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## How Not to Run out of Money

### Smart Ways to Tap Your Nest Egg

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While you're working, "retirement planning" includes building up as big an investment portfolio as you can. But planning takes a different turn after retirement or after you stop working full-time.

**Needed:** A blueprint for how much of your investments to tap each year.

### ENOUGH BUT NOT TOO MUCH

Long-term, stocks have returned about 10.4% a year, including dividends, on average, while long-term government bonds have returned around 5.5%. A blended portfolio might earn around 7% to 8% over the course of your retirement.

**Trap:** If you withdraw, say, 7% of your investment portfolio each year, your withdrawals in *dollars* will move up and down -- perhaps sharply -- with market movements. Given human nature, you probably won't cut back on retirement spending in years when the market is down.

**Example:** A hypothetical Alan Smith retired in 1998 with a \$1 million investment portfolio. He withdrew \$70,000 (7%) in 1999.

In 2000, 2001 and 2002, the bear market in stocks reduced his portfolio each year. Nevertheless, Alan was newly retired and very much wanted to travel, so he kept withdrawing \$70,000 per year. Upon withdrawing \$210,000 over three years and suffering \$200,000 in market losses, Alan would have seen his portfolio fall below \$600,000 -- a 40% drop -- and only three years into retirement! If he continued to withdraw \$70,000 per year (which would have represented almost 12% of his portfolio by Year Four), he probably would deplete his investments during his lifetime.

**Better:** Start your retirement with a more modest withdrawal percentage, then increase the amount withdrawn each year to keep up

with inflation.

**Key:** Decide on a wise withdrawal percentage in Year One. Assuming your portfolio is invested 60/40 between stocks and bonds, a 4% initial withdrawal gives you a very good chance of never running out of money.

**Example:** In Year One of his retirement, Alan Smith might withdraw \$40,000 -- 4% of his \$1 million nest egg. If inflation is 3%, he could withdraw \$41,200 in Year Two to preserve his spending power. And so on.

**Result:** Assuming an average return of 7% per year, an initial withdrawal of 4% and annual inflation adjustments of 3%, a portfolio would likely last for 35 years -- a comfortable cushion in case the market or inflation worsens.

**Tactic:** If you are willing to take more risk of running out of money (or if you have other assets such as real estate that you can tap), you might increase your first-year withdrawal to 5%. The same 5% initial withdrawal might be prudent if you are retiring after age 70, so you expect to have fewer years of living off your portfolio. Substituting a 5% withdrawal rate in the scenario above, a portfolio would probably be safe for 20 years.

## PICKING THE RIGHT POCKET

Saying that you should take \$40,000 from a \$1 million portfolio is one thing. But most people will have money in taxable as well as tax-deferred accounts.

**Strategy:** Generally it's best to tap your taxable accounts first. That will allow more time for tax deferral in your IRA and other tax-deferred plans.

There's another reason to keep your money in your IRA, at least until you're age 59½. Before that age, withdrawals usually are subject to a 10% penalty as well as regular income tax.

**Exception:** It might pay to take money from your IRA after age 59½ but before you have exhausted your taxable accounts to take advantage of low tax rates.

**Example:** Bob and Carol Jones, both age 60, expect their taxable income this year to be around \$50,000. They can take about \$11,000 from their IRAs this year and owe only 15% to the IRS.

Taking out money at 15% now may turn out to be a good deal. Required distributions or changes in tax law might cause future IRA withdrawals to be taxed more highly.

If you don't need the spending money, you might want to move some money from a traditional IRA to a Roth IRA, if you qualify, while paying tax at a 15% rate. After five years, Roth IRA withdrawals will be tax free.

### KEEP THE CASH FLOWING

Now you must determine what part of your portfolio the money will come from.

**Strategy:** Before you retire, aim to accumulate at least one year's worth of portfolio withdrawals in cash reserves.

Alan Smith, in the example, kept \$40,000 in a money market fund.

**Advantage:** This money can be used for spending so you won't be forced to sell other stocks when their values are down, or bonds in which you have no appreciation.

As you spend down your cash reserve each year, you'll need a plan for replenishing it. *Possible tactics...*

- **Rely on investment income.** Interest, dividends and mutual fund distributions might go into your cash reserve. This will enable you to keep your investment principal intact.

- **Start with your bonds.** Your investment income might not be enough to fully refill your cash account. Say that you expect the annual shortfall to be \$25,000. You might sell \$25,000 worth of bonds and/or bond fund shares each year and use the proceeds to restore your cash account.

**Advantage:** Bonds and bond funds are not as volatile as stocks. Chances are, each year you'll be able to find \$25,000 worth of bonds or bond fund shares in your portfolio that are trading near what you paid.

**Tactic 1:** Sell the bonds or shares that will generate the smallest loss of principal or the smallest taxable gain to minimize your tax bill.

**Tactic 2:** If you hold individual bonds, invest in issues that will mature periodically, as you go through retirement, say, in 2007, 2008, 2009,

etc. The redemption proceeds can go into your cash reserve.

- **Stick with your stocks.** By using your bonds to replace your cash, you extend the time you hold on to your stocks and stock funds. Historically, stocks held for the long term have outperformed bonds or cash.

Therefore, a hold-onto-stocks strategy is likely to boost your investment returns during a lengthy retirement.

**Caution:** By selling bonds while holding stocks, your portfolio eventually will tilt more toward stocks. As your time horizon shrinks, you may not want a stock-heavy portfolio.

**Reason:** Just as stocks have performed the best over the long term, they also have generated the sharpest short-term losses. You might not want to bear such risk as you grow older.

**Strategy:** Review your portfolio each year to see if you are comfortable with your current allocation. If you would like less risk, sell some of your stocks or shares of stock funds.

Those proceeds can be reinvested in bonds, if interest rates are appealing, or cash, if you need liquidity.

- **Set up a credit line.** Before going into retirement, make sure you have a home-equity line of credit. You can tap it for unexpected cash needs without being forced to liquidate assets when markets are down. Then, pay off the debt when a bond matures or you rebalance your portfolio.

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