Money

Income for life: Slicing up your savings

How to turn your 401(k) into a monthly income that supports you through retirement.

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NEW YORK (Money) -- **Question:** How do I convert the balance in my 401(k) into a monthly income when I retire? - Jim, Midlothian, Virginia

Answer: You're dealing with an issue that more and more people, especially aging baby boomers, must face as they enter retirement without the benefit of a traditional "check a month" pension from their employers. Yes, Social Security does provide a reliable monthly income - in fact, one that rises with inflation - but it's not enough for most people.

So the question is, how do you take what is essentially a lump sum of cash sitting in your 401(k) - or, in your IRA rollover account, if you move your 401(k) to an IRA after retirement - and convert it into an income that in combination with Social Security can support you throughout a retirement that could easily last 30 years or longer?

You've got several options. One is to simply invest the money in a diversified portfolio of stocks and bonds and then pull out enough so that your withdrawals plus Social Security will provide enough to live on.

That sounds simple enough, but there are a number of practical issues you'll have to sort out in order to pull it off. The main one is how much can you afford to draw from your account without running through your money while you're still alive. After all, a 65-year-old man today has about a 50/50 shot at living to 85 and a one-in-four chance of still being around at 91.

And unless Federal Reserve Chairman Ben Bernanke and the rest of the gang at the Fed find a way to stop inflation, during that time prices are likely to keep rising. Which means you'll have to increase the amount you pull from your portfolio each year if you want to maintain your purchasing power.

A variety of studies show that if you limit your initial withdrawal to 4 percent to 5 percent of your account balance, and then increase that amount for inflation each year, you stand a pretty decent chance of your money lasting 30 or more years. So, for example, if you've got $1 million in your 401(k), you would withdraw $40,000 to $50,000 the first year. If inflation cruises along at, say, 3 percent a year, you would then withdraw $41,200 to $51,500 the second year, and increase that amount by 3 percent the next year, etc.

A big advantage of this strategy is that you've got control of your nest egg and you can dip into your stash for more money if you need it. But there's also a downside. If you run into a bear market that triggers big losses in your portfolio, you could run out of money while you've still got many years to live.

Another way to go is to put your money into what's known as an immediate annuity - a.k.a. an income or payout annuity. In that case, you would turn over your 401(k) balance to an insurer that would promise you monthly checks for life (or, as long as either you or your spouse is alive, if you choose the joint-and-survivor payment option). Today, for example, a 65-year-old man buying a $250,000 immediate annuity would receive lifetime fixed payments of roughly $1,700 a month.

The plusses to this approach are that you know in advance how much income you're going to receive each month and you know it will keep flowing in as long as you're alive. But there are disadvantages too. Your monthly income won't keep pace with inflation, so your purchasing power will decline as you age.

Another drawback is that when you buy a lifetime annuity you generally give up control of your principal, which means you can't dip into it to pay unanticipated expenses. I recommend a strategy that I believe gives you the best of both of these options: the liquidity and growth potential of managing your own money and the security of a guaranteed monthly payment.

Here's how the strategy works: You put a portion of your 401(k) balance into an immediate annuity and then invest the rest in a diversified portfolio of stocks and bonds (or, more likely, stock funds and bond funds). The annuity gives you payments that won't run out and that, combined with Social Security, can fund much of your day-to-day needs.

The money you invest can provide any extra money you need as well as a stash for emergencies. And because that money is invested in stocks and bonds it should provide enough growth over the long term to help maintain your purchasing power in the face of inflation.

All in all, I think this is a pretty good way to convert a lump sum in a 401(k) - or any other account, for that matter - into a sustainable income that can support you throughout retirement. I've given you the basic outline of the strategy here.

One final note: This is a very important decision. So before you take any big step - like actually buying an immediate annuity - I think it's a good idea for you to run the numbers on a few different scenarios (different amounts in an annuity, varying mixes of stocks and bonds, higher and lower withdrawal rates). This will give you a better sense of how you might want to pull off this strategy and how long your money might last under different scenarios. If you're not comfortable doing this sort of number-crunching, then it's probably a good idea to have a financial planner run some scenarios for you. After all, retirement can be a long trip these days. And you want your money to be there for the entire ride.