A Few of Our Best Income Strategies

By Kerry Pechter *Thu, Dec 12, 2019*

For today's issue of RIJ, we've retrieved several of our best income-planning articles from our archives. In each case, the adviser goes beyond the "safe withdrawal" method to design a customized, outcome-driven solution for the client.

Bill Sharpe, the Nobel Prize-winning economist, once described retirement income planning as the most complicated financial problem he's ever faced. There are "up to 100, 200 parameters that you've got to nail down before you can find an optimum strategy," he said in a 2014 interview.

At *Retirement Income Journal*, we report on many of the different strategies that advisers can use to tackle this Rubik-ian challenge. We're receptive to any approach, but we favor techniques that blend guaranteed sources of income and risky investments in the same retirement portfolio.

For today's issue of *RIJ*, we've retrieved several of the best income-planning articles from our archives. (Synopses and links can be found below.) In each case, the adviser goes beyond the "safe withdrawal" method to design a customized, outcome-driven solution for the client.

Income plan for two well-funded therapists

"Andrew" and "Laura," married psychotherapists in their early 60s with a combined annual income of $300,000, hoped to retire in a few years with an income of about $140,000, consisting of their Social Security benefits, Laura's pension, and about $77,000 a year in withdrawals from their $1.24 million portfolio.

Their adviser, Bill Lonier of Osprey, FL, believed that such a high drawdown rate (6.2%) could exhaust their savings in only 18 years. He recommended that they build a 30-year ladder of Treasury Inflation Protected Securities for essential income and re-characterize $30,000 of their spending needs as "discretionary" (contingent on favorable markets) instead of "essential."

To reduce Andrew and Laura's "longevity risk," Lonier advised them to buy a joint-life qualified longevity annuity contract (QLAC) with 10% of their investable assets. To give them an alternative source of cash during future market downturns, he also advised them to open (but not tap) a home equity line-of-credit.

Jim Otar's Advice for 'Andrew' and 'Laura'

When assessing new clients, Jim Otar, the creator of the Retirement Optimizer, categorizes them either as "green zone," "yellow zone," or "red zone" retirees. Green-zone retirees have enough assets to cover their expenses throughout retirement, come good markets or bad. Red-zone retirees will most likely run out of money unless they purchase income-generating annuities. Yellow-zone retirees require creativity on the part of their advisers if they hope to realize their goals and avoid misfortune.

Otar quickly identified Andrew and Laura as Green zoners, so he recommended no annuities or bond ladders for them. Instead, he took note of the fact that they owned two homes worth a combined $1.8 million (bringing their current net worth to more than $3 million). He suggested that they cover their expenses by spending $50,000 a year from their $1.24 million investment portfolio and their combined $72,000 in Social Security benefits (at age 70).

If equity markets performed badly and the couple appeared likely to live into their 90s, Otar, a Canadian who is now retired, suggested that they make up any shortage of liquidity by, for instance, selling one of their homes and moving into the other. In the meantime, he suggested that they put 58% of their investable assets into equities, 39% into bonds and 3% into cash.

Income plan for a couple with $750,000

Jerry Golden, CEO of Golden Retirement, a Manhattan-based advisory firm, was asked to create an income plan for the "M.T. Knestors," a couple with $755,000 in savings. At 66, the husband intended to work for four more years and then claim Social Security benefits of $3,000 a month. His spouse, 60, was already retired.

In the first rough draft of a plan for the Knestors, Golden suggested that they receive retirement income from a combination of dividend stocks, annuities and systematic withdrawals from investments. He used $132,500 (the sum of 25% of each spouse's IRA savings) to buy a QLAC that would provide income when each reaches age 85.

In addition, he recommended investing about $400,000 in a 50% stocks/50% bond portfolio to provide systematic withdrawal income for 15 years, until the QLAC income starts. For additional monthly income, he recommended putting about $170,000 of after-tax savings in dividend-bearing stocks. He allocated the remaining $56,000 in after-tax savings to an inflation-adjusted, joint-life, single premium immediate annuity (SPIA).

Safety First or Safety Last?

Are guaranteed monthly checks more important to retirees at the beginning of retirement, when systematic withdrawals and market volatility can combine to raise a client's "sequence of returns" risk (the risk that a retiree will need to liquidate depressed assets for income)?

Or is guaranteed income more important at the end of retirement, when a history of good health habits can make a client vulnerable to longevity risk (the risk of outliving assets)?

In this hypothetical case, the clients, a 65-year-old married couple with $1 million in savings, only want to commit 25% of their savings to an income annuity. They'd also like to receive the income either early in retirement, when they plan to travel, or late in retirement, as a hedge against the risk of living longer than expected.

Their adviser points out that they could fund the first decade of retirement a 10-year bond ladder (or a 10-year period-certain SPIA) costing $250,000 and paying out about $28,000 a year, while spending up to $30,000 a year from their remaining savings of $750,000. Or they could use $250,000 to buy a deferred income annuity that pays $40,000 a year starting when they reach age 80, while taking withdrawals from their $750,000 in savings over the intervening 15 years.

In a presentation at the Investments & Wealth Institute Conference for retirement income specialists in 2018, advisers Dana Anspach, of Sensible Money, and Asset Dedication's Brent Burns and Stephen Huxley, recommended using a bond ladder for essential income in the first 10 years of retirement and investing other money in an asset class with a history of benefiting from a 10-year time horizon, such as small-cap value funds. The choice of strategy might depend most on the client, and which gives him or her more peace of mind: protection from investment risk or protection from longevity risk.

Bill Sharpe's 'Lockbox Strategy'

In his proprietary 'Lockbox' software, Nobel laureate Bill Sharpe divides retirement into two periods. During the first period, starting at the retirement date, a retired couple takes withdrawals from an investment portfolio. In one of his examples, the first period lasts 19 years and consumes 64% of savings. In the second period, if the retirees are still living, they buy an income annuity with the remaining 36%. Each year of the systematic withdrawal period is represented by a “lockbox.”

Each lockbox contains a certain portion of Treasury Inflation-Protected Securities (TIPS) and a share in an investment portfolio consisting of ultra-low-cost total market stock and bond index funds.

“The idea is to provide the discipline to say to yourself, ‘I will only cash the number of shares in this year’s lockbox,’ he said in an interview. “Obviously, the lockboxes aren’t really locked. If you have an emergency, you can take money out. You still have the key.” The asset allocation depends on the client’s appetite or capacity for risk.

“For implementation, you’d buy a certain number of TIPS, and a certain number of mutual fund shares,” Sharpe told *RIJ*. “You build a spreadsheet with one column for the initial amount in TIPS and another column for the amount in a risky portfolio. Then you would multiply the number of TIPS and shares for each lockbox by their current values and figure out what they’re worth in each period. Once a year, you would sell off that year’s portions of the two at their current price. It’s an accounting/spreadsheet task.”

In the 20th year of retirement—i.e., at age 85, which roughly corresponds to the average life expectancy of an affluent 65-year-old American—the couple, if living, buys a joint-and-survivor fixed life annuity. For the sake of liquidity, flexibility, and cost-reduction, they might prefer to make the annuity purchase an option, rather than buying an immediate or deferred annuity at retirement.