Retirement Income 'Smackdown'

By Kerry Pechter *Tue, Oct 12, 2010*

In a three-way competition at the CFDD conference, the winning income plan was one that maximized Social Security, converted a 401(k) to a Roth IRA, and rebalanced the remaining portfolio monthly.

James and Ann West, your average hypothetical American couple on the cusp of retirement, face a dilemma. They hoped to retire in 2014 on $451,000, most of it in qualified plan savings. But Jim, 66, recently suffered a mild infarction and has decided to retire now. Ann, 62 and still earning $30,000, is baffled about what to do next.

What's the best retirement income plan for the Wests? That was the challenge laid down for individual and plan sponsor advisors in the "Retirement Income Smackdown," a contest sponsored by the Center for Due Diligence and judged at the CFDD's 2010 Advisor Conference last week in Chicago.

The winning strategy, determined by a paper-ballot vote among about 150 people, came from John Mulligan, a 53-year-old Oregon CFP and CIMA. He "advised" the Wests to live on earned income and savings for four years, then maximize Social Security, and invest their excess capital in a globally diversified portfolio of stocks, bonds, real estate, commodities and cash.

In a phone interview, Mulligan described his influences as Moshe Milevsky, the RIIA's "build a floor and create upside" philosophy, fellow advisors Ed Slott and Craig Israelsen, and *Horsesmouth*'s "Savvy Social Security Planning for Boomers" product—though not necessarily in that order.

There were two other Smackdown finalists at the CFDD conference, the best of about 25 entries. Burlington, Iowa, advisor Curtis Cloke recommended that the Wests top up their monthly income in retirement by purchasing two installment-refund income annuities, one immediate and one deferred until Ann's retirement in 2014, with $290,000 of their savings.

A third contestant, William Heestand, a plan sponsor advisor in Portland, Oregon, approached the Wests as plan participants rather than as individual clients. (The CFDD is primarily an organization of plan sponsor advisors and ERISA specialists.) Heestand advised the Wests, who both had qualified plans, to put an in-plan, stand-alone guaranteed lifetime withdrawal benefit rider on their $451,000 in retirement accounts.

The people behind the Smackdown—Phil Chiricotti, the CEO of CFDD, Keith Diffenderfer, the advisor who hatched the idea, and Garth Bernard, the consultant who MC'd the Smackdown—kept the elements of the West hypothetical as uncomplicated as possible. The Wests, for instance, were renters, not homeowners. It wasn't said whether they had heirs or beneficiaries.

The takeaway from their comments: the problem of designing an income plan was both difficult to solve and, perhaps paradoxically, amenable to a wide variety of solutions. Chiricotti wants to reprise the contest at the 2011 CFDD Advisor Conference.

Maximize Social Security

In examining the Wests’ situation, John Mulligan noticed that the couple was four years apart in age. He also noticed that their stated monthly income needs were about $4,000, and that they could eventually meet their fixed costs simply by maximizing their Social Security benefits.

So Mulligan’s plan called for Jim to retire now but delay Social Security until age 70, when he’d qualify for the maximum benefit: $2,990 a month. He advised Ann to work for four more years, then take spousal Social Security benefits of $1,450 for four years before switching to her personal benefits of $1,943 at age 70. (The Social Security estimates include cost of living adjustments, or COLAs.)

During the four-year gap, when Ann was still bringing home $2,250 each month but Jim was foregoing Social Security, Mulligan prescribed a simultaneous Roth IRA conversion of Jim’s $250,000 401(k) assets (in five annual steps) and a $1,775-a-month drawdown of his Roth account to cover living expenses. He paid part of the Roth tax bill with the Wests’ $25,000 money market savings.

As for the Wests’ invested assets, Mulligan advised them to allocate their savings to twelve categories, a la Craig Israelsen (small, medium and large cap domestic stocks, non-U.S. stocks, emerging market socks, real estate, resources, commodities, domestic and non-U.S. bonds, TIPS, and cash), and to rebalance monthly. Such a portfolio would have averaged 9.51% a year from 2000 to 2009, Mulligan said.

Buy income annuities

At the heart of Curtis Cloke’s strategy were two income annuities. Cloke, the creator of the THRIVE Income Distribution System, advised Jim West to take $2,265 a month in Social Security benefits immediately. He recommended that Ann retire in four years and claim lifetime benefits of $1,472.

To supplement Jim’s Social Security benefits and Ann’s salary until 2014, Cloke had the Wests put about $250,000 in an inflation-adjusted (5%), installment-refund, joint life income annuity that paid $754 a month starting in April 2011. In addition, Ann used $39,000 of her qualified savings to buy a deferred installment-refund joint life income annuity that paid a level $341 a month, starting in January 2018. At that time, Ann would begin taking $624 a month in RMDs from her 403(b) plan.

After purchasing their annuities, the Wests would have about $160,000 for emergencies and splurges. If they needed more liquidity for any reason, they could tap the commuted value of their $250,000 annuity. Cloke’s plan also included a conversion of Ann’s 403(b) to a Roth IRA. He rejected other scenarios—such as Jim delaying Social Security or Ann retiring in 2010—because they consumed so much capital over the next four years.

Get a living benefit rider

Then there was the GLWB solution. William Heestand, president of The Heestand Company, a Portland, Oregon plan sponsor advisor, assumed that Jim’s 401(k) and Ann’s 403(b) plans each offered a stand-alone lifetime withdrawal benefit rider like Prudential’s IncomeFlex or Great-West’s SecureFoundation in-plan annuity programs.

Heestand’s advice: Jim should retire now and claim Social Security, while Ann should work until 2014 and then claim. They should cover their entire $410,000 in qualified savings with a GLWB and activate the 5% annual withdrawal ($20,500). He assumed that their expenses started at about $56,000 per year, including Medicare supplements and long-term care insurance premiums.

Spreadsheeting the variable annuity’s investment performance under benign and adverse market conditions, Heestand observed—as others have—that the GLWB was superfluous under a benign scenario. But under adverse conditions, it provided about $300,000 more in income over a lifetime and left a larger estate than an uninsured, investment-only strategy. In particular, it protected the Wests from sequence of return risk, which Heestand described as “the real deal—the biggest financial risk in retirement.”