Secrets of Tax-Efficient Drawdown

By Editorial Staff *Wed, Apr 8, 2015*

In a regular new feature on the latest retirement-related research, we look at a variety of recent articles, including one that might just change the way you think about tax-efficient spending strategies.

The well-known authors of a book on Social Security claiming strategies have turned their attention to a perennial financial problem for retirees: how to minimize the annual tax bill when drawing income from a hodgepodge of taxable and tax-deferred accounts.

In a paper in the March/April issue of the Financial Analysts Journal, William Meyer and William Reichenstein, authors of *Social Security Strategies: How to Optimize Retirement Benefits*, along with Kirsten Cook of Texas Tech University, depart from making the usual recommendation to drain taxable accounts first, then tax-deferred accounts, and then Roth IRAs.

Instead, they suggest tapping tax-deferred accounts early in retirement, but without taking out more than will fall within the 15% marginal tax rate. Their approaches, they claim, can add several years to the life of a retirement portfolio.

"The optimal strategy is substantially different from the strategy espoused by the conventional wisdom," the authors write.

In their article, "**Tax-Efficient Withdrawal Strategies**," they simulate a retiree with $916,500 in a tax-deferred IRA, $234,900 in a Roth IRA, and $550,000 in an after-tax account. The retiree has a spending goal of $81,400 a year, or an initial annual withdrawal rate of 4.8%, and will pay federal income taxes at the rate of 15% on the first $47,750 in taxable income.

[For the sake of simplicity, the authors assume the accounts are the retiree's only sources of income; adjustments could be made to control the top marginal tax rate for retirees receiving Social Security.]

They then compare five different withdrawal strategies. In Strategy 1, the retiree spends down her Roth IRA first, then her traditional IRA, and then her after-tax money. In Strategy 2, the retiree follows conventional wisdom and spends after-tax money first, then the IRA assets, then the Roth IRA. These strategies lead to portfolio longevity of 30 years and 33.15 years, respectively.

The remaining strategies are more creative and more complex. In Strategy 3, the retiree each year spends up to the limit of the 15% tax bracket from the IRA ($47,750), and then meets additional spending needs ($38,641) by drawing first from the after-tax account and then, when that is exhausted, tapping the Roth IRA. That strategy lasts 34.37 years.

Strategies4 and 5 involve Roth conversions. In Strategy 4, the retiree moves $47,750 from the IRA to the Roth every year for the first seven years of retirement, and satisfies all of her spending needs plus the money needed to pay the tax on the conversions from her after-tax account. When her after-tax account is exhausted, she draws income from her Roth IRA. This method extends the portfolio life to 35.51 years.

Strategy 5 is more complicated, and perhaps not something our readers should try at home. It involves Roth conversions to traditional IRA. Every year for the first 27 years of retirement, the retiree creates two $47,750 Roth IRAs with money from the traditional IRA, holding a one-year bond in one Roth and stocks in the other. She covers her spending needs and taxes out of her after-tax account until she exhausts it.

Here's the twist: At the end of each year, she converts the lower-valued of the two Roth IRAs back to an IRA. She will thus owe taxes on only one conversion and replenish the tax-deferred account. Beginning in year 28, she spends only up to the 10% tax bracket threshold from her IRA and taps the Roth IRA for the balance of her income needs. Strategy 5 last about seven months longer (for 36.17 years) than Strategy 4.

Tontine pensions: Where the annuity meets the lottery

The English government used tontines in the 17th century to fund its mammoth war debts, and U.S. Treasury Secretary Alexander Hamilton proposed using them to pay off America's debts from the Revolutionary War. In "**Tontine Pensions**," a University of Pennsylvania Law Review article by Jonathan Barry Forman, a University of Oklahoma law professor, and Barry J. Sabin, a consultant, proposes reviving the tontine in the form of pension annuities.

A tontine is a shared loan or common investment pool in which regular payments to surviving stakeholders—either lenders or investors—continue until the last survivor dies. Because the tontine payments would fluctuate, no life insurance company would be involved, vastly reducing the costs of the program and potentially leading to higher payouts.

The authors of this article believe tontines could form the basis of financial products to provide retirement income, whether directly to investors or through employers seeking to avoid the risk of traditional pensions. In their example, new investors could be recruited to perpetuate the annuity payments as earlier investors die.

Israelsen's four flavors of diversification

The 2008 financial market collapse taught many older Americans that the sequence of their returns can determine their investment success and their level of retirement income. A good defense against market volatility is diversification, writes Craig Israelsen, an advisor and author of the 2010 book, *7Twelve: A Diversified Investment Portfolio with a Plan*. In an article called "**Retirement Crash Test**" in the January issue of Financial Planning, Israelsen argues that diversifying a portfolio can "address each unique risk while maintaining adequate exposure to needed portfolio growth."

As he demonstrates through historical back-testing, effective diversification can be achieved with familiar asset classes and doesn't require the use of liquid alternatives or fancy volatility-management strategies. He compares the longevity of an all-U.S. bond portfolio with that of two other hypothetical portfolios—one whose U.S. bond allocation equals the retiree's age and one that contains equal shares of U.S. bonds, large-cap stocks, small-cap stocks, and cash. The author simulates withdrawal rates from the portfolios of 3%, 4%, and 5% of assets. Even at 5%, the diversified portfolio has the highest probability of lasting into old age

The Great Recession: Permanent damage to retirees or not?

For people in their 50s who were lucky enough to hang onto their jobs and continued to work, the negative fallout of the Great Recession has turned out to be transitory, according to a new paper, "**The Great Recession, Retirement and Related Outcomes,**" published in February by the National Bureau of Economic Research.

The researchers studied baby boomers between the ages of 53 and 58 just before the recession hit. Although older workers with long tenures in the labor force are typically less vulnerable to economic downturns, they confirmed that boomers who did lose their jobs took nearly twice as long to find new employment during the recession.

But there is no evidence of a long-lasting negative effect, wrote Alan Gustman and Nahid Tabatabai of Dartmouth and Thomas Steinmeier of Texas Tech. Further, the recession also did not permanently depress wages for older workers beyond the reductions typically experienced by those who have suffered layoffs.

Other recent research paints a less hopeful picture for U.S. workers, however. Brooking Institution economist Barry Bosworth reported that there has been a “major slowdown in workers’ wages” resulting from lower labor force participation and lower productivity. This secular trend may be “only marginally related to the recession,” and there is “little room for a cyclical recovery,” he wrote in “Supply-side Costs of the Great Recession,” a **paper** prepared for the Nomura Foundations Macro Economy Research Conference, held last January 27.

A January 2015 **report** by Susan Urahn and Travis Plunkett of the Pew Charitable Trusts echoes his concerns: “Many families, even those with relatively high incomes, are walking a financial tightrope,” with few resources they can draw on in emergencies.

Historically low interest rates: how worrisome?

Federal Reserve chair Janet Yellen is expected to raise the Federal funds rate later this year and reverse the historically low rates that have propelled the U.S. economic recovery. A **speech** given by a U.K. central banker Kristin Forbes to London’s Institute of Economic Affairs in February provides another take on thinking among Western central bankers about the risks of a low-rate policy. Forbes, a member of Bank of England’s monetary committee, analyzes this policy in detail in a speech titled, “Low Interest Rates: King Midas’ Golden Touch?” Chief among her concerns are inflationary pressures, asset bubbles, and a lower savings rate. Although none is of great concern yet, she said, all three issues “merit close attention.”