Money

An Income Plan That's Built to Last

Once you've constructed that golden nest egg, you're not quite ready to retire. You still have to turn it into an income that will support you in style for decades to come.

By Walter Updegrave
September 19, 2006 8:54 AM EDT

(MONEY Magazine) – You saved diligently throughout your career, plowing as much as you could into your 401(k) and other retirement accounts. Now you're looking forward to kicking back and relaxing, secure in the knowledge that your nice plump portfolio will carry you comfortably through retirement.

But are you really set for life? Or do you suffer from what Olivia Mitchell, University of Pennsylvania insurance professor and executive director of the Pension Research Council, calls the lump-sum illusion? "People see that they have a hundred thousand dollars in their 401(k) and say, 'I'm rich,'" says Mitchell. But what you may be ignoring is that your savings, whether it's $100,000 or $2 million, will have to support you for 20, 25, even 30 or more years.

Therein lies what may be the biggest challenge of retirement planning: How do you take the money you've amassed in your 401(k)s, IRAs and other accounts and turn it into a reliable income to support a post work life that could last almost as long as your career did?

In many ways, managing your assets so that you don't run out of money is trickier than saving it in the first place. One reason is that you have less wiggle room. During your career, you have plenty of time to bounce back from stock market slumps and poor investment choices. After you've retired, the clock is no longer on your side. Plus, you can't pump up your sagging retirement accounts simply by shifting more cash from your paycheck into savings.

Fortunately, though, creating a steady income that, along with Social Security and a pension, will fund a long retirement is well within your power. What it takes is a strategy based on realistic assumptions and frequent monitoring along the way. Essentially, you have three choices. You can manage your retirement portfolio entirely on your own, investing it as you see fit and drawing income as needed. Or you can put it all into an immediate annuity, which will give you a guaranteed monthly income for the rest of your life. But both of those strategies have flaws. So your best move may be to mix the two in a way that gives you security and flexibility. Here's what the first two approaches get right--and wrong--and how to create a winning combination.

THE DO-IT-YOURSELF APPROACH

You may like the idea of handling your own money because it gives you the most control. In any given year, you simply take from your investments whatever income you need. That could mean cashing a dividend check, collecting interest or selling shares of stocks or mutual funds. And if your spending spikes for some reason--perhaps you decide to take a little cruise or the roof on the old homestead needs replacing--you just dip into your assets to cover your rising expenses. Managing your assets also gives you a chance to minimize your taxes. If you're facing losses on some of your stocks or funds, you can unload those shares and use those losses to effectively erase taxable gains in other parts of your portfolio.

Problem is, it's easier to run out of cash this way than you think. You're probably going to be pulling money from your portfolio for a long, long time. A 65-year-old man today has about a 50% chance of living to age 85 and a 25% chance of making it to 91. You may have to count on your savings to support you into your early to mid-nineties or even longer.

During all this time, of course, prices will likely be rising. So you'll also have to increase your withdrawals to maintain your standard of living. Let's say, for example, that you call it a career at 65 and withdraw $40,000 from your portfolio in year one. Even if inflation moseys along at a 2.5% annual pace--lower than its average for the past 20 years--you'd have to increase your withdrawal to more than $50,000 by age 75 and to more than $65,000 by 85 just to keep your spending constant in 2006 dollars. Those mounting withdrawals year after year can put a real strain on your portfolio's staying power.

Faced with today's long life spans and tomorrow's inflation, you've got to keep a tight rein on your withdrawals to prevent your portfolio from running dry while you're still alive. This is why most experts recommend that if you want to be reasonably sure your money will last 30 years, start by taking out no more than 4% to 5% of your savings, and then increase that amount annually by the inflation rate. So, for example, if you retire with $1 million and inflation is running at 3% a year, you could pull $40,000 from savings your first year and then increase that amount to $41,200 the second year, roughly $42,400 the third year, and so on.

Taking out 4% to 5% may seem downright stingy. After all, since stocks delivered annualized gains of nearly 20% in the 1990s, you might figure you could easily pull 10% or so from your savings annually without any fear. But don't try it. For one thing, history suggests that the financial markets will deliver much more moderate gains in the years ahead, perhaps 8% to 10% for stocks and 5% to 6% for bonds. And even if the markets do well, there's another risk, namely that your portfolio could be whacked by a bear market early in retirement. When that happens--as it did to people who retired as the dotcom bubble was bursting in 2000--your steep market losses, combined with annual withdrawals, can so devastate your portfolio that it's extremely difficult to rejuvenate it even when the market recovers.

BUYING A LIFELONG PROMISE

Perhaps calculating withdrawal rates and contending with the uncertainties of the financial markets is the last thing you want to do once you retire. You don't have to. There's a simple way to guarantee a steady income that you won't outlive: Buy an annuity, specifically an "immediate" annuity, also sometimes called an income or payout annuity.

In a process that goes by the ungodly name of "annuitization," you turn over a lump sum of money to an insurer and in return get monthly checks for the rest of your life. The size of those checks depends, for the most part, on your life expectancy, the level of interest rates when you buy the annuity and what payment option you select (for your choices, see the box below).

Aside from the peace of mind that comes from knowing you won't outlive your assets, an annuity has another plus--namely, payments are larger than you could pay yourself from your investments even if you earned the same rate of return. Insurers sell annuities to thousands of people, some of whom will die earlier than others. Annuity payments reflect the fact that insurers are effectively transferring money from people who die early to those who live beyond life expectancy. So the longer you live, the better a deal an annuity is.

But just as managing your own money can be perilous, this assured lifetime payment, this "longevity insurance" of sorts, has some serious drawbacks. For one thing, you give up flexibility. Once you turn over cash to an insurer, the money is gone. Clearly, that can be a problem if, say, you need cash to meet an unanticipated expense, such as an emergency medical bill. (Some annuities let you tap into your assets after you begin receiving income, but their monthly payments are lower and the access is usually very limited.)

Another problem: The annuity's fixed payment leaves you vulnerable to inflation. If you start retirement with a flat monthly check and inflation averages 2.5% a year, the purchasing power of that check would decline by more than 20% by the time you're 75 and nearly 40% by 85. A few insurers have begun offering income annuities that adjust their payments with the consumer price index, but in return your initial payment may be 25% to 30% or so lower. At a 2.5% inflation rate, it can take upwards of 16 years for the payments to catch up to what you would have been collecting all along with a fixed payment.

THE BEST OF BOTH WORLDS

<u>Fortunately, you don't have to choose between doing it yourself and putting your whole retirement in an insurer's hands. You can reap the advantages of both options--the flexibility of managing your withdrawals and the peace of mind of a steady check--by combining the two approaches.</u>

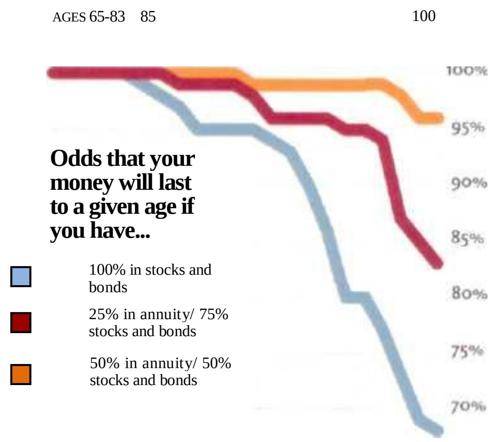
<u>The concept is simple. Put part of your retirement savings in an income annuity and then invest the rest in a diversified portfolio of stock and bond funds (or individual stocks and bonds, for that matter). The annuity payments give you a steady month-to-month income that won't run out. The investment portfolio provides whatever additional income you need and a kitty for unanticipated expenses, plus the long-term growth that can help you keep up with inflation.</u>

This combination has another advantage: It can improve the odds that you'll be able to live off your money for 30 or more years. To get a sense of how much the annuity can help, take a look at the graph on page 108. It compares how a <u>65-year-old man who wants to draw 4%</u> from his portfolio in year one, increasing that amount each year for inflation, would fare by managing withdrawals on his own vs. putting some of his money in an annuity. Until age 85, the manage-it-yourself method works just fine. But the older he gets, the greater the chance that his portfolio won't make it (although in real life, of course, he would probably scale back his lifestyle and cut back on withdrawals).

By contrast, if he stashes 25% of his retirement assets in an immediate annuity, his odds of falling short drop to just 5% at age 95. The reason: The annuity payments, by reducing the amount you have to pull from your savings, limit the damage to your investment portfolio during market downturns. What's more, even if your assets were to run dry, the annuity checks would keep rolling in. That's not to say this combination approach is free of the problems that plague the other methods--you still lose access to a chunk of your money, for instance. But if your goal is to assure that you'll have income you can count on, it's a good way to go.

HOW ANNUITIES CAN HELP

You are much less likely to run out of money if you split your savings between an immediate annuity and stocks and bonds. **Consider how a 65-year-old who** spends 4% of his **funds a year** would **fare using** three **different strategies.**



NOTES: Withdrawals are adjusted annually for inflation. Assumes long-term annualized returns of 9.7% for stocks and 4.5% for bonds, 3% inflation and 0.75% in annual expenses; annuity is for lifetime income as of August 2006. **SOURCE:** Ibbotson Associates.

HOW TO BUILD YOUR INCOME PLAN

Once you have the blueprint for your retirement income plan--putting, say, 25% to 50% of your money in an immediate annuity and leaving the rest in a diversified stock and bond portfolio--you have to come to grips with some practical issues.

First you'll have to settle on how much you're devoting to an annuity--the exact amount depends on how much guaranteed income you want beyond Social Security and a pension. After you do, buying one is fairly simple. Aside from the different payment options, immediate annuities all work pretty much the same way. (You could buy a variable immediate annuity, but stick with fixed. Payments on a variable one can rise over time, but you're already getting growth potential from the rest of your portfolio.)

• HOW TO INVEST THE REST As you enter retirement, you need to strike a balance with the portion of your money that's not in an annuity. You want to invest aggressively enough to generate long-term growth, yet not so aggressively that your money could be decimated by a stock market meltdown. To achieve that, you'll probably want to start with anywhere from 50% to 60% of your assets in stocks and gradually scale back until you're down to 20% to 30% in equities by age 85 or so.

• PLAN YOUR INCOME STREAM Living off your investments isn't as simple as selling a stock every time a bill comes due. You need a cash-flow strategy. When you rebalance your portfolio once a year, estimate how much spending money you'll need over the next 12 to 18 months at the same time. Set aside that amount in a money-market fund that you can tap throughout the year. So if a run-up in the price of large-company growth stocks has made them too great a percentage of your portfolio, sell off some shares and plow the proceeds into your reserve account. You'll get both the income you need and the portfolio mix you want.

• BE TAX SMART Another consideration is which accounts you tap and in what order. The general rule is to leave tax-deferred accounts such as 401(k) plans and IRAs alone as long as possible to take advantage of tax-free compounding. That means you should dip into taxable brokerage and fund accounts first, spending dividend and interest payments before selling shares of stocks and funds, because you'll owe tax on that money even if you reinvest it. Next up: 401(k)s and traditional IRAs and, finally, any money you have in a tax-free Roth. An exception to this pecking order: Once you reach 70½, you'll first want to take required minimum draws from 401(k)s and IRAs. Otherwise you could be hit with hefty IRS penalties.

The main point: However you do it, it's crucial that you enter retirement with some sort of plan for estimating how much income you'll need from your savings and how you intend to get it. After all, while building a big lump sum may make you feel rich, living securely on that money is what proves you really are.