

# Quarter Notes

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## Income management in retirement

Some retirees have enough money coming in, between their pensions, Social Security and investment income, that they don't need to touch their principal to meet living expenses. Because Social Security payments are indexed for inflation, they also have that base covered to some extent.

Most retirees are not in so fortunate a position. For them, an important question looms. How much of my savings can I consume each year and still be reasonably confident that I won't outlive my money?

### A starting point

Financial planner William P. Bengen addressed that question in an article published in the *Journal of Financial Planning* in 1994. Relying upon financial market performance data dating back to 1926, as compiled

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## Be prepared

Funding a comfortable retirement is among the more difficult challenges that most Americans face. You can't really have too much money for retirement, but how much is enough? How much of your capital can you consume in periods of low interest rates? Should you consider an annuity for your retirement income? What about inflation?

These are the questions that we begin to explore in this issue of *QuarterNotes*. If you have questions on these matters, please give us a call anytime.

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## Income management . . . continued

by Ibbotson Associates (now a Morningstar division), Bengen tested hundreds of scenarios. He assumed that the money would be coming from a tax-deferred account, which left the balance to grow without a tax drag. His models adjust the annual dollar amount of withdrawals by inflation every year for various 30-year periods. Given these parameters, how much should a retiree be able to draw down in the first year from principal?

Not more than 4.5%.

If the money is coming from a taxable account, the figure is just 4.1%. However, the income tax burden is

likely to be significantly lower when one invades previously taxed accounts—basis is recovered tax free, and the long-term gains are still taxed at preferential rates.

Before the great recession, some people thought that 4.5% seemed rather low. In today's uncertain economy, some now think it too high. It is important to understand what the 4.5% figure represents. For all the 30-year periods that Bengen examined, there was money left in the account when the beginning withdrawal was 4.5% or less. In periods of strong financial performance, starting with a 4.5%

withdrawal resulted in as much principal in the account at the end of the 30 years as at the beginning. But in all cases, the 4.5% beginning level turned out to be safe.

### Active investment management

Implicit in Bengen's program is a plan for active investment management. He generally recommends that at the beginning of retirement, one have as much as 75% of assets in stocks, which might be above the comfort level of many retirees. Over time, the portfolio will need to be rebalanced, a job that many prefer to delegate to professionals.

Individual factors should come into play for setting a withdrawal rate. A client with some health problems may not need to plan for 30 years, and so he or she could have a higher withdrawal rate. One whose family has a history of good longevity may want to consider a lower rate. Market prospects need to be taken into account as well. A stock market crash early in retirement, for example, can have a devastating effect on a retiree's financial security in the longer term.

To learn more about these retirement income strategies, see Bengen's 2006 book, *Conserving Client Portfolios During Retirement* (available for \$65 from Amazon.com).

### We can help with your investment choices

There are some retirees who enjoy managing their investments. Many others prefer to enjoy their retirement activities rather than pit their skills against investment professionals. Whichever camp you are in, we are at your service. We can help you to achieve financial confidence, so you can live your retirement to the fullest.

### Should you consider an annuity?

When a retiree is concerned about outliving his or her money, one alternative to evaluate is an *immediate annuity*. Annuities are contracts issued by life insurance companies that may meet a wide variety of investing and income needs.

With an immediate annuity, an individual is trading a lump sum of money for an income stream, payments to

be made monthly, quarterly or annually. Payments may last for the individual's lifetime, for the joint lives of an individual and a spouse, for a specific number of years, or for life, but not less than a specific number of years. The amount of the payments may be fixed or variable, determined by financial market performance. The age of the annuitant or annuitants also will be a factor in determining the size of the payments.

Other choices to consider in evaluating annuities is deferred versus immediate, variable versus fixed. Each approach has advantages and disadvantages.

For some retirees an annuity may be helpful by shifting the burden of investment management to professionals. On the other hand, one is sacrificing access to a significant sum of money, which may remain unavailable in case of emergency. If you decide to explore purchase of an annuity, you'll need to understand all your choices and keep an eye on expenses. Annuities are not right for everyone, but they have been a boon to many.

## The inflation rate during retirement

In 1987 Congress directed the Bureau of Labor Statistics (BLS) to begin calculating a Consumer Price Index (CPI) for the elderly. Did the regular CPI still accurately reflect the changes in the cost of living experienced by retired Americans, and had the inflation adjustments to Social Security benefits been done appropriately? An experimental CPI-E was created for the population aged 62 and older, using 1982 as the base year.

Analysis by the BLS of the first quarter-century of the CPI-E found that the elderly have experienced slightly higher inflation than the population at large. As a share of expenditures, older Americans spend twice as much on medical services, 10.81% of their purchases, as does the population generally (5.27%). As the cost of medical services has outpaced inflation, this burden falls upon the elderly disproportionately.

Still, the differential is not as much as might be supposed. During the period of the study, the elderly experienced average annual price increases of 3.3%, compared to the 3.0% benchmark that was used to adjust Social Security benefits for inflation. What's more, the gap has been narrowing in recent years, the authors concluded.

### Inflation's impact

The more important problem for retirement income planning is the erosion that inflation causes to everyone's purchasing power. That 3.0% annual price increase really can add up over time.

The table at right is based upon actual inflation experienced over



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the past 30 years, not projections of hypothetical rates. In the table we've assumed that a retiree had \$40,000 of purchasing power in the year of retirement, and then we used the BLS calculator to determine the equivalent in 2011 dollars.

For example, if you retired with \$40,000 of expenses in 2006, you would need \$44,624.21 to have the same purchasing power this year. But if you retired in 1986, during President Reagan's second term, with the same \$40,000, you'd

need more than double that amount to maintain the same standard of living.

### Your personal inflation rate

Government statistics are one thing. The actual changes that you personally experience in costs today, and during retirement, may be quite different. Many people have wondered how the reported official inflation rate can be so low when gasoline prices have risen so dramatically. Because prices for food and fuel may be volatile, they are not included in the measurement of "core" inflation. Also, inflation measurements attempt to take into account the improvement in the quality of consumer goods over time. For example, the iPad 2.0 was superior to the original, but sold for the same price. But as one New Yorker quipped, you can't eat an iPad.

There's no substitute for financial planning. Some sources of retirement income, such as Social Security benefits, are indexed for inflation, but many others are not. That's where sound portfolio management has to fill the gap. We can help you with that problem.

Retirement purchasing power	
Year of retirement	Amount required in 2011 to equal \$40,000 of purchasing power in retirement year
1981	\$98,968.54
1986	\$82,082.48
1991	\$66,051.69
1996	\$57,337.41
2001	\$50,797.52
2006	\$44,624.21

Source: Bureau of Labor Statistics; M.A. Co.

## Just ask us

What is the “yield curve”?

What does it tell us?

Does the Federal Reserve Board control the yield curve?

How do I take the yield curve into account in shaping my portfolio?

The yield curve is a graph of current interest rates for various bond maturities. Normally, the curve slopes upward; that is, interest rates are higher as the time to a bond’s maturity increases. Sometimes the curve flattens, as short-term interest rates and longer-term rates edge closer together. When the yield curve slopes downward, when long-term rates are lower than

short-term rates, the curve is said to be “inverted.” This situation may occur when investors think that the prospects for future inflation are much lower than today’s. An inverted yield curve is thought by some observers to be a signal of a coming recession.

The Fed controls only the shortest-term interest rates, the discount rate and the federal funds rate, which are overnight interest rates. However, the Fed’s program of Quantitative Easing had effects all along the yield curve.

There are many strategies that we can tell you about, including:

- Matching maturities to your time horizon;
- Building a bond ladder;
- Balancing risks with intermediate maturities.

We’d be pleased to tell you more at your earliest convenience.

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