3 Simple Questions That Might Singlehandedly *Make* or *Break* Your Retirement

Have you answered them for **your** retirement portfolio yet?

BY ROBERT BROKAMP, CFP®, AND DAVID BRAZE

A SPECIAL REPORT BROUGHT TO YOU BY

Motley Fool™ Wealth Management

FROM THE DESK OF **NICK CROW, CFA**
PRESIDENT, MOTLEY FOOL WEALTH MANAGEMENT

Dear Fellow Fool,

Just because you're retired doesn't mean you don't have questions *about* retirement. They're probably something along these lines:

"How much can I withdraw from my portfolio and be reasonably sure my money will last as long as I do?"

"How can I protect my retirement income from a bear market?"

"When it comes time to sell investments to pay the bills, what should I sell?"

Have no fear, Fool.

In celebration of the grand opening of our stand-alone Motley Fool Wealth Management offering, we'll be making a slew of highly informative, 100% FREE investment content — covering topics just like the above — available to interested Fools like you over the next few weeks...

And that includes the articles you'll find directly below by Motley Fool LLC's *Rule Your Retirement* lead advisor, Robert Brokamp, CFP®, and longtime Fool David Braze, which will hopefully help clear up any lingering anxiety you may have about any of those aforementioned retirement questions.

But in case this is the first time you're hearing about Motley Fool Wealth Management, just know that we're a Registered Investment Advisor... meaning we actually have a *legal obligation* (known as a "fiduciary standard" in the financial world) to always provide you with financial advice that is in YOUR best interest. Can you say the same about the person who manages your money?

Meanwhile, we're saving time-strapped Fools just like you hours upon hours of exhaustive research that goes into every buying... selling... and rebalancing decision you make...

Freeing you up to actually *enjoy* the things you spent your entire life wishing you had more time for while you were still working — like taking that trip to the Mediterranean or the Outback that you've always dreamed of... picking up a new hobby or three... or simply spending more time with your kids or grandkids.

Before I get too far ahead of myself, though, I invite you to read Robert's and David's enlightening articles below. I think they will not only identify... but also *answer* some of the key questions all retirees must be asking themselves to guarantee they'll have enough money to last for the rest of their lifetime. And hopefully illustrate how important it is to have somebody you can trust to reliably manage and grow your money over the critical years and decades to come.

Afterward, please feel free to explore the rest of our Fool Wealth home page to see if this innovative wealth management solution may be right for you. If it is, I invite you to join us in Motley Fool Wealth Management over the next few weeks (please note, we're already accepting new clients as we speak!).

My team and I are so proud of what we've created here in Fool Wealth, and we'd be delighted for you to be a part of it. So I hope to hear from you soon!

In the meantime, please enjoy Robert's and David's articles below, and Fool on.

Nick Crow, CFA
President
Motley Fool Wealth Management

Nick Crow, CFA — President, Motley Fool Wealth Management

Creating a Comfy "Income Cushion"

BY DAVID BRAZE

As a retiree, I maintain a five-year cushion of income that is not invested in the stock market. Like many Fools, I do so because I know I will spend that money within the next five years, and I don't wish to sell stocks during a down market when I need that cash. Accordingly, I keep that five-year income cushion in things like money market funds, Treasury bills, certificates of deposit, and short- to mid-term bonds, where it can still earn interest, yet avoid most of the volatility found in the stock market.

There are a number of ways you can establish the size of your five-year pot. I simply start with the gross income I want for the first year. From that, I subtract my known income from pensions, wages, Social Security benefits, etc. That establishes the year's shortfall that must come from investments. Then, using an assumed inflation rate, I simply inflate that estimate to determine my shortfall for each of the next four years. Let's look at a hypothetical example to see what I mean.

Say I desire $75,000 in pretax income for my first year in retirement. I'll get $20,000 of that from a company pension, $20,000 from Social Security, and the remaining $35,000 from investments. I expect inflation to average 3% annually over the next five years. My pension will not increase along with inflation, but my Social Security benefit will. Given all that, I can construct the following table:

	Year 1	Year 2	Year 3	Year 4	Year 5
Income	$75,000	$77,250	$79,568	$81,955	$84,413
Less:					
Pension	$20,000	$20,000	$20,000	$20,000	$20,000
Social Security	$20,000	$20,600	$21,218	$21,855	$22,510
Shortfall	**$35,000**	**$36,650**	**$38,350**	**$40,100**	**$41,903**

Note that I have inflated my desired income in the second and subsequent years by the assumed inflation rate. I did the same for my Social Security benefit. My five-year income cushion is simply the sum of the shortfalls for Year 1 through Year 5, which is $192,003.

I now subtract that amount from my initial retirement stash, which leaves the rest to invest in stocks. Does that sound anything like asset allocation to anyone?

At the end of Year 1, I note what happened. I see that my actual inflation rate was 2% for the year, so I increase my second year's desired income by that amount to keep pace with the actual inflation rate, and construct a new table for the next five years based on the new year's desired income. However, I keep future inflation constant at 3%. The new table looks as follows:

	Year 2	Year 3	Year 4	Year 5	Year 6
Income	$76,500	$78,795	$81,159	$83,594	$86,101
Less:					
Pension	$20,000	$20,000	$20,000	$20,000	$20,000
Social Security	$20,400	$21,012	$21,642	$22,292	$22,960
Shortfall	**$36,100**	**$37,783**	**$39,517**	**$41,302**	**$43,141**

The new shortfall for all years shows my five-year income cushion should be $197,843. Let's say the income cushion at the end of Year 1 is down to $159,000, since $35,000 has been withdrawn, but it's also earned a little bit of interest. So now the shortfall is $38,843, an amount I take from the stock portfolio — either from the cash that has accumulated from dividends or by selling some shares.

Had stocks been down for the year, I would not take anything from that portfolio. Instead, I would take only the $36,100 I need as income in Year 2, and that would come from the income cushion. I would then replenish the cash and bonds in a later year when stocks were up again. It's also a good idea to cut back on your expenditures during the down years so you can leave more of your income cushion intact as you await a stock market rebound.

A final thought about expenses in retirement: Even though I'm adjusting my annual income for inflation, the truth is that as most retirees age, expenses actually drop. Mortgages get paid off, fewer miles get put on the car, and vacations become more modest. Older folks actually eat less. Incorporate changes in your expenses in the calculation of your income cushion.

So there you have it: one Fool's way of determining a five-year income cushion and investing based on that amount. It's not the only way or even necessarily the best way. It's just one way of many. Your task, should you choose to accept it, is to find the way that works best for you.

David Braze is not an employee of Motley Fool Wealth Management or its sister company, The Motley Fool LLC. David is a former contributor to fool.com and Motley Fool Rule Your Retirement *and may have been paid by The Motley Fool LLC for his contributions, and the fee for licensing this content has been paid by Motley Fool Wealth Management LLC. The views expressed in the report are those of the author and should not be relied upon as investment advice.*

How to Make Your Money Last a Lifetime

BY ROBERT BROKAMP, CFP®

The goal of retirement is to make sure your money lasts longer than you do, and to have plenty of fun along the way. Although we won't tell you how to have fun, we will tell you about the research behind the so-called safe withdrawal rate (SWR) — the amount you can take from your retirement account each year and still be reasonably sure that your portfolio will outlast your days on this earth.

The most commonly accepted SWR is 4%. Here's how it works: Withdraw 4% of the value of your savings in your first year of retirement. The following year, adjust that amount for inflation and make that withdrawal. For example, a retiree with $300,000 would pull out $12,000 in the first year. If inflation were 3% over the subsequent year, the next annual withdrawal would be $12,360 (the original withdrawal amount increased by 3%).

That magical 4% figure is the product of several studies, derived from historical investment returns and inflation (often using the Ibbotson series that begins in 1926). Most analyses assume a 30-year retirement, and while some studies have come up with a slightly smaller number than 4%, others have arrived at a somewhat bigger number. But 4% is the general consensus.

WHY IS IT CONSIDERED A "SAFE" WITHDRAWAL RATE?

The SWR aims to mitigate two risks:

1. **Market risk:** The 4% withdrawal rate has survived the worst investment conditions of the past century, including the Great Depression, as well as the crash of the "Nifty Fifty" large-cap stocks in the early 1970s and subsequent high inflation.

2. **Longevity risk:** Although most studies assume that retirees will live until their mid-90s, such an age is well beyond the average life expectancy. According to the Social Security Administration, the average 65-year-old male will live another 17 years and the average female another 20 years. So, assuming a three-decade retirement is playing it very safe.

For the 4% withdrawal rate to fail, markets would need to be worse than anything we've seen in the past century, and the retiree would have to live a long life. Historically, the odds of both of these things happening at the

Tips From an Early Retiree

John Greaney is the founder of www.retireearlyhomepage.com and a longtime Fool. John worked for several Fortune 500 companies in the oil and gas and chemical industries before he retired at age 38. He is a recognized expert on keeping your portfolio working long after you've quit your job. He offered these important considerations when managing a portfolio in retirement.

Asset allocation is key. Having a mix of both stocks and fixed-income securities in your retirement portfolio improves its long-term survival. Most of the safe retirement withdrawal studies found that a simple mix of 60% stocks (a broad-market index such as the S&P 500 or Wilshire 5000) and 40% fixed-income securities (usually bonds with five-year maturities) fared the best.

Tapping your nest egg. How you actually withdraw the money depends on your choice of investments and accounts. Start by spending the dividends and interest you receive from your investments in taxable (i.e., non-retirement) accounts. Then, factor in any required minimum distributions (RMDs) from your retirement accounts. After that, you'll have to decide between selling assets inside or outside your retirement accounts. That decision will depend on tax considerations and the individual investments, but consider selling whichever asset class needs to be reduced to get you back to the 60/40 allocation.

Keep fees down. A retiree holding mutual funds with an annual expense ratio of 1.5% or paying a financial advisor a similar fee, and then paying trading costs of an additional 1.0%, couldn't even safely withdraw 3% per year. In fact, a retiree holding the average mutual fund might be paying far more to his or her mutual fund manager than to the IRS.

	25-34 Years	35-44 Years	45-54 Years	55-64 Years	65-74 Years	75 Years and Older
Income Before Taxes	$58,609	$80,218	$82,149	$73,634	$52,604	$33,470
People in Household	2.8	3.3	2.7	2.1	1.9	1.6
Vehicles	1.6	1.9	2.2	2.1	1.9	1.3
Percentage With a Home Mortgage	32	50	50	43	31	13
Average Annual Expenditures	$47,738	$60,045	$62,627	$55,758	$48,006	$35,342
Food	$6,364	$7,833	$8,056	$6,710	$6,179	$4,220
Housing	$17,020	$20,530	$19,928	$17,778	$15,854	$12,859
Transportation	$8,859	$10,993	$10,852	$9,731	$8,199	$4,790
Health Care	$2,346	$3,662	$4,034	$4,606	$5,568	$5,267
Entertainment	$2,224	$3,078	$3,136	$2,664	$2,742	$1,545
Cash Contributions	$1,034	$1,484	$1,967	$2,069	$2,250	$3,054
Federal Income Taxes	$4,405	$8,159	$9,590	$8,993	$3,617	$1,074
State and Local Income Taxes	$1,599	$2,346	$2,579	$2,178	$887	$230

same time are very low. In an article in the *Journal of Financial Planning*, Michael Finke, Wade Pfau, and Duncan Williams estimate that a retiree has a mere 1.8% chance of experiencing significantly below-average markets and living well into his or her 90s.

YOUR MILEAGE WILL VARY

Although 4% is a good starting point, several factors could warrant a different SWR.

You're willing and able to spend less during down markets. The basic 4% rule assumes that the retiree needs a level of income that doesn't change except for inflation adjustments. However, some studies have found that retirees can choose a withdrawal rate above 5% as long as they're willing to decrease withdrawals during market slumps.

Here's a way to ensure your portfolio is never exhausted.

Rather than starting with an initial withdrawal rate and adjusting it annually for inflation, withdraw a percentage of the portfolio value every year — perhaps 5%, as many charitable endowments do. Thus, your income will rise and fall with the portfolio but will never be zero unless all your investments become worthless.

You plan to reduce spending later in retirement. As mentioned previously, spending tends to decrease as we age. For specifics, check out thes chart above, which displays select items from the Department of Labor's Consumer Expenditure Survey, according to the age of the head of the household.

Note that income peaks in the 45-to-54 age range, as does most of the spending. The expenses that drop the most, by far, are federal, state, and local taxes. Not surprisingly, health care is one of the few expenditures that rises. Perhaps surprisingly, "cash contributions" also increase. According to the survey, that category includes alimony, child support, and charitable contributions. I'm assuming that for the older folks, that money is much more about the latter category, and I must admit that I find it heartening that people seem to become more generous as they get older — even as their income goes down.

In his report "Estimating the True Cost of Retirement," David Blanchett (the head of retirement research at Morningstar) estimates that a 5% withdrawal rate has the same chance of success (that is, there's still money in the portfolio after 30 years) as the traditional 4% rate, as long as the spending pattern in retirement looks more like what most people actually experience. That essentially means that someone can get 25% more income from his or her portfolio when compared with ye olde 4% rule. Put another way, someone can retire with 20% less in the amount of savings required before he or she retires.

Thus, it might make sense to take out a bit more during the first few years of retirement as you enjoy this new stage of life, and then withdraw less later on as you slow down.

You have significant other sources of income. The more you rely on your portfolio to cover your expenses, the more you need to play it safe. However, the more other resources — such as a pension, Social Security, rental income, or an annuity — cover your must-pay expenses, the more

you nudge up your withdrawal rate. That way, even if the market tumbles and your portfolio takes a big hit, your basic lifestyle won't be threatened.

You think the market is overvalued. Several recent studies have discovered a relationship between market valuation on the eve of retirement and the SWR over the next 30 years — the higher the market's price-to-earnings ratio (as measured by the so-called P/E 10 or Shiller P/E), the lower the SWR. The current P/E 10, which uses the average of the previous decade's earnings (adjusted for inflation), indicates that the market is overvalued.

You retire earlier or later. You'll need to adjust your SWR for the assumed length of your retirement. People who retire in their 50s should take out less; folks who retire in their 70s can withdraw more.

STAY FLEXIBLE, FOOL

Even if you're not in or close to retirement, the 4% SWR is helpful for determining how much you'll need to accumulate before you can stop working. However, regardless of where you are along the road to retirement, it's important to remember that nothing is set in stone. Your income, expenses, and net worth will fluctuate after retirement just as they did beforehand. Throughout your life, you'll be best served by reviewing your personal income statement and balance sheet each year and adjusting accordingly.

Where Does Income Come From?

BY ROBERT BROKAMP, CFP®

Once you've decided how much you'll withdraw from your portfolio each year, the next questions are: Where will you get it? Which accounts should you tap first? And which investments should be sold?

There are actually many ways to do it. You can start by living off the interest and dividends paid by your investments. However, with the low yields from bonds and stocks these days, you could expect only a 2% to 3% yield from a diversified portfolio of stocks and bonds. So chances are you'll have to sell some investments.

WHAT TO SELL?

The decision about which investments will be turned into cash depends on five interrelated factors: required minimum distributions (RMDs), account types, asset allocation, taxes, and fees and other costs of selling. Let's take a closer look.

1. **Required minimum distributions.** Investors must begin taking RMDs from traditional IRAs whether they're retired or not. The same goes for owners of traditional and Roth 401(k)s, unless the account owner is still working for the company sponsoring the plan. So any account subject to RMDs should be the first place from which a retiree makes withdrawals.

2. **Types of accounts.** Generally speaking, the best route for most retirees is to liquidate assets in taxable (i.e., non-retirement) accounts first, and then move on to tax-deferred accounts, and tap Roth accounts last. So once the RMD issue is resolved, retirees should look to the investments in their taxable accounts.

3. **Asset allocation.** As mentioned earlier, one way to rebalance your portfolio once your asset allocation has strayed from where you think it should be is to sell the investments that should be pared back. Rebalancing your portfolio too often and without regard to taxes and costs can be counterproductive. However, when you have to sell an asset to produce

income, looking at the assets that have done well recently is a good place to start.

4. **Taxes.** Whenever you sell an asset, you have to consider the tax consequences. Withdrawals from retirement accounts are straightforward: money taken from a tax-deferred account is taxed as ordinary income, whereas qualified distributions from Roth accounts are tax-free (after-tax contributions to tax-deferred accounts also can be withdrawn without being taxed). It's when you sell investments in a taxable account that things get a little tricky. In such situations, consider the following:

- If you're holding on to investments that are underwater and you're not confident in their ability to resurface, it might be worthwhile to sell the investments and use the capital loss to reduce your taxable capital gains or income on your tax return.
- If you bought shares of the same investment at different times, designate the shares that result in the smallest tax bill when you sell. For example, if a few years ago you bought 100 shares of a stock at $15 a share, and then a year later you bought another 100 at $25 a share, sell the stock with the higher cost basis. On the other hand, if you have a year in which your income (and thus taxes) will be below what's normal for you, that might be a good time to sell the investments with the lower cost basis. Remember that investors in the 15% federal tax bracket and lower brackets don't pay any taxes on long-term capital gains and qualified dividends. Just make sure you actively designate with your broker which shares are being sold. Otherwise, the broker will use the default method, such as the first shares you bought (aka first in, first out).
- Gains from investments held for a year or less are taxed at a higher rate than gains on investments held for more than a year.

5. **Fees, penalties, and other costs.** Finally, consider the costs of selling an investment. Commissions might be involved, though they shouldn't be significant if you chose the right broker. Many mutual funds impose redemption fees or deferred sales commissions if shares are sold before a certain number of years. If you own an annuity, you may pay a surrender charge or penalty if you withdraw too much too soon. And if you're not yet age 59½, you might pay a 10% penalty on distributions from your retirement accounts.

Robert Brokamp is not an employee of Motley Fool Wealth Management. Robert is employed by The Motley Fool LLC for his work as Advisor of the Motley Fool Rule Your Retirement *newsletter and has been paid by Motley Fool Wealth Management LLC for this report. These views should not be relied upon as investment advice.*

THE FOOLISH BOTTOM LINE

There's no one-size-fits-all withdrawal strategy. Some Fools rely on their dividends for income and sell a little stock to make up the difference. Others reinvest their mutual fund distributions and instead live off their "income cushion" that gets replenished each year. Why reinvest fund distributions after you retire? For one reason: If you plan to liquidate your taxable accounts first, then you should keep reinvesting the dividends and interest paid by the investments in your retirement accounts until you begin making withdrawals from them.

One final thing. While we did briefly discuss possible equity/bond portfolio allocations, we never touched on which particular investments you should be making... or, far more important, how to identify the right investments to make once you have determined the allocation that you want.

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Nick Crow, CFA
President
Motley Fool Wealth Management

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