Improving Your Finances

Get a Plan for In-Retirement Withdrawals

By Christine Benz | 12-17-09 | 06:00 AM | E-mail Article

My upcoming book, *30-Minute Money Solutions*, provides guidance on completing 36 financial-planning tasks, each in a half hour or less, including how to prepare your portfolio for withdrawals in retirement. This was an issue acutely faced by Jack and Catherine, a couple who e-mailed me in 2009 seeking direction on how to invest during their impending retirement.

Both were in the process of stepping back from demanding careers--Jack as an executive at a large pharmaceutical firm and Catherine as a hospital administrator. Although they had amassed more than enough money to retire--their combined portfolio totaled more than $2.5 million--their portfolio was, in Jack's words, "a mess."

Jack, who had been in charge of the couple's investments for most of their lives, used the "all-you-can-eat buffet" approach to portfolio management, meaning that their investment accounts consisted of a little bit of this and a little bit of that. He had sought the advice of advisors for portions of their portfolio and used the DIY method for other accounts. In all, this couple had more than 80 separate holdings, both individual stocks and bonds as well as traditional mutual funds and a few exchange-traded funds thrown in for good measure.

And because both partners had logged busy careers with multiple employers, the couple's portfolio was a crazy quilt of multiple brokerage accounts, IRAs (both traditional and Roth), and company retirement plans.

Their question wasn't whether they could retire--they clearly could. Instead, they were wondering how to retire. Before they said farewell to the working world, they had to position their portfolio for withdrawals during retirement, determining which accounts they would draw on first and which they would tap later in retirement (or perhaps not at all).

But, you may be wondering, why does it even matter? After all, money is money, and a $1,000 withdrawal to cover monthly expenses during retirement is still $1,000, right?

Not exactly. In fact, by sequencing your withdrawals properly, you can help make your overall retirement nest egg last longer.

Taxes are a key reason why. To the extent that a retiree has both taxable and tax-sheltered assets like IRAs and company retirement plans, it's best to hold on to the assets with the most generous tax treatment the longest, thereby "stretching out" the tax benefit.

There isn't a one-size-fits-all sequence of withdrawals; your age and your tax rate when you take withdrawals also play a role. But assuming that you have more than one pool of assets to draw on during retirement, the following sequence makes

sense for many retirees:

1. If you're over age 70 1/2 , your withdrawals should come from those accounts that carry required minimum distributions, or RMDs, such as traditional IRAs and company retirement plans. (You'll pay penalties if you don't take these distributions on time.)

2. If you're not required to take RMDs or you've taken your RMDs and still need cash, turn to your taxable assets. Start by selling assets with the highest cost basis first and then move on to those assets where your cost basis is lower (and your tax hit is higher). Relative to tax-deferred or tax-free assets, these assets have the highest costs associated with them while you own them, so it makes sense to deplete those first.

3. Next, move on to any accounts funded with nondeductible contributions, such as traditional nondeductible IRAs.

4. After that, tap company retirement plan accounts or traditional IRAs funded with pretax contributions.

5. Finally, tap Roth IRA assets.

The sequence in which you tap your accounts will, in turn, help you determine how to position each pool of money. The money that you'll draw upon first--to fund living expenses in the first years of retirement--should be invested in highly liquid securities like CDs, money markets, and short-term bonds. The reason is pretty commonsensical: Doing so helps ensure that you're taking money from your most-stable pool of assets first, and therefore you won't have to withdraw from your higher-risk/higher-return accounts (for example, those that hold stocks or more-risky bonds) when your account is at a low ebb. That strategy also gives your stock assets, which have the potential for the highest long-term returns, more time to grow.

To find the right sequence of in-retirement withdrawals, you'll need:

- An estimate of your annual spending needs for the next three to five years
- Most recent statement for all retirement accounts

Start the Clock

Step 1
Every retiree should have two to five years' worth of living expenses set aside in highly liquid (that is, checking, savings, money market, CD) investments at all times.

Once you've arrived at the amount of cash that you need to have on hand, determine if your RMDs will cover your income needs for the next two to five years (if you're older than 70 1/2).

If you're not 70 1/2 and/or your RMDs won't cover your income needs, see if your taxable account will cover your income needs over the next two to five years.

If your taxable account doesn't cover two to five years' worth of living expenses,

carve out any additional amount of living expenses from your IRA or company-retirement-plan assets using the sequence outlined above.

Step 2

Once you've set aside your cash position, put in place a plan to periodically refill your cash stake so that it always will cover two to five years' worth of living expenses.

Step 3

Next, determine a sequence of withdrawals for your longer-term assets, based on the guidelines provided above. The accounts you tap sooner should be in relatively more-liquid investments than those you tap later in retirement. (Chapter 30 discussed how to create an appropriate stock/bond mix for your in-retirement portfolio.) Your longest-term, riskiest assets should go in your Roth IRA or 401(k).

Next Steps

- The preceding has focused primarily on retirees who are older than age 59 1/2, the age at which you can begin tapping retirement accounts without penalty. However, if you're between 55 and 59 1/2 and you left your employer after you turned age 55, you can tap your 401(k) without penalty. (You will pay taxes, however, as with all 401(k) distributions.)
- While taxable assets usually go in the "sell early" bin, that's not true if you have highly appreciated assets and plan to leave money to your heirs. If, for example, you own stock that has appreciated significantly since you bought it (and you have no way of offsetting that gain with a loss elsewhere in your portfolio) you may be better off leaving that position intact and passing it to your heirs. The reason is that your heirs will receive what's called a "step up" in their cost basis, meaning that they'll be taxed only on any appreciation in the security after you pass away. If you have a lot of highly appreciated securities in your portfolio (lucky you!), an accountant can help you sort through your options.

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Christine Benz is Morningstar's director of personal finance and author of 30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances, due out in January 2010. She is also editor of a monthly newsletter, PracticalFinance, and author of the Morningstar Guide to Mutual Funds: 5-Star Strategies for Success. Follow Christine on Twitter: @christine_benz and on Facebook.

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