Strategies for Turning Retirement Savings Into Retirement Income

How to move from accumulating assets to utilizing them

Retirement Income Planning is more than just understanding the rules around contributing to, and withdrawing from, savings plans. It's also about figuring out a strategic approach to turning those savings into a regular income stream. Strategies for doing this can range from the simplistic to the very complex, and can involve a variety of investment vehicles.

Systematic Withdrawal Plan

This approach requires identifying an amount to withdraw from the portfolio in the first year of retirement – either a specific dollar amount or a percentage of the beginning balance – and then adjusting that amount each year based on inflation or other factors. Numerous studies have been done to identify the optimal percentage of the portfolio to withdraw in the first year, and 4% is most often cited. However, varying that withdrawal percentage based on market conditions, etc. can potentially allow even larger amounts in most years.

- ***Investment Portfolio*** – In this case, the portfolio would be implemented with a variety of asset classes and investment types, managed with a total return focus.
- ***Advantages*** – This method is easy to understand and to implement. It allows the retiree to manage the investment portfolio however they wish without being locked into specific products or asset classes, and because of that it offers the greatest opportunity for growth. Retirees can more easily respond to changes in tax law by shifting from one investment type to another.
- ***Risks to this approach*** – Determining the right initial withdrawal amount is the biggest issue. Beginning with a large withdrawal amount may make it difficult for investment returns to support that withdrawal over time. In addition, market fluctuations could result in the retiree eventually running out of money. This could also be the case if they live longer than they had initially planned for.

Required Minimum Distributions

This approach is a more structured form of the Systematic Withdrawal Plan. It mimics what many retirees will face when they turn age 70½ and are required to begin taking withdrawals from their retirement accounts. Retirees would use the life expectancy tables provided by the IRS to determine the annual amount to withdraw from their total portfolio. Each year, the withdrawal percentage would increase, with the actual dollar amount withdrawn based on the value of the portfolio.

- ***Investment Portfolio*** – Like with a Systematic Withdrawal Plan, the portfolio would be managed with a focus on total return, using a variety of investment vehicles and asset classes.
- ***Advantages*** – The RMD method allows the retiree the flexibility to adjust withdrawals as needed, but it also provides some guidance around how much to withdraw by relying on specific life expectancy tables.

It also allows the retiree more control over the investment portfolio and the ability to manage the tax liability associated with the withdrawals.

- ***Risks to this approach*** – Even though the withdrawal percentage would be increasing each year, negative market performance could cause a decline in the dollar amount withdrawn. Higher inflation could reduce the purchasing the power of those withdrawals, as well.

Bond Ladder

A bond ladder approach involves investing the retiree's assets in a series of bonds that are scheduled to mature at different times in the future. For example, the retiree may invest in 10 different bonds, with one maturing each of the next 10 years, and the retiree will receive a fixed amount of income based on the interest paid on those bonds. As the bonds mature, the proceeds are reinvested in new bonds that will mature 10 years in the future. In this case, the retiree consistently has a portfolio of individual bonds that range in maturity from 1 year to 10 years, or whatever time frame they feel is appropriate at the outset of the plan.

- ***Investment Portfolio*** – The Financial Advisor will be responsible for managing the individual bonds in the portfolio. Initially, they will choose a series of bonds maturing at different time periods. In subsequent years, the advisor will look for bonds that mature at the back end of the initial time frame.
- ***Advantages*** – Because the interest payments on the bonds are known at the time of purchase, the retiree can expect a consistent amount of income, at least at the outset of the plan. The bonds themselves are liquid, so if the retiree needed to access the principle, they could usually sell an individual bond at any time.
- ***Risks to this approach*** – The biggest risk to this approach is reinvestment risk. If interest rates have fallen since the initial implementation of the strategy, the proceeds from the maturing bond will be reinvested in a bond paying a lower interest rate, resulting in decreasing income to the retiree. There is also the risk of purchasing a bond where the issuer is unable to meet their obligations and defaults on the bond, which may be enhanced due to the small number of issuers in this strategy. This risk can be managed by limiting investments to high quality issuers with insured products. Lastly, selling a bond prior to its maturity date can result is less proceeds than holding it to maturity and will result in loss of interest payments from the sold portion. You will also incur brokerage commissions when selling bonds.

The Bucket Approach

This method involves dividing retirement into several distinct time periods, or buckets, and implementing different investment strategies for each period. These time periods might be based on the timing of outside income sources, such as pensions or Social Security, or on retirement objectives such as traveling or volunteer work.

- ***Investment Portfolio*** – Because each time period will have a unique piece of the portfolio dedicated to it, the investments in each bucket will be different. The early buckets will contain more conservative investments, while the buckets for later time periods will be more growth-oriented. Over time, the later buckets will move to more conservative investments as you get closer to the time period they're meant to support.

- ***Advantages*** – Breaking the portfolio into different buckets forces you to budget more carefully, as each bucket is meant to last a specific amount of time. It also helps force the assets needed sooner to be invested in more conservative vehicles, thereby helping ensure they'll be available when needed.
- ***Risks to this approach*** – This method requires more up-front effort to identify the appropriate time periods. If the assets allocated to those time periods are depleted ahead of schedule, retirees may be forced to access longer-term investments earlier than planned. The retiree is bearing the risk that market performance or inflation will cause a change in their lifestyle over time.

Annuitization

With most income strategies there is a risk that the portfolio won't last long enough to meet the retiree's income goal. Annuitization strategies using products like Single Premium Immediate Annuities (SPIAs), allow retirees to set aside a pool of assets up front in exchange for a consistent, guaranteed income stream for life or a specified period of time (may be joint lifetime with their spouse).

- ***Investment Portfolio*** –The investments in SPIAs are directed by the annuity company themselves. Therefore, the internal rate of return of the income stream is based on the performance of the insurer's general account, which is typically comprised of fixed income investments.
- ***Advantages*** – SPIA's mitigate the risk of outliving your assets by providing you with a stream of income of your choosing, including lifetime, regardless of how long you live. Some even include inflation adjustment options (require additional premium) to limit inflationary impacts on your income. Finally, when purchased with non-qualified money, only the earnings portion of each payment is taxable creating a tax-efficient income stream.
- ***Risks to this approach*** – While the payments are referred to as guaranteed, they are always subject to the claims-paying ability of the insurer. Finding strong, well financed carriers can help mitigate this risk. The income stream may be fixed for the life of the retiree, resulting in reduced purchasing power of the income stream over time via inflation. Also, retirees sacrifice control of the lump-sum payment to the insurance company, creating a level of liquidity risk and minimal, if any, wealth transfer at death.

Guaranteed Lifetime Withdrawal Benefit products

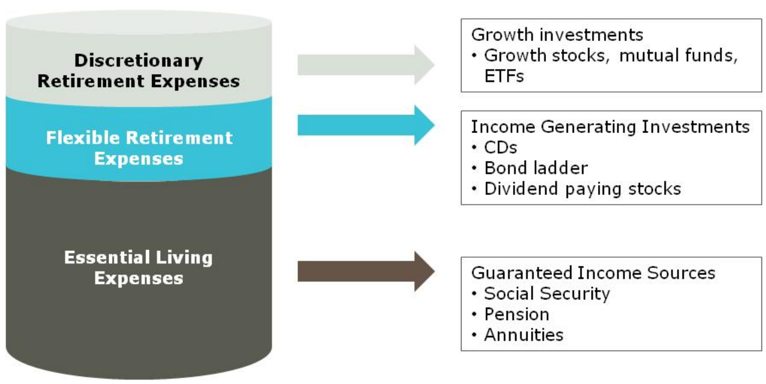
Tax-deferred variable annuities offering Guaranteed Lifetime Withdrawal Benefits, or GLWBs, combine the guaranteed income of the Annuitization strategy with the ability to manage the underlying asset for long-term growth found in the Systematic Withdrawal Plan strategy. These types of variable annuities allow the retiree to begin taking payments from the annuity contract based on a percentage of the annuity value, and the withdrawals are guaranteed to continue for the life of the retiree. The real advantage of these products is that if the value of the annuity increases due to positive investment performance, the payments to the retiree will increase along with them. If the account subsequently drops in value, the payments to the retiree are locked in to their higher amount. These products mitigate much of the market risk found in other strategies, while still allowing the retiree to potentially receive increasing levels of income.

- ***Investment Portfolio*** – Because this is an annuity product, the Financial Advisor is limited to the investments offered within the annuity. The available options typically consist of a wide variety of subaccount offerings that have the potential to provide a combination of growth and stability.
- ***Advantages*** – Annuities with GLWB's offer retirees a potential solution to market volatility by helping them stay invested in the markets while guaranteeing a baseline level of income in retirement. This income stream will last for the rest of the retiree's life (or joint life if added as a spousal benefit), without requiring them to relinquish control of the asset.
- ***Risks to this approach*** – Like the Annuitization strategy, the guarantees are subject to the claims-paying ability of the insurer. GLWB's are optional riders that carry separate fees and may impose penalties if a retiree takes more than their guaranteed amount. Furthermore, deferred annuities include fees and charges and contain an element of liquidity risk by assessing surrender penalties if the entire amount is liquidated prior to the end of the specified term of the contract. Spousal benefits will result in lower guaranteed payments.

The Balanced Approach

There is no guarantee that any of these strategies will be successful, and because each of them has significant advantages and disadvantages, a combination of different strategies may be most appropriate. Matching the different strategies with different retirement goals will allow the retiree to find the right combination of control, flexibility and guarantees for their situation.

For example, the retiree might begin by dividing their retirement goals into categories such as Essential, Flexible and Discretionary:



- ***Essential Living Expenses*** – These expenses are the day-to-day living expenses that you need to meet on a consistent basis. Included in this category would be things like insurance premiums, property taxes, utilities, groceries and gas, as well as debt payments. These expenses would be paid for using guaranteed income sources, such as Social Security, pension or annuity payments or guaranteed withdrawal benefits on deferred annuity contracts.
- ***Flexible Retirement Expenses*** – This category includes the things that add extra variety and pleasure to retirement, but where the budget can be adjusted over time. This would be dining out, gifting, hobbies and other activities. Investments for these expenses would include those that provide regular

income payments that may still fluctuate over time, such as interest received from a bond ladder, dividend-paying stocks or master limited partnerships.

- ***Discretionary Retirement Expenses*** – Lastly, these are the larger expenses that are the bigger goals during retirement, such as large vacations, significant gifting to family or charity, home remodeling, or even a second home. These are expenses where funds may not be available today, so a longer-term investment strategy may be required, using more growth-oriented options such as stocks, mutual funds or ETFs.

Conclusion

Retirement income planning ultimately comes down to making the best use of the resources available to address the retiree's lifestyle goals. Once retirement begins, accumulating additional retirement assets becomes difficult. Therefore, it is imperative to set and manage a plan that utilizes existing assets – through proper management of investments and careful and honest budgeting – to help provide retirees the best chance at an enjoyable, successful and fulfilling retirement.

Annuities are investment vehicles designed for long-term planning. Variable annuities are subject to risk, including the loss of principal. All guarantees are based on the claims-paying ability of the insurance company. Withdrawals of taxable amounts are subject to income tax, and if taken prior to age 59 ½, a 10% federal tax penalty may apply. Neither Robert W. Baird & Co. Incorporated nor its Financial Advisors offer legal or tax advice.

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