Common Questions About Investing In Retirement

Q.

I see lots of posts about how to get to early retirement and financial independence, but have you considered writing a post specifically for optimal draw-down strategies once you are in retirement. Specifically, would you address the following subjects?

A.

I actually get this complaint fairly often. While I have certainly written on many of these subjects in the past, there are three reasons I don’t spend a lot of time on the subject. The first is that I have little personal experience with it. The most valuable writing is when I can share my own experience. The second is that the vast majority of my readers aren’t in retirement. In fact, only about 1/3 of readers are attending physicians. (1/3 are residents, 1/6 are med studs, and 1/6 are dentists, veterinarians, lawyers etc.) Finally, the truth is if you can get the early stuff right, the retirement issues are relatively minor. Those who really need
to be sweating the retirement issues are those who didn’t do a great job in their early career. That said, this reader asked 7 specific questions, all of which are very common and worth addressing, so let’s do that.

How do I go on so many trips while working as a doc and running WCI? Personal Hotspot. There are very few places left in North America without cell coverage. This was a campground in Banff.

Q.

Is 25x yearly income enough or is 40x better?

A.

This question has an issue. The issue is the word income. To retire successfully there is no important ratio between the size of your nest egg and your pre-retirement income. However, there is an important ratio between the size of your nest egg and the size of the portfolio withdrawals you need to cover your expenses. For example, if you plan to spend $100K a year in retirement, and Social Security will provide $30K, and you have a pension or a Single Premium Immediate Annuity (SPIA)
that covers another $30K, then you only need the portfolio to cover the last $40K. At “25X,” or a 4% withdrawal rate that’s a $1 Million nest egg. At “40X,” or a 2.5% withdrawal rate that’s a $1.6 Million portfolio. Obviously, having $1.6 Million and only needing $40K a year is better than having $1 Million and still needing $40K a year from it.

Unfortunately, predicting what is the ideal withdrawal rate for any given individual is dependent on many factors, including their asset allocation, their fees, their taxes, future performance of their investments, and especially how long they will live. Since most of the variables are unknown and unknowable, there are two methods you can take to try to guess an answer.

The first method is to look at the past and see what worked in the past. This resulted in the Trinity Study which gave us the 4% rule. However, one thing many people forget is that if you used a 4% withdrawal rate in the past, not only did you not run out of money something like 95% of the time, but most of the time you died with 2-3 times as much money as you started retirement with. So if you get hyper-conservative and use a 2.5% withdrawal rate, the most likely thing is you won’t spend anywhere near as much as you could have. No big deal if you’re already buying everything that could possibly make you any happier, but if you skimped on something to keep your spending that low, that’s kind of a tragedy.
The second method is to use current valuations to predict future returns and then use that data to calculate some kind of a safe withdrawal rate. Wade Pfau prefers this method and ends up with some really, really low recommended withdrawal rates (like 2.5%). While I think there’s a very good chance that future returns, especially in the next decade, will be lower than past returns, even that isn’t guaranteed. Before signing onto a plan like that you should consider that, ignoring inflation, if you just stuffed all your money under the mattress you could take out precisely 3.33% per year to spend and guarantee your money will last 30 years. So when you start getting very far below that number, I think you’re probably being overly conservative. I mean, you can easily buy a TIPS for each year of retirement at 0% or better and ensure you keep up with inflation.

If you are so worried about running out of money that you’re using a 2.5% withdrawal rate, you are a great candidate for annuitizing more of your nest egg. But most retirees use what I like to call the Taylor Larimore method of retirement spending. He says he basically looks at what he has each year, looks at how it did over the last year, and then decides how much to spend. It’s not like most of our spending is fixed anyway. So I think the wisest thing to do is to annuitize a little such that most or all of your fixed expenses can be covered by guaranteed income and then adjust as you go rather than adhere to some slavish withdrawal rule. Next question.
Q.

For a physician who has a Roth, a 403/401k, 457, Taxable Brokerage account what is the optimal withdraw strategy, which comes first?

A.

This question is a little easier than the last but can still get a little bit complicated. Here is a general list:

1) Required Minimum Distributions from Tax-deferred Accounts

If you don’t take out your RMDs, you have to pay a monstrous tax on what you should have taken out. So if you’re 70+, that’s your first priority.

2) Taxable account dividends, capital gains distributions, rental income

This one is also a no-brainer. The money is coming out and is going to get taxed. You might as well spend it. While we’re discussing taxable account no brainers, tax loss harvesting is also a no brainer. Be sure to rebalance your account, of course, by buying that same asset class either in taxable or one of your tax-protected accounts, but there is no reason to hold on to a taxable asset with a loss if you can exchange it for a very similar asset with little expense and claim the loss on your taxes.

3) Guaranteed payments

Now, if you are receiving Social Security, or pension payments, or have purchased a SPIA, this is your next source of revenue. They’re already coming to you and you’re already going to be paying tax on them, so you might as well spend it next.
4) 457 money

A 457 is different from other tax-deferred accounts in one major way- it is really deferred compensation from your employer that technically still belongs to your employer. So this should be an account that is tapped and depleted relatively early in retirement lest your employer go bankrupt and take your 457 with it.

5) Taxable assets with high basis

At this point, your main goal is to prolong the tax-protected growth aspect of retirement accounts as long as possible, without doing anything stupid in your taxable accounts. And by stupid, I mean paying taxes you could otherwise not only defer, but avoid completely. But if you have taxable assets that don’t have much of a capital gain (with an associated capital gains tax) this is the best asset to tap next. Even better if there is a capital loss.

6, 7, 8) Taxable assets with low basis, additional tax-deferred withdrawals, and tax-free withdrawals

This is where things start to get a little murkier. The general rule is to spend taxable assets before tax-protected (and asset-protected) assets, but not to do so stupidly. For example, if Grandpa is on his deathbed with terminal cancer and has lots of low basis taxable investments, don’t cash those out. Take money from the tax-deferred account instead. When he passes, the heirs will get a step-up in basis to the value on the day he died. Likewise, if you flush low basis taxable investments out of your account using charitable contributions, don’t sell those investments, donate them.

Additional tax-deferred withdrawals are fully taxed at your marginal tax rate, but you do get to fill up the low brackets first. So if you spend a 6 figure amount in retirement each
year, and you only fill up the 0% (remember deductions and exemptions) and 10% brackets with guaranteed income, investment income, and RMDs, then using tax-deferred withdrawals to fill up the 15% and 25% bracket can be very smart. If you want more money above and beyond one of those lines, that’s a good place to use your tax-free withdrawals such as from a Roth IRA. Combining your tax-deferred and tax-free accounts in this manner allows YOU to set your marginal and effective tax rate in retirement.

However, estate planning considerations also come into play. For instance, if you plan to leave a large chunk of your portfolio to charity, then spend tax-free money in preference to tax-deferred money since it all goes to the charity tax-free. But if you plan to leave most of your money to your kids, then spend tax-deferred money in preference to tax-free money, since Roth IRAs don’t have RMDs and your kids would much prefer to inherit something that won’t generate tax as they stretch it over decades. Of course, if your kids are in a much lower bracket than you, you might want to spend the tax-free money and leave them the tax-deferred money. Like I said, it’s complicated at this point.

9) **Life insurance cash value**

If you got [suckered into buying cash value life insurance](#) as a retirement account and then [decided to keep it](#) since you had already paid the huge commissions, you’ll need to figure out how you want to use it. “Withdrawals” from this account have their own rules. The first money you take out is tax-free and interest-free, since it is technically a partial surrender. So you can use that just like a Roth IRA. However, beyond that it is a loan with the policy as collateral. So, like any other loan, it is tax-free but not interest free. I would put that way down here near the bottom of the list. Life insurance is a great asset to leave behind to your heirs as it is very liquid and passes income tax-free. So only spend it if you get desperate.
Reverse mortgages

While we’re down here at the desperate end of the list, we should probably mention a reverse mortgage. Wade Pfau makes a pretty good academic argument for these, but the issue is that you don’t buy them in an academic world. You buy them in a world full of scammers and high fees. I would rather see most people sell their house and downsize or move in with kids or let their kids supplement their income in exchange for the house they’re going to inherit anyway than introduce this fee-laden, difficult to understand product into the mix. But you know what? If you did a terrible job saving for retirement, have no kids capable of assisting you, and are living on nothing but Social Security with a paid-off house, there’s probably a place there for a reverse mortgage.

Next question.

Q.

Should you get a SPIA for a portion or all fixed expenses in retirement? If so, which type of account should the money come from? When is the optimal time to get the SPIA, should one wait for a higher interest environment or do an annuity ladder? Should one split the annuity among different companies?

A.

It depends. How comfortable are you with market risk? If very comfortable, that leans away from using an annuity. If your portfolio is mostly bonds anyway, an annuity makes more sense. How much of your fixed expenses does your guaranteed income cover? If you could live mostly or completely off your Social Security and a pension, there’s no reason to buy a SPIA.
are your desires for leaving money behind? Remember SPIA money is gone when you die, even if you die next month. Are you close to the edge when it comes to having enough retirement assets, or do you have plenty? The higher your necessary withdrawal rate, the more useful a SPIA can be. If you’re looking at a withdrawal rate much over 4-5%, you should seriously consider a SPIA.

Personally, I would fund a SPIA using a tax-deferred account. That keeps things relatively simple, as everything it pays you is taxable and the money that went for the SPIA is no longer used to calculate your RMDs. But you can also buy them with taxable money, but then part of the payment is taxable and part isn’t. Plus, you likely will have to pay capital gains taxes before you even buy the SPIA. I suppose you could also use tax-free (Roth) money to buy a SPIA, but that’s such a great asset for your own and your heir’s use, that I probably wouldn’t blow it on a relatively low return vehicle like a SPIA.

As a general rule, SPIAs should be bought around age 70. You can buy them earlier and later, but at that age the rate offered on the SPIA is starting to depend much more on your life expectancy than prevailing interest rates. You can also ladder annuities, buying one at 65, another at 70, and another at 75 for instance. There is no right answer to this question. There are two nice things about laddering. First, it helps protect against inflation. Since most SPIAs are not indexed to inflation, laddering allowed you to leave some of your assets in vehicles that were likely to keep up with and beat inflation for an extra 5 or 10 years. Second, you probably want to split annuities up between several different companies to make sure each annuity gets the maximum state guaranty corp coverage. Those later annuities also pay a much higher rate than an earlier one.
Splitting up annuities between multiple companies is a good idea, especially if you are annuitizing a lot of assets. Most state guaranty corporations only cover about $250,000 per company. So if you want to annuitize $750K, you probably want three separate companies. Next question.

Q.

Should one look at market conditions and change withdrawal locations (Brokerage vs 457 vs 401k vs Roth) based on that?

A.

Great question. I’m not sure anyone has worked out a great answer to that. The issue with doing anything based on market conditions is that you really need a functioning crystal ball for it to work out well. Ideally, you would withdraw from tax-deferred accounts and taxable accounts at market bottoms, and tax-free accounts at market tops. But if you can reliably figure out when we’re at market bottoms and tops, you should be so rich you don’t need to worry about which account to take your withdrawals from. Obviously if you have losses or very high basis taxable assets in a taxable account, those are a great place to find spending money. Next question.
Q.
How much cash reserves should I keep in case of a down market?

A.
Like all the other questions, it depends. If your entire spending needs are met by guaranteed income sources, you probably don’t need much at all. Likewise, if the rest of your portfolio is in risky assets (stocks, real estate, precious metals etc), then you probably need to have more cash than you would if your portfolio were mostly short-term treasuries. The idea behind keeping cash in the portfolio is not to maintain liquidity, since you can liquidate any stock or bond fund any day the market is open. The idea is to keep you from having to sell assets when stocks, real estate, AND bonds are all down. That doesn’t happen often, and when it does, it usually doesn’t last long. If you just look at bear stock markets, the average bear market lasts 14 months, although it can take longer than that for your portfolio to get back to even. Bear in mind that even in a very long bear market with a long recovery time, once you burn through your cash you can usually tap bonds and so might not even need to look at selling stocks low for a decade or more.

So there isn’t any good academic answer. But what would I do? I think 10% of the portfolio in cash is a good idea. At a 4% withdrawal rate, that’s 2.5 years of withdrawals that don’t depend on how the stock, bond, or real estate market is doing at all. That should also be plenty to cover those “one time” items like replacing a car in a recession (great time to get a great deal, by the way.) Next question.
Q.

What about some of the fancy withdrawal strategies like those that depend on a cyclically adjusted P/E ratio (CAPE) to determine how much to withdraw each year?

A.

I know there are a lot of people who have written endless articles, blog posts, and even books on these strategies. Wade Pfau and his peers make their living researching, talking, and writing about nothing but this. However, I think it’s all a bit of hooey. The point of the Trinity Study was not to discover that the Safe Withdrawal Rate was precisely 4% and not 3.7%. It was to point out that 8% or 10%, as many advisors were recommending in the 90s, (and Dave Ramsey still is,) was not safe. It wasn’t to actually tell you how to spend your money in retirement. Here’s the bottom line:

When you retire, plan to spend something like 3, 4, or 5% of your portfolio in any given year. If that isn’t enough income for you, or if that makes you uncomfortable, annuitize enough
of your portfolio until you can sleep at night. Then keep an eye on things. If it turns out you retired on the eve of the worst bear market in the history of the world, you’re going to need to make some adjustments and spend less. But if things turn out like they usually do, and your portfolio is continuing to grow despite your withdrawals, then you can be confident in your plan and maybe even spend a little more. Adjust your income as you go, like you did for your entire working life. Next question.

Q.

What investments should I have in retirement? Should I use a target retirement fund or keep a mix of index funds like I do now? What should my stock and bond ratio be?

A.

There is no perfect answer to this question, but there are a few considerations. First, you want an investment mix that is going to have a great return over your retirement. The more your portfolio makes, the more you can spend or leave to heirs or charity, especially with the effects of inflation over 30 years. But you also want a portfolio with relatively low volatility in case sequence of returns risk shows up. A very
volatile portfolio that has bad returns before good returns, combined with withdrawals from the portfolio, can end up being much worse for you despite having a higher average return. So, high returns and low volatility. Unfortunately, it’s tough to find that holy grail of investments. Some interesting data suggests that because sequence of returns risk is highest in the few years just before retirement and just after retirement that you should have the least risky asset allocation of your life during those years and then can actually INCREASE your stock to bond ratio throughout retirement. Of course, you also need a portfolio that lets you sleep at night. If the future resembles the past, you basically want the riskiest portfolio that you can both tolerate in the short run and handle as far as sequence of returns risk. If the future doesn’t resemble the past, and more risk shows up, you’ll be happy you had a lower stock to bond ratio.

Another consideration in retirement is your own declining abilities and those of your spouse. This argues for a simpler portfolio, such as a target retirement or life strategy type fund, or perhaps the use of an advisor or trusted family member. But you don’t necessarily need to switch everything over the day you retire. In reality your portfolio the day before you retire should be precisely the same as your portfolio the day after you retire.

What do you think? How do you intend to invest/withdraw/spend your money in retirement? Will you/do you use a SPIA? Why or why not? If you are retired how much of your portfolio do you spend each year? Comment below!