How to RIG Your Retirement

What are you going to do with your retirement years? Are you going to continue to work? Will you play golf every day? Travel the world? Volunteer? Spoil your grandkids? All of the above? Whatever you choose for yourself, we hope it's something meaningful and enjoyable, and that your retirement is a long and healthy one.

But speaking of the idea of having a long retirement, there are many financial questions that loom. Will your retirement income be fixed at a certain dollar amount each year, or will it grow along with inflation? Will your nest egg be locked up in a financial security you're not able to easily sell, or will it be liquid in case you need to access it for a large unforeseen expense? If prevailing interest rates do eventually rise to a more normal level, how will that impact your retirement income? Or, to sum all the questions up into one….. which will live longer—you, or your money?

Two Hundred and Ninety-Two Roads Diverged In a Wood

To address those questions, the financial services community has come up with a bevy of possible solutions, collectively known as Retirement Income Generators (RIG). From Social Security to annuities (both immediate and variable) to reverse mortgages and more, including continuing to work part- or full-time, there are literally hundreds of options for today's retirees to RIG their portfolios in such a way to be able to earn enough income to fund their lifestyle.

In fact, according to a recent report by the Stanford Center on Longevity and the Society of Actuaries, there are 292 distinct retirement income strategies available to Americans today. The study's authors evaluated a variety of hypothetical retirees (e.g., a single 65-year old female with $250,000 in savings, a married 65-year old couple with $400,000, etc.) under each of those 292 scenarios, to see which ones fared best.

Examining each scenario against eight variables (e.g., inflation protection, liquidity, probability/magnitude of income shortfall), the study quickly eliminated from consideration 271 of the possibilities, since their results were so clearly sub-optimal compared with the other 21. Of those remaining 21 systems, one showed itself to meet more retirement planning goals than any other.

Quite Possibly the World's Perfect Retirement System

Do you remember those old commercials for Chiquita bananas, which claimed that the banana was "quite possibly, the world's perfect food"? Well, according to the Stanford/Actuaries study, you have the U.S. government to thank for creating "close to the perfect retirement income generator." The Social Security system we each participate in does more to address retirees' financial needs than any other:

* it maximizes the amount of expected lifetime retirement income
* it minimizes income taxes

* it protects against some big and common threats such as
  - longevity
  - poor investment choice
  - cognitive decline leading to clerical errors
  - inflation
  - spousal death
  - fraud

Since Social Security is such a valuable benefit and tends to make up the majority of the income most American retirees earn, the study's authors urge retirees to seek to maximize their monthly Social Security check. The most common way to do this is to delay as long as possible the start of benefits for the primary wage-earner of the household. Each family's situation is unique, though, so depending on the physical and financial health of the family, other strategies may be preferable. The Social Security Administration has a free online tool to help retirees make this important decision.

All of these are fantastic selling points for the safety net we call Social Security. However, there is one important drawback: it's not enough. That is, the income most people receive through Social Security payouts is not high enough to fund the lifestyle they are accustomed to. We need to find another RIG to supplement our retirement income.

The Best Auxiliary RIG

The authors of the study evaluated all the options and have endorsed one in particular that works best. They advise retirees to think of the income they receive from Social Security as their "retirement paycheck" and the income they receive from this auxiliary RIG as a sort of "retirement bonus." The "paycheck" should be used to pay for basic living expenses, and the "bonus" (which is an apt metaphor, since its value can fluctuate from year to year) could be used for more discretionary items.

Here is how to come up with the amount of that bonus. Think of your personal retirement savings as a sort of endowment. During your working years, you were presumably investing your money primarily in stocks, which have a great deal of volatility but also have the highest expected long-term returns. Now you will be withdrawing money from your portfolio, similar to the way a university pays for part of its operating expenses by withdrawing from its endowment.

The traditional allocation for a university endowment is something along the lines of having 60-65% of its assets invested in stocks, 30-35% in bonds, and around 5% in cash. From that portfolio, an endowment will typically withdraw about 4% per year. You should aim to set up your portfolio in a similar fashion.

In practical terms, that means that for every $100,000 you have in personal retirement savings, you can withdraw $4,000 each year as your "retirement bonus." A hypothetical $600,000 portfolio, then, would be able to provide you with $24,000 of income each year, over and above what you receive from Social Security.

You are a person with a definite life expectancy, though, not an endowment with an indefinite lifespan. So while 4% may be a suitable number for you in your 60s, you may safely increase that percentage once you enter your 70s and beyond. In fact, the IRS has a handy table you can use to determine what percentage to use once you reach a certain age. It takes your actuarial life expectancy, adds a bit to that to come up with something called a Distribution Period, and then divides that into 1 to determine your annual withdrawal rate. For example, a 75-year old has a life expectancy of around 13 years. Adding around 10 to that, for the sake of a margin of safety, gives a Distribution Period of 22.9 years. And 1 ÷ 22.9 = 0.0437, or 4.37%.

Age	Distribution Period	Withdrawal Rate
73	24.7	4.05%
74	23.8	4.20%
75	22.9	4.37%
76	22.0	4.55%
77	21.2	4.72%
78	20.3	4.93%
79	19.5	5.13%
80	18.7	5.35%
81	17.9	5.59%
82	17.1	5.85%
83	16.3	6.13%
84	15.5	6.45%
85	14.8	6.76%
86	14.1	7.09%
87	13.4	7.46%
88	12.7	7.87%
89	12.0	8.33%
90	11.4	8.77%

source: Internal Revenue Service

A Word of Caution

Note that, in order for all of this to work, a retiree must have accumulated sufficient savings—in her 401(k), IRA, or regular investment accounts—to be able to fund this strategy. You can't wait until you're ready to retire and then magically wish into existence a portfolio large enough to pay for your living expenses out of its 4% annual withdrawals.

Each year leading up to retirement, you must be diligent about putting away a portion of your income, investing it in the best vehicle for long-term compounding of wealth (i.e., stocks), and not touch it until you need to. That means you should not take any early withdrawals from your IRA or 401(k), in which case the IRS will exact its pound of flesh via a 10% penalty, or take any loans against your 401(k) balance. Once the money enters the 401(k), just leave it there and let the magic of compounding do the rest.

Also, this plan does not address other important risks such as catastrophic injury or illness which may require long-term medical care. While those cannot be ignored, they fall outside the scope of this study which is primarily financial in nature. Medicare, Medicare supplement policies, and long-term care insurance are just a few ways to deal with these issues, but they should be dealt with in addition to the considerations of this topic.

Retirement Recap

Here is a quick summary of the important points from this discussion:

* Develop a plan and stick to it.

* Maximize your Social Security benefits by delaying their start as long as possible.

* Avoid high-cost, illiquid vehicles such as variable annuities.

* Try not to consider reverse mortgages, except as a very last resort. The Consumer Financial Protection Bureau not only says they are "complex products and difficult for consumers to understand," but they also carry the "risk of fraud and other scams."

* During your career, salt away a portion of your income each year into a 401(k), IRA, or other tax-advantaged account. As much as possible, invest these funds in low-cost stock funds.

* When you do reach the point of retirement, think of Social Security as a paycheck to fund your basic living expenses. Your annual bonus, which will fluctuate, can be taken as a 4% (or more, if you're older) withdrawal from your personal retirement savings.

* Finally, and most importantly, enjoy yourself!

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