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Cracking the Nest Egg: When Accumulation Becomes Distribution

By Elaine Floyd, CFP®

It's a big transition when clients leave the workforce to live off their savings, requiring an attitude adjustment in both you and your clients. Here are the issues to consider when time, compounding, and other conventional investment principles no longer work in your favor.

Retirement planning is easy during the accumulation phase. Just stash as much savings as possible into retirement and investment accounts, and maximize total returns. All that really matters is what the client ends up with at retirement. It's a race to grow the nest egg as large as possible. Success is measured by account values, pure and simple.

Then comes the day when the client can finally crack the nest egg and start withdrawing funds. Now the goal is no longer simply to grow the account balance, but to provide clients with enough current income to meet spending needs and allow the nest egg to diminish, as it naturally must, without letting it disappear. Success is measured by client happiness and the careful monitoring of withdrawal rates and account values to ensure that the clients' money will not run out.

ATTITUDE ADJUSTMENT

Some of the fundamental truths that apply to an accumulation strategy fall short under a distribution strategy. This means that certain basic concepts that have been drilled into clients' heads at 401(k) meetings and advisor consultations must be relearned. Consider these shifts:

Dollar-cost averaging works in reverse. Clients have learned that investing a fixed dollar amount during volatile markets allows them to buy more shares when prices are down. This is a good thing. But when clients are withdrawing fixed dollar amounts from a volatile portfolio, temporary dips can do serious damage because more shares must be liquidated to provide the same amount of cash.

Compounding also works in reverse. In the classic "Why save now?" pitches, clients learn that the early build-up of an investment account provides a larger base for future compounding. The rule comes into play a little differently when determining withdrawal rates: taking out too much too soon will diminish the impact of compounding on the remaining assets.

The sequence of investment returns matters. Under an accumulation strategy, dips in asset values can be made up by a bull market or increased savings. What matters is the average annual total return. During the distribution phase, poor returns in the early years can cripple a portfolio and cause money to run out early.

Time is the enemy. Under an accumulation strategy, the longer the money stays invested, the more it will grow. When funds are withdrawn, the opposite is true.

Mistakes can be fatal. During the accumulation phase, mistakes in planning, saving, or investing can always be fixed by adding more money, revising the portfolio, working longer, and so on. In retirement, when money is coming out and no new money is going in, there is far less room for error.

Part of transitioning clients into retirement is helping them learn some fundamental concepts related to the management of their nest egg. In particular, warn them of the dangers of volatility, excessive withdrawals in the early years, and a longer-than-expected withdrawal period. These potential dangers can undo a lifetime of diligent saving and these mistakes may not show up until it is too late to reverse their impact.

INCOME PLANNING

Planning for income requires careful number crunching and a strategy for actually getting cash into client hands. Here are some popular strategies:

Live off the interest (or dividends). The classic retirement-income strategy is to shift from a growth-oriented portfolio at retirement to investments that generate income. These might include bonds and dividend-paying stocks. The client's income consists of the actual payments thrown off by the investments. Any assets not needed for current income generation may be invested in equities for inflation protection and long-term growth.

Set up a withdrawal plan. Another approach is to invest for total return and set up a withdrawal plan starting at, say, 4% of the account balance. Each subsequent withdrawal would be increased by the annual inflation rate. Under the so-called "4% rule," the assets are invested in a diversified portfolio of stocks and bonds.

Draw from a cash bucket. Another strategy is to keep enough cash in a money-market fund to fund two years worth of expenses and invest the bulk of the portfolio for total return. As the cash bucket empties, enough long-term assets are liquidated to fill it back up.

TRANSITION PLANNING

Once you've run the numbers and determined how you are going to get income to your client, the next step is to determine exactly how you will position the portfolio and make the transition. Because major portfolio shake-ups can have serious tax and investment implications, transitioning to a distribution-phase portfolio could take several years of planning. Here are some things to think about.

WHERE ARE THE ASSETS?

The retirement-income strategies you use for taxable accounts won't necessarily be appropriate for nontaxable accounts. For example, if the client wants tax-free income from a taxable account, you can buy municipal bonds. If he wants tax-free income from an IRA, you'll have to convert it to a Roth, which means paying taxes on the account at the time of the conversion.

By the time clients reach retirement, they may have many accounts. When arranging for distributions, you'll need to look at them as a whole for overall investment planning, and also individually to determine which accounts will generate which distributions.

WHEN SHOULD YOU SELL?

The liquidation of assets is often an important part of the transition to the distribution phase. If you will be doing a major portfolio overhaul, you'll need to consider tax and investment implications of asset sales.

For taxable accounts, you should know the tax basis of each and every holding. You'll also need to know the client's overall tax situation in any year you propose a sale of assets, including previous loss carry-forwards, AMT status, the receipt of taxable retirement distributions, and so on.

If you think a major reorganization of the client's investment portfolio is in order to meet the client's new objectives of income, liquidity, and capital preservation, meet with the client's tax advisor and map out a plan for the orderly liquidation of assets. This could take years. Periodic asset sales will also be necessary during the client's retirement years, especially if you are using the cash bucket strategy. Each time liquidation becomes necessary, you'll need to balance tax and investment considerations and time these asset sales for optimal benefit.

WHAT WILL BE THE IMPACT OF IRA WITHDRAWALS?

If part of the client's income will come from regular IRA withdrawals, you'll need to consider the current—and future—tax impact of these withdrawals. It may not make sense to defer distributions from traditional IRAs until the last possible moment if doing so might create such large required minimum distributions that the client ends up in a higher tax bracket.

Also, consider the income and estate tax consequences of a large IRA that is allowed to grow out of control. Long-term income projections need to be part of your transition planning so you can set up accounts and plan distributions from the outset.

WHAT FUTURE TRANSITIONS ARE IN STORE?

Many clients don't plan to retire at once. They may plan to ease into retirement by working part-time for a while and then seeing how they feel. Distribution planning for this type of retirement involves a series of transitions. You may set up the accounts and the portfolio to generate a relatively small income now with the idea of increasing the income later. This may require another transition or two, with all the same attention given to asset positioning, the timing of liquidations, and the tax impact of IRA withdrawals—not to mention all the hand-holding and warnings about drawing down their nest egg too quickly.

Perhaps one of the biggest differences between accumulation plans and distribution planning, at least from the advisor's standpoint, is that once clients begin drawing income from their investment portfolio, their accounts require much closer attention. Not only must you invest the assets in a prudent manner, but you also must watch the amount and timing of distributions to ensure that the nest egg lasts. Advisors who are used to investing only for growth may need to go through an important transition themselves to fully understand the nuances of retirement-income planning.

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