Retirement Income Planning

Retirees are living longer, healthier, and more active lives. For example, according to the 2000 Annuity Mortality Tables, the life expectancy of a male age 65 is 20.4 years. This means that there is a 50 percent chance that a 65-year-old male will live beyond age 85. Under these same tables the life expectancy of a female age 65 is 23.0 years, meaning that there is a 50 percent chance that a 65-year-old female will live to at least age 88. Further, with a couple who are both age 65, there is a 50 percent chance that one or both of them will live beyond age 92. Such long life expectancies make it essential that adequate retirement income planning take place.

Retirement income planning requires a shift of focus from performance and accumulation to withdrawal and sustainability. The basic objective is to assure that the retiree will receive an *inflation-adjusted stream of income that will not be outlived*. In retirement jargon . . . a “sustainable withdrawal strategy” must be developed.

**Determining resources**. The first step involves identifying potential sources of retirement income. Sources of income, and assets that can be converted into income, include:

1. Government benefits such as Social Security and veteran benefits.

2. Tax-favored retirement plans including:

a. Qualified retirement plans, both *defined contribution* *plans* (pension plans such as money purchase and target benefit plans, and profit sharing plans such as 401(k) plans and savings/thrift plans) and *defined benefit plans* (traditional defined benefit plans, cash balance plans, and 412(i) plans).

b. Individual retirement arrangements, such as traditional IRAs, Roth IRAs, SIMPLE IRAs, and simplified employee pension plans (SEPs).

c. 403(b) plans and 457 plans.

3. Cash reserves including checking accounts, money market accounts, regular savings, CDs, and life insurance cash values.

4. Income assets such as bonds, fixed annuities, installment payments, and nonqualified deferred compensation plans.

5. Equity assets including stocks, mutual funds, variable annuities, and business interests.

6. Tangible assets such as real estate investments (primary residence, second home and commercial rental property).

7. Anticipated inheritances and life insurance death benefits.

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**Establishing a plan**. The planning process is significantly different and can be more complex than that needed when accumulating assets. However, having a well thought out plan can bring peace of mind to those who would otherwise be uneasy about beginning the drawdown of a lifetime’s savings and investments. There are a lot of variables to be considered and tradeoffs to be made. For example, the process will likely include:

1. Determining *retirement income needs* using realistic inflation assumptions (typically between 2 and 4 percent per year, but increases in healthcare costs have been substantially higher). Life expectancies must be estimated. Lifestyle choices and increases in the years of healthy life during retirement will significantly impact income needs. The spending lifecycle of persons during their retirement years must be anticipated. For example, in the early retirement years retirees typically spend more on travel and entertainment, whereas the latter years bring increased health care expenditures.

2. Projecting realistic *rates of return on investments*, taking into consideration the retirees’ time horizons and tolerance for risk. For example, because investment returns are not linear, Monte Carlo simulations are used to determine the likelihood that a particular withdrawal rate can be sustained (typically between 4 and 6 percent annually). Asset allocation, rebalancing of investments and annual plan review are essential.

3. Determining income, if any, that will come from part-time *employment* (e.g., the trend toward “phased” retirement has led the IRS to issue regulations that permit workers who are near retirement age to reduce their working hours and make up lost wages by taking in-service distributions from defined benefit plans, see 72 FR 28604).

4. Avoiding *penalties* associated with tax-deferred savings (e.g., before age 59½ withdrawals and after age 70½ distributions) and determining the impact of early retirement on Social Security retirement benefits.

5. Evaluating and using *techniques* and *products* that are effective in meeting retirement objectives. These include using systematic withdrawal plans with mutual funds and annuities, laddering of bonds, purchasing long-term care insurance, and using reverse mortgages to access home equity. Indexed annuities can mitigate not only the longevity and inflation risks, but can reduce the investment risk by providing a guaranteed minimum income benefit.

6. Determining the taxconsequences of distributions, minimizing taxes, and selecting those accounts to be drawn down first.

7. Implementing estate *plans* involving powers of attorney, wills, trusts, gifts, and asset protection.

8. Establishing and monitoring a *retirement budget*.