

Managing Your Retirement Income

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When it comes to money we generally go through three phases in our lifetime. The first is the “accumulation” phase. From the time we are 20 years old until we turn roughly 65, most Americans are focused on saving enough money so that they don’t have to work the last twenty-five or so years of their life. Once we retire we generally hit the “distribution” phase, which is where we take income from our retirement nest egg, trying to make it last as long as possible before we die. Then, as we come close to the end of our life, and at death, we have the “transfer” phase. Here the usual goal is to pass as much money from one generation to the next or to other agencies that will further the interests of the donor, without giving it to the government in the form of estate taxes or probate fees.

In order to increase my knowledge of the distribution phase, a couple of months ago I flew to Washington D.C. to attend the Retirement Income Management course offered by the International Foundation for Retirement Education. When I signed up for the class I was expecting to receive the definitive answer on how to manage ones retirement dollars in order to ensure a stable income throughout retirement. Although various ideas were shared, what I found was that throughout the industry the body of information on this subject is minimal and lacking in much direction. However, there were a couple of ideas that I learned that I want to share with you.

First, write down all the risks that you now have as a retiree or pre-retiree. Start by taking out a piece of paper and making a list. You might come up with ideas like running out of money, inflation, excessive medical expenses, etc. Surprisingly, the biggest risk most people may have in retirement is inflation. This is because our retirement incomes and pensions may not increase from year to year, but the price of ordinary milk and bread generally does. Consider that with 3% annual inflation on consumer goods, the price of milk will double in price in 24 years. That means that groceries may double in price between your retirement date and the end of your lifetime.

Second, write down all of your fixed expenses. This means, what it costs you to survive each year. We are not talking about eating out, or going to the movies. We are referring to the basics like shelter, heat, food, insurance, transportation, etc. Once you have a column with all of your fixed expenses, create a second column with all your discretionary expenses. Here is where you put down going out to dinner, going to the movies, family vacations, or what ever else you like to do.

The next part is tricky because there appears to be no right answers, only opinions. Here is one possible scenario. Divide your annual fixed expenses by the percent that you expect to earn on your investments. For example, if your fixed expenses are \$30,000 per year and you think you can make 5% invested in government bonds, then \$30,000 divided by .05 equals \$600,000. So, if you invest \$600,000 and earn a conservative 5% per year, you should expect to receive \$30,000 per year in dividends. To make this more realistic, suppose you receive Social Security income of \$12,000 per year, you can decrease the dollars needed for fixed expenses by \$12,000 so then all you may need is \$18,000 from another source. Divide 18,000 by .05 and now all you need in investment dollars is \$360,000 earning 5%.

Regarding your discretionary expenses, suppose you came up with \$15,000 per year. Using the same assumptions and formula, it would take \$300,000 at 5% to produce this portion of your income. However, instead of investing this portion of your money into government bonds, you might consider investments that would generally appreciate with inflation. Some options are TIPS bonds, stocks, hard assets and others. The key here is that you can only have as much fun as your discretionary investment money will let you have. If these investments don't do well one year, then you may have to put off that cruise until next year. The additional return on this portfolio may also be used to offset increases in your fixed expenses due to inflation.

Some financial advisors recommend putting the majority of ones retirement dollars into the stock market because they can show that statistically that is what will grow the most in the long term, and statistically that is true. However, what they fail to include in their presentation is a simulation of a worst-case scenario, depicting that if the stock market performs poorly in the first couple of years of retirement, it can significantly reduce the probability of your investment dollars lasting the remainder of your lifetime, especially if you income distribution stays the same. Please don't misunderstand me. I'm not saying your money should not be in stocks. As I mentioned above, there appears to be no industry standard on how to manage your money in retirement. But you should be aware of all the risks. There are risks in being too conservative as well as being too aggressive.

Planning your retirement income is not an easy process. Ultimately you, with the assistance of your financial advisor, will need to develop a plan that takes into consideration all of the risks while creating a workable solution for achieving your goals while allowing you to sleep at night.