for immediate fixed annuities. One must read the prospectus and talk to insurance company representatives in order to understand all the details. This is another reason why I prefer to use immediate fixed annuities first to meet retirees' lifetime cash flow needs and keep the equity part of the portfolio elsewhere.

Immediate variable annuities provide the benefits of cash flow guaranteed for lifetime with the additional flexibility of the retiree's ability to continue to manage the underlying investments. Depending on how the investments perform, this may be good or bad.

For both immediate fixed and variable annuities, the retiree must decide among the many payout options offered by the insurance company—whether to buy an annuity for the life of a single individual, for that of the husband and wife or for one of the many other combinations. There is also the popular option of having lifetime payouts with a "time certain." For example, 10-year time certain

guarantees that payments will continue for 10 years even if there is premature death. The cost of this option at retirement is typically small because the probability of death within 10 years is low.

In summary, the primary benefit of immediate annuities is that retirees can increase cash flow by consuming capital with the assurance that they cannot outlive their capital. The primary disadvantage is the irreversibility of the decision once the purchase is made. Capital cannot be accessed and the income stream cannot be significantly altered once started. Capital is consumed leaving nothing for heirs, but this is the characteristic of an immediate annuity that makes it work.

Identifying Surplus Capital. Identifying surplus funds is a second strategy for consuming capital. Unlike an immediate annuity, which provides cash flow for the retiree's lifetime, this is capital the retiree plans to consume before he or she dies. It is critical that a sound lifetime cash flow management plan is in place that assures income to meet all expected and unexpected expenses first. Then any surplus above this can be safely consumed. The retirees can use the funds for travel, home improvements or gifts to family and charities. I call this the "Fun Account." Retirees can plan to use these dollars early in retirement while their health permits them to take advantage of them. Spending these dollars can provide a short-term increase in cash flow while other parts of retirees' plans assure they receive desirable lifetime income.

Summary

These are the tools that a planner can use to increase cash flow to retirees. The impact on their lives

can be dramatic. Using these tools, planners can help their clients retire on time even though their portfolios may have dropped during the recent bear market. In other situations, planners may be able to help clients generate higher cash flows from their portfolios than was thought possible and thus improve their standard of living.

Part II. Creating Investment Pools to Fund a Retirement Plan

Introduction

When retirees start taking large withdrawals from their portfolios, they should dramatically change their portfolio strategies. The strategy for making cash withdrawals becomes as important as their strategies for asset allocation and choosing the investments. Yet, little has been written about how to manage retirement cash flow or how to relate it to the investment process.

Addressing the issue of assured cash flow in retirement is particularly important because most employees are now approaching retirement without the benefit of company pensions. They are entirely dependent on Social Security and their own savings. They must take a much greater role in controlling their own financial well-being. This comes at a time when they face very uncertain financial markets and a longer life expectancy. The threat of outliving their resources is a major concern for many.

Blending many factors to form a coherent investment strategy is

complicated. Many retirees need professional assistance. There is no computer model that can determine an optimum solution. Ideally, all the parameters discussed below would be coordinated simultaneously. In practice, this cannot be done. I like to create a trial solution, test the results with my client, and then go back and adjust the various parameters until I come up with the combination that I feel will best serve their needs. This is the art of financial planning.

Creating Asset Pools and Determining the Client's Objectives

Creating a retirement strategy involves very complex financial analysis. Explaining the strategy to retirees so that they can understand it is equally challenging. Then there is the challenge of helping retirees formulate their objectives.

I have found that breaking a client's assets down into pools, each with its own purpose, and discussing these pools with the retiree is not only a useful way to develop a coherent retirement strategy, but also to help formulate the client's retirement objectives. I use four pools.

Pool 1 provides guaranteed income for life with the capital exhausted on death. Social Security, pensions and immediate annuities are in this pool. Retirees are not bothered by the fact that it is hard to quantify the asset base supporting the cash flow from this pool.

Pool 2 is a traditional investment portfolio, typically stocks and bonds, that provides income for life. Retirees do not intend to exhaust this capital and eventually, it will pass to heirs.

Pools 3 and 4 provide ways to increase cash flow from existing

capital. Pool 3 provides additional guaranteed lifetime income, typically by using immediate annuities purchased, using capital from Pool 2. The benefits are increased cash flow and lifetime guaranteed payment from an insurance company.

Pool 4, or the "Fun Account," is created after all other financial needs have been taken care of. Excess capital is moved to a Fun Account where it will be consumed during the retiree's lifetime. The funds can be used for additional expenses such as travel, home improvements or gifts to family or charities. Because they consume capital, both the third and fourth pools increase the retiree's cash flow considerably compared to a traditional portfolio (Pool 2).

The creation of a Fun Account is the retiree's reward for successfully accumulating assets over his or her lifetime and developing a comprehensive retirement plan. Retirees can use the Fun Account while they are able to enjoy it, and planned consumption reduces the size of their estates.

Using the four pools, I create a sample strategy to show retirees how their assets might be divided to serve different purposes. The strategy shows both the dollars invested in each pool and the resulting cash flow. I ignore the dollars invested in Pool 1, although it is interesting to talk about how much they have contributed to secure their Social Security, pensions and immediate annuities. Chart 4 illustrates a typical situation.

With Chart 4 in front of them, we discuss the many trade-offs that they need to make when selecting a retirement strategy. We are helping them develop their objec-

Chart 4
Sample Retirement Strategy Using Four Income Pools

		Asset Value	Annual Income
Pool 1	Social Security and Pensions		\$22,000
Pool 2	Traditional Portfolio	\$500,000	\$12,500
Pool 3	Additional Annuities	\$200,000	\$13,000
Pool 4	Fun Account	\$50,000	\$5,000
	Total	\$750,000	\$52,500

tives. The topics and questions we discuss include:

- the level of guaranteed monthly income they want;
- the importance of having a portfolio with low volatility if the portfolio is expected to generate high levels of income and the risk of exhausting principal if large withdrawals are made in a down market;
- the need to have some inflation protection;
- the pros and cons of locking capital up in an immediate annuity versus preserving flexibility;
- the need to maintain reserves for emergencies and for expenses later in life such as entering a retirement community;
- the need for long-term health care;
- the trade-off between consuming capital to generate extra cash flow now and the desire to leave assets to heirs; and
- the ability to safely spend surplus funds once a sound strategy is in place.

Throughout this discussion, I explain that we are increasing their ability to control their finances in retirement so they can do what they like with their money. Their response is very positive.

Having reviewed the initial allocation by pools with the client and having helped them develop their objectives, I then go back and adjust the amount allocated to

each pool to come up with what I think is the best allocation. All of the information in the next sections must be integrated into the analysis in determining the recommended retirement strategy.

Assigning Assets to the Pools and Scheduling Cash Flow

Retirees' various assets have to be assigned to the four pools in a way that will best meet their needs. The ability of the pools to create the desired cash flow is a major factor in this assignment. Assets vary by ownership and type. They include nonqualified and qualified funds, assets owned jointly or separately by a husband and wife, annuities and any trust assets.

It is logical to use taxable funds first before withdrawing funds from IRAs. This is because of the tax-deferred benefit of IRAs. Before 70 1/2, when retirees must begin making withdrawals, IRAs can continue to grow, while taxable portfolio assets can be drawn down to generate the desired income. Even at 70 1/2, IRA withdrawals can be kept to the modest required minimum distributions and taxable portfolios can be used to supplement the income

from IRAs thus maximizing the benefit of the tax-free environment of IRAs. However, there are many factors that make the assignment more complicated.

Pool 1 Assets. Pool 1 assets are predetermined. No investment decisions are involved. Retirees must determine when to begin to take Social Security and which pension payout option to select. The decision of whether to select a pension payout option such as single life, 50 percent joint and survivor or 100 percent joint and survivor, is related to how the rest of the retirement strategy evolves. My default choice is to use 100 percent joint and survivor to assure the surviving spouse has the same cash flow. Psychologically, retirees like a term certain. This

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assures that if both die prematurely, something is left for heirs. The cost of including a 10-year certain in a lifetime payout is low, as the odds of both dying in 10 years are small, so I usually recommend this.

Pool 2 Assets. Pool 2 assets are the retiree's traditional stock and bond portfolios, less the amount that will be diverted to Pools 3 and 4.

Generating cash flow from Pool 2 may be as simple as collecting dividends and interest (Option 1 above). There are several techniques for increasing the cash a

portfolio can generate without the risk of depleting the retiree's capital including (Options 5, 6 and 7):

- taking a constant percent of the portfolio and adjusting the dollar payment as the portfolio's value fluctuates;
- following the IRS Required Minimum Distribution; or
- developing a performance-based distribution strategy.

For a retiree with adequate income from Pools 1 and 3, Pool 2 may only need to generate modest cash distributions, with the goal that its assets will grow over time to protect against inflation or to be available for future use. Thus, dividends and interest may provide sufficient cash flow, and generating larger distributions may not be necessary.

Pool 3 Assets. Pool 3 assets provide higher levels of guaranteed lifetime income while exhausting capital. There are multiple issues to consider, including:

- how large to make the pool;
- whether to fund it with taxable or IRA assets; and
- whether to use immediate fixed or immediate variable annuities.

Buying immediate annuities is an irreversible act, so the decision is important. Staging purchases over time, perhaps purchasing some annuities at age 65 and some at age 70, is a way to ease into the decision. Insurance company payouts are larger when annuities are purchased by older clients, so waiting has economic benefits as well.

How much of a retiree's investment portfolio should be used to fund Pool 3 depends on how much additional increased guaranteed lifetime income the retiree wants. The answer is a trade-off against other uses of the

assets and how best to achieve the retiree's objectives. This may require extensive discussion with the client.

The increased income from an immediate annuity is significant. Table 3 compared the cash flow from an immediate fixed annuity with a government bond.

Deciding whether to use taxable or IRA funds to purchase immediate annuities can be challenging. Distributions from immediate annuities from IRA funds are fully taxable. Annuity distributions from taxable accounts are only partially taxable since part of the distribution is a tax-free return of capital. However, if portfolio assets must be sold in order to buy an immediate annuity, using taxable funds to purchase immediate annuities might trigger immediate capital gains. Leaving IRA funds for heirs, now a feasible option under the new lower Required Minimum Distribution Rules, permits the tax-free investing to continue, possibly for many decades. On the other hand, keeping taxable funds available gives retirees more flexibility, permits a step-up in basis on death and does not require heirs to take minimum distributions.

For many individuals, putting in place an immediate annuity may be achieved by annuitizing an existing deferred annuity (either fixed or variable). When the cash value is significantly below the cost basis (for example, if the market value of a variable annuity has decreased significantly since purchase or the cash is exchanged from a life insurance policy with a higher cost basis), this may be a sound way to generate tax-free income and recapture the taxable loss.

Psychological factors are also important in deciding how much of a retiree's portfolio assets should go into Pool 3. Locking in a plan is important to many retirees. We must also recognize that the ability of retirees to make decisions may diminish as they grow older, so sound retirement plans should be implemented before they lose any decision-making ability. Many retirees are more concerned about establishing a retirement plan than minimizing taxes. They are comfortable using qualified assets to annuitize even when they have taxable funds available. In most cases, the psychological benefits of locking in a major component of their retirement plan, even if it means using IRA funds before age 70 1/2, is more important than the tax savings from using taxable funds first.

Retirees must also decide whether to use immediate fixed or variable annuities. Once again, this is a cash flow issue. Immediate fixed annuities pay the same amount monthly for the life of the retiree. Their initial payouts are higher than those from an immediate variable annuity (given same amount invested). Immediate variable annuities have lower initial payouts, but the payouts are structured to grow over time (with no guarantee). Immediate variable annuities are complicated investment vehicles whose prospectus must be carefully studied. I tend to overweight the amount invested in immediate fixed annuities versus immediate variable annuities and to rely on outside assets, such as stocks, for growth. A retiree wishing to consume a high proportion of his assets in his lifetime, however, will need to invest a high propor-

tion of his assets in immediate annuities, both fixed and variable, and thus will rely on immediate variable annuities for growth of income.

Deciding which payout option to select for immediate annuities is similar to deciding the payout for a pension as discussed for Pool 1.

Pool 4 Assets—the Fun Account. With Pools 1, 2 and 3 structured to meet living expenses and other objectives, the retiree can identify excess income, which can be consumed well before death. Ideally, taxable funds should be used since the tax rate for accessing them is lower. The retiree controls the rate at which this Fun Account is spent. One option is to have a planned 10-year spend down with the expectation that one-tenth will be spent each year. This gives a 65-year-old retiree-enhanced income until age 75.

Chart 5 shows how the four pools can create projected cash flow over time.

There are other factors that may have to be considered when as-

signing assets to the pools. Husband and wife, particularly in a second marriage, may have different estate plan objectives, and the desire to deplete or protect one of the partner's assets must be considered. Availability of income from other sources such as trusts also makes a difference in the plan design. Retirees can more aggressively consume their own assets if they know they have trust assets to fall back on. However, care needs to be taken when only one partner has access to the trust to make sure the surviving partner has sufficient assets if the partner with the trust dies first.

Determining Asset Allocation by Pool and in Total

Each pool must have its own allocation selected to meet the retiree's objectives for that pool. Asset allocations should be based on reason and not just by following some arbitrary rule such as a formula related to the retiree's age.

Pool 2, the traditional portfolio, which provides income to retir-

ees for their entire lives with the remaining assets going to heirs, can have a weighting of 50 percent or more in stocks. If a pool is designed to meet long-term objectives and needs to produce little to no income, a heavy stock allocation may be appropriate. This must be tempered by the psychological risk tolerance of the investor so he or she does not bail out in bad markets and lose the benefits of long-term investing. When retirees understand the inherent volatility of stocks and need only low levels of distributions from the pool, the stock allocation can approach 100 percent. Portfolios heavily weighted to stocks have higher expected total returns but they are very volatile and can be destroyed when large cash withdrawals are made in bear markets.

If the portfolio must generate high levels of income, it should be heavily weighted to fixed income investments such as bonds. The primary reason to use fixed income investments is their low volatility, not their higher cash

Chart 5

		Balance Sheet						
		65	66	70	75	80	85	90
Pool 1	Social Security and Pensions	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Pool 2	Traditional Portfolio	\$500,000	\$527,500	\$653,480	\$854,072	\$1,116,238	\$1,458,879	\$1,906,696
Pool 3	Additional Annuities							
	Fixed	\$125,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
	Variable	\$ 75,000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Pool 4	Fun Account	\$ 50,000	\$ 45,000	\$ 25,000	\$ -	\$ -	\$ -	\$ -
	Total	\$750,000	\$572,500	\$678,480	\$854,072	\$1,116,238	\$1,458,879	\$1,906,696
		Cash Flow						
		65	66	70	75	80	85	90
Pool 1	Social Security and Pensions	\$ 22,000	\$ 22,880	\$ 26,766	\$ 32,565	\$ 39,621	\$ 48,205	\$ 58,648
Pool 2	Traditional Portfolio	\$ 12,500	\$ 13,188	\$ 16,337	\$ 21,352	\$ 27,906	\$ 36,472	\$ 47,667
Pool 3	Additional Annuities							
	Fixed	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
	Variable	\$ 3,000	\$ 3,165	\$ 3,921	\$ 5,124	\$ 6,697	\$ 8,753	\$ 11,440
Pool 4	Fun Account	\$ 5,000	\$ 5,000	\$ 5,000	\$ -	\$ -	\$ -	\$ -
	Total	\$ 52,500	\$ 54,233	\$ 62,024	\$ 69,042	\$ 84,224	\$103,430	\$127,756

yields as many think.

Pool 3 should be invested heavily in fixed income. An immediate fixed annuity is the ideal investment vehicle to provide guaranteed income with low risk. Immediate variable annuities, funded with stock portfolios, have both mortality risk and portfolio risk. They should be used only when a retiree wants growing income that an outside stock portfolio will not be able to provide. Thus, Pool 3 should have more invested in immediate fixed annuities and less in immediate variable annuities.

Pool 4, the Fun Account to be consumed over a limited number of years, should have an asset allocation of mostly fixed income. A laddered bond portfolio may make sense. Other options include short- or immediate-term bond funds.

The asset allocation of the individual pools is of primary importance. Overall asset allocation is of secondary importance, but it is worth checking to make sure it looks reasonable. I check it to make sure the overall asset allocation includes some stocks as a way to provide growing income over time. I also check to make sure a conservative invest-

or does not have too much in stocks. When examining the overall asset allocation, I recognize that pensions and immediate fixed annuities already purchased are really fixed income. I treat Social Security as fixed income also. If the asset allocation for each of the individual pools was selected to meet the retiree's objectives, it would be surprising to find that the overall asset allocation was out of kilter and needed adjustment.

Summary

Advisors can prepare a retirement plan that better meets their clients' needs by using the four pools. Each pool within the plan serves a specific function. The mission of some pools is to generate maximum income that is guaranteed for life with nothing left for heirs. Other pools have the mission of preserving or growing capital that can be accessed during the retiree's life with the remainder passed to heirs. After these pools are adequately funded, surplus funds can be identified and safely consumed as the retiree desires by creating a Fun Account.

The advisor determines which of the client's assets are best suited for each of the four pools. The

pools are then managed so as to best serve that pool's objectives. Typically, the need to generate income will determine the investment strategy for each pool.

For some retirees, the results of the plan will be as simple as increasing their monthly income with the assurance they will not exhaust their capital before they die. These retirees can use increased cash flow to meet critical expenses such as rent, food or medical bills. For others with significant assets, the implications are equally important but in a different way. These individuals will be able to safely increase spending while living and to reduce the amount controlled by estate plans. They will be able to use this additional cash flow to improve their standard of living, to travel or to enjoy gifting to relatives or charity. Retirement planning becomes more important while estate planning becomes less important. This represents a huge shift in attitude for both planners and retirees.

ENDNOTES

- ¹ Robert P. Kreitler, *Annuity Attitude Adjustment*, J. RETIREMENT PLANNING, Nov.–Dec. 2001, at 15.
- ² Robert P. Kreitler, *Immediate Variable Annuities Make Sense*, J. RETIREMENT PLANNING, Mar.–Apr. 2002, at 39.

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