

Tools and Pools

Strategies for Increasing Retirement Cash Flow

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Before they retire, most clients concentrate on rates of return and on how much portfolio volatility they can live with. At and near retirement, however, their objectives change. They become concerned with how to maximize the size of the check in the mail each month and ensure that those checks will continue to arrive throughout their lifetime.

Advisers need to make the same philosophical and psychological shifts to meet the changing objectives of their retiring clients. To redesign their clients' portfolios, they need to understand the *tools* available that may increase retirement income in ways that will not prematurely exhaust capital. The next step is to help their clients manage their total assets in ways that meet multiple retirement objectives. They can accomplish that by assigning a separate *pool* of financial resources to support each objective and by using the tools to create a separate investment strategy and cash-distribution strategy for each pool.

This chapter reviews some of the traditional approaches to retirement-income distribution still used today, discusses their limitations, and offers methods that can make planning retirement income a far less risky business.

Conflicts and Hazards

As advisers consider how to help retiring clients restructure their portfolios, it's useful for them to understand that their clients may have two frequently competing objectives for using their assets: First, retirees want

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to live off income and leave principal for their heirs. At the same time, they want to create maximum lifetime income, and they're willing to consume principal to achieve this.

To achieve the first objective, retirees consume only the income from their portfolios, which can include dividends, interest, and portfolio appreciation. This is the total-return approach in which all categories of earnings are available for distribution. It's logical to adjust for inflation and calculate income and principal left to heirs in real terms.

With the second objective, retirees strive to maximize lifetime income and are willing to consume principal, leaving nothing for heirs. Logically, consuming capital maximizes cash flow. All other approaches provide less income. Many retirees will choose a combination of these two objectives.

Retirees and their advisers face three unknowns, or risks, as they plan lifetime income:

- The cost of future living expenses, including medical expenses
- Future portfolio returns
- Longevity risk, or how long each retiree will live

Clients face these risks at every stage in the life cycle, but they are particularly important for retirees, who have few options to restore capital once it's spent.

Living expenses. Future retirement costs are a function of future inflation, changes in lifestyle, and future medical advances and their costs, all of which are, of course, unknown. These costs can vary tremendously. The risk of cost increases is borne by the retiree, supporting family members, prior employers, and the government.

Employers and the government increasingly find that assuming the risk for these future costs is untenable and that doing so may even threaten the survival of the entities providing such benefits. Few employers index pensions for inflation, and most now cap medical insurance assistance. The government is also concluding that accepting unlimited risk for inflation and medical costs creates too large a burden for taxpayers. We are in the midst of a national debate about shifting some of these costs back to retirees through Social Security, Medicare, and Medicaid reforms. The net result is that retirees bear much of the risk for these future costs and their share of the risks will likely increase.

For those still saving for retirement, the solution for handling the risk of future increases in living expenses is to amass as large an asset base as possible before retiring. For retirees with a fixed asset base that isn't going to increase, the solution is to maintain flexibility. That means making as few irreversible decisions as possible. Fixed costs should be kept to a minimum. Expenses should be kept discretionary. Portfolios should be kept as

large as possible. Once money is spent, it cannot be spent again at a later date to meet another need.

Portfolio returns. Future portfolio returns are unknown. The adviser and the retiree do not know how much future income can be drawn off a portfolio to live on. Long-term bonds or guarantees by insurance companies can provide some certainty, but their rates are well below what many retirees will wish or expect to receive from their entire portfolios. The rates are low, of course, because the entity issuing the bonds or the guarantees assumes the investment risk.

Like protecting against the risk of unknown future costs, the primary tools for protecting against unknown future portfolio returns are to maintain flexibility in making cash distributions and to keep surplus resources. Techniques that lock in portfolio management or distributions do not provide the flexibility retirees need to deal with unexpected events.

Longevity risk. Longevity risk arises because no one knows how long an individual will live. Retirees may live longer than they anticipate, and outliving their resources has severe consequences.

Longevity risk is one of the three risks that a third party is willing to assume. Insurance companies are uniquely capable of handling these risks by spreading the risk over a large number of individuals.

Advisers must deal with these three risks when designing strategies for retirees. Ironically, the first two risks discussed require maintaining flexibility, whereas protecting oneself against longevity risk can be handled by purchasing an immediate annuity from an insurance company, an irrevocable decision. Whether or not to make an irrevocable decision such as this is one of the many trade-offs a retiree will have to make. Advisers need to understand how to help their clients weigh the consequences of these trade-offs.

Tools

Financial advisers use two basic techniques to help create retirement cash flow:

- Withdraw only income from the portfolio.
- Withdraw both income and a portion of principal, doing so in a way that will not put the retiree in danger of outliving the principal.

Advisers and retirees need to fully understand all the tools available to implement one or more cash flow strategies. Some tools increase distributions more than others. Some are more complex than others. Financial advisers need to help retirees choose the specific implementation tools that best meet the retirees' objectives.

Taking Income From the Portfolio

1 *The unplanned approach: Taking withdrawals as needed.* Using this tool, retirees take what they need without regard to the ability of the portfolio to generate cash flow. This approach is entirely without a plan. Some retirees will spend too little, penalizing themselves with too little income and leaving too much for heirs. Others, in their early retirement years, are likely to spend at levels that the portfolio cannot sustain, leaving themselves impoverished in their later years. The unplanned approach, however, may work for very wealthy retirees whose portfolios' income-generating capability exceeds their income needs.

2 *Living off dividends and interest.* This is the approach followed by many of our parents and grandparents, who believed they should "never use capital." If the retiree never uses capital, he or she will most likely never run out of capital. If interest rates are about 5 percent and dividends are 2 percent, a portfolio's distribution will be between the two amounts, depending on the portfolio's mix of stocks and bonds. Annual distributions will vary based on many factors, but they're likely to be relatively stable and predictable. Over time, if stock appreciation adds to the portfolio's value, the retiree receives an increasing cash flow as dividends grow and through increased interest after rebalancing to buy more bonds. Other benefits of the approach include the built-in bias for long-term appreciation and the ease of understanding and implementation.

The primary disadvantage of this approach is that annual cash distributions are likely to be significantly lower than other options provide and lower than what the portfolio is capable of distributing. Greater cash flow is very important to many retirees, so this disadvantage can be significant. To generate more current cash flow from their portfolio, retirees may overweight bonds, which, over longer periods, historically have provided lower rates of long-term return than stocks, and thus reduce the total return of the portfolio, a second disadvantage.

3 *Taking a fixed dollar amount.* A retiree using this tool regularly withdraws a fixed amount from the portfolio. For example, a retiree might withdraw \$50,000 annually from a \$1 million portfolio. Once set, this amount may remain unchanged for many years. Because individuals frequently have greater trouble making decisions as they grow older, adjusting this number up or down may be difficult to do later in life even if such a change will better a client's situation.

The approach does have advantages, however: it's easy to administer and it makes it easy for the retiree to budget expenses. Because future returns are unknown, however, retirees either will take out less than the portfolio can sustain and thereby increase the amount they leave to heirs,

or they will take too much from the portfolio in their early retirement years and face reduced income in their later years.

4 *Taking a fixed amount and adjusting withdrawals for inflation.* This tool takes the fixed dollar amount in tool 3 and increases it each year by the amount of inflation. In doing so, the retiree retains the benefits of the fixed-dollar approach but also receives increased income to offset inflation.

This option receives wide recognition in the literature. There are many articles discussing how an individual with a \$1 million portfolio invested approximately 60 percent in stocks and 40 percent in bonds can withdraw \$40,000 to \$50,000 per year plus inflation and have a 90 percent chance of not exhausting principal. Monte Carlo simulations are used to support this conclusion. The analysis has a bearing on determining appropriate stock/bond allocations for retirement portfolios and helps one calculate how much should be saved before retirement begins. The distinction, however—and it's critical—is that this analysis is not useful for determining how much cash should be withdrawn from a portfolio each year once retirement has begun. The approach is rigid and inflexible.

Because of the frequency with which this tool is discussed in professional magazines, let's look at a similar problem to show why the approach may not be practical. When NASA prepares to launch a rocket, it runs massive computer models to determine the parameters such as direction and thrust needed to make the launch. This preparation is similar to using Monte Carlo simulations in determining the amount of assets needed before retirement and in establishing the initial portfolio composition and withdrawal rates.

Once the rocket is launched, NASA monitors its progress and periodically adjusts its course. NASA does not launch the rocket and consider its work done. Without ongoing adjustments, the rocket has little chance of reaching its destination. Monitoring and adjusting are necessary for managing retirement portfolios, just as they are for sending rockets into space. In an ever-changing world, periodic adjustments must be made so that retirees can stay on track for meeting their objectives.

The problem with inflexible tools is that they do not allow for those periodic changes needed to meet real-life dynamics. Because future events such as annual returns are unknown, sticking to a rigid, predetermined formula virtually assures retirees will either withdraw too little or too much, either of which means less-than-optimal use of their retirement resources.

Maintaining flexible withdrawals, as do the tools described below, makes it likely that retirees over time will be able to exceed the withdrawal rates projected by the Monte Carlo simulations. Flexibility, meaning the retiree's ability and willingness to cut back on spending in poor

markets, helps assure that excessive withdrawals will not prematurely deplete the portfolio. The 90 percent odds of success—or 10 percent odds of failure—projected by Monte Carlo simulations are not good enough. Financial advisers must do better.

5 *Withdrawing a constant percentage of the portfolio.* Using this tool, a predetermined percentage of the portfolio value—6 percent, for example—is withdrawn each year. Because the withdrawal rate is fixed, the amount withdrawn changes as the portfolio value changes. After a series of bad years, the withdrawal amount will have dropped. Similarly, retirees will benefit from increased distributions after a series of good years. Although the income reductions may cause discomfort, the retirees should never exhaust their principal. The challenge is to determine an appropriate withdrawal rate. Choosing a low rate is likely to lead to increasing portfolio value over time, with commensurate increases in annual distributions. Choosing a high rate runs the risk that the portfolio will drop in value, with a commensurate reduction in annual distributions.

6 *Following the IRS minimum-distribution rules.* This tool applies only to an individual retirement account and begs the question of what to do with a taxable account. On the positive side, retirees who have all of their assets in IRAs and follow the new minimum-distribution rules to help determine their retirement cash flow are not likely to exhaust the principal in their IRAs. For example, assume that a husband and wife with a \$1 million IRA take \$37,736 at age 70½ as their first-year distribution. If their portfolio returns 7 percent per year, by the time they are 80, the withdrawal amount increases to \$65,358, and when they're 90, it will be \$90,914. Because of the low distribution rate in early years, the value of the IRA is likely to grow to a maximum of \$1,335,000 by age 85 before beginning to drop.

For most retirees, there is a difference between the withdrawal amount the IRS requires and the optimal withdrawal needed for living expenses. Some may want to consume their IRA capital at a higher rate to meet their needs. Others could reinvest the excess withdrawals not needed to meet expenses in a taxable account and save the money for future expenses. The minimum distribution required by the IRS is not usually equal to the retiree's needs.

7 *Varying the annual distribution, based on portfolio performance.* Retirees willing and able to periodically adjust cash distributions to reflect portfolio performance can make higher withdrawals over time while still avoiding most of the risk of prematurely exhausting their capital.

One way of doing this is to set up two separate distributions. The first, a base payment, is an amount that the portfolio can sustain even in bad times. The second, a performance distribution, is based on how a portfolio performs. The performance distribution is higher in good years and cut

Developing a Flexible Formula for Determining Annual Withdrawals of Dividends and Interest

The client and adviser determine an annual withdrawal formula that includes:

- A percentage of the portfolio's value that will be taken as a base payment
- A percentage of portfolio returns in excess of the base payment to be taken as a performance payment

Returns in excess of this base payment are reinvested in the portfolio. For example, if a client decides to withdraw:

- A base payment of 4 percent and
- A performance payment of 40 percent of the returns in excess of the base, then

$$\text{Portfolio value} \times 0.04 = \text{Base annual payment}$$

$(\text{Portfolio value increase in excess of 4 percent}) \times 0.40 = \text{performance payment}$

$(\text{Portfolio value increase in excess of 4 percent}) \times 0.60 = \text{increase in portfolio value}$

If the retiree's portfolio value for the year is \$1 million, then:

Retiree's base annual payment	$\$1,000,000 \times 0.04 = \$ 40,000$
Portfolio annual return	$\$1,000,000 \times 0.12 = \$120,000$
Increase in excess of 4 percent annual base	$\$120,000 - \$40,000 = \$ 80,000$
Performance returns distributed to retiree	$\$80,000 \times 0.40 = \$ 32,000$
Increase in portfolio value	$\$80,000 \times 0.60 = \$ 48,000$

Retiree's cash withdrawals for this year

\$40,000 base + \$32,000 performance bonus = \$ 72,000

back or even eliminated in bad years. To simplify administration, the performance distribution can be based on the prior year's performance and, therefore, always would lag portfolio performance by a year.

For example, a retiree with a \$1 million portfolio sets a base withdrawal of \$40,000 per year, or 4 percent of the portfolio's value. The retiree budgets his or her fixed expenses based on this amount. In bad markets, he lives on only this amount. There are many ways of setting a formula for the additional performance distribution. The retiree could distribute 40 percent of the annual return that exceeds the 4 percent base amount. The retiree could use this performance distribution for discretionary expenses, such as a new car, travel, or gifts to children and charity. The remaining 60 percent is left in the portfolio to add to capital to offset losses in bad years or to build the portfolio so as to provide higher base distributions in years to come.

If the total portfolio return in the example in the sidebar was 12 percent, the performance distribution would be \$32,000, providing a total distribution including the base of \$72,000. Total return is 7.2 percent—higher than what most advisers would typically consider a prudent withdrawal when using a rigid system.

A flexible distribution system can be structured in many ways. The retiree's flexibility and willingness to cut back in bad years protect the portfolio against the damage that occurs when large withdrawals are made from a portfolio after it has dropped in value.

The primary disadvantage with this option is that it requires the retiree to be willing and able to cut back in bad years. Many may not be in a position to do that. Flexibility permits one to take out larger amounts, with the understanding that cutbacks must be made when bad markets occur.

Consuming Capital

The way to maximize retirement cash flow is to consume capital. Most of the tools discussed below assume the retiree desires a cash flow that's guaranteed for a lifetime. There may be situations, however, in which retirees plan to consume a particular sum for a specific number of years and not for their entire lives. If retirees are assured lifetime income, they may see depleting a portion of their surplus capital as a logical choice for generating additional retirement cash flow.

Many retirees who want to consume capital want assurance that they won't outlive their capital. Providing guaranteed lifetime income requires finding ways to manage longevity risk—the risk of outliving one's financial resources. Insurance companies are prepared to assume that risk. By spreading out the risk over a large number of individuals, insurance companies can make a profit and still assume the risk that some people will live long lives. The product they offer to manage longevity risk is called an immediate annuity. It's the reverse of life insurance. People buy life insurance when they are concerned about dying early. They buy an immediate annuity when they are concerned about living too long.

Many people, including many financial advisers, view consuming capital as a financial sin. Therefore, they automatically reject the use of immediate annuities or any other retirement tool that calls for capital consumption. This attitude is by no means universal, however. At universities, where the employees are accustomed to 403(b) plans, annuities, and the concept of annuitization, potential retirees are far more receptive to using immediate annuities. As baby boomers with limited resources begin to face retirement, buying an immediate annuity or annuitizing a deferred annuity will become a much more interesting option for them to consider.

The increase in income from an immediate annuity can be significant. **FIGURE 14.1** compares the cash flow from an immediate fixed annuity with the cash flow from a 25-year government bond. Because underlying investments are similar (high quality with fixed payments guaranteed by the issuer), the example shows the increased income resulting from consuming capital with lifetime payment guaranteed by an insurance company. The immediate annuity for a couple, both age 65, provides 37 percent more income than the government bond.

If a 70-year-old couple purchases the annuity, the increase in income is 50 percent. The older the retirees are, the greater the increase in income they can realize. At age 80, the increase would be 101 percent.

With today's interest rates considerably lower than they were several years ago, annuity payments have dropped. However, the return on gov-

FIGURE 14.1 *\$100,000 Investment:
Joint Survivor With Husband and Wife, Life Only,
Current 25-Year Treasury Bond Is 4.85%**

AGE	ANNUITY		TREASURY ANNUAL	INCOME INCREASE
	MONTHLY	ANNUAL		
65	\$554.55	\$6,654.60	\$4,850	37%
70	607.78	7,293.36	4,850	50
75	688.78	8,265.36	4,850	70
80	811.21	9,734.52	4,850	101
85	992.37	11,908.44	4,850	146

*All data obtained January 12, 2005.

ernment bonds has also dropped and the relative advantage of the immediate annuity is still substantial.

Age 65 is probably the earliest a retiree should purchase an immediate annuity. The increased payment from capital consumption before this age is too small to offset the disadvantages of making the irreversible decision of consuming capital to buy the annuity. The increased cash flow from depleting capital is spread over so many years that it becomes questionable whether the small increase in payment is worth the loss in flexibility inherent in buying an immediate annuity. Two kinds of immediate annuities are available: fixed and variable.

Immediate fixed annuities. With an immediate fixed annuity, the insurance company sets and guarantees the amount of a retiree's monthly payment for life. The insurance company manages the funds and assumes both the investment risk and the longevity risk. Payment is an obligation of the insurance company and cannot change, no matter what happens to interest rates.

Immediate variable annuities. With an immediate variable annuity, the insurance company assumes the longevity risk, but the policyholder picks up the investment risk. The retiree chooses among investment options that the insurance company makes available in a way similar to the choices offered under deferred variable annuities. Monthly payouts vary according to how the selected investments perform.

The primary reason for choosing an immediate variable annuity rather than a fixed variable annuity is the expectation that the retiree, by picking up the investment risk, will be able to do better than the guarantee provided by the insurance company. The insurance company has higher internal costs, so the return must be high enough to cover these and still do better than the immediate fixed annuity.

Immediate variable annuities provide the benefits of allowing the investor to maximize cash flow and receive a lifetime guarantee while still managing a portfolio invested in stocks and bonds. Depending on how the investments perform, this can be good or bad.

Comparing the immediate variable products offered by the insurance companies can be difficult and complex. The offerings have many moving parts and the insurance companies add a lot of bells and whistles, making it difficult to understand what the contracts actually cost. The adviser may need to go beyond a simple reading of the prospectus and conduct independent analysis to fully understand how various products compare. (FIGURE 14.2 provides one way to compare two policies.) Because of this, when structuring a portfolio that contains both traditional assets and immediate annuities, my preference is to use immediate fixed annuities to fill the retiree's needs for both fixed income and income that can't be

outlived and use immediate variable annuities only if even more guaranteed lifetime income is desired. Shopping for immediate fixed annuities is relatively easy: find out the monthly payout that similarly rated insurance companies quote for the same investment and take the best deal, while retaining a preference for using only a quality insurance company.

FIGURE 14.2 *Immediate Variable Annuity Comparison*

\$100,000 INVESTMENT MONTHLY DISTRIBUTION*

YEAR	COMPANY A	COMPANY B
1	\$559	\$568
2	\$557	\$566
3	\$555	\$563
4	\$553	\$561
5	\$551	\$558
6	\$549	\$556
7	\$547	\$553
8	\$551	\$558
9	\$542	\$549
10	\$540	\$546
11	\$538	\$544
12	\$536	\$541
13	\$534	\$539
14	\$532	\$537
15	\$530	\$534

ASSUMPTIONS USED

Husband and wife, both age 65, joint life only

Insurance charges 1.10% 1.25%

Portfolio admin. expense 1.00% 1.06%

Nonqualified money, assumed investment rate 5%, gross return 7%.

*All data obtained February 2005.

Figure 14.2 shows the projected 15-year payouts for immediate variable annuity illustrations provided by two popular insurance companies (A and B). Comparing immediate variable annuities is best done by looking at their performance over time, not just for one year. That's because salespeople have tricks for making the first-year numbers look good.

In buying an immediate variable annuity the client selects an assumed investment rate (AIR). The insurance company then quotes what the initial payout will be for that AIR. Future performance determines what the future payouts will be. If the actual performance over time (net after costs) is better than the AIR, the payouts will exceed the forecast. Similarly, if the performance is worse, the payouts will be less. Choosing a high AIR will make the product look good in the first year but will likely lead to disappointment in future years. For the illustration in Figure 14.2, the AIR is set at 5 percent for both Company A and B. In creating projections, the adviser also must select a predicted gross return of the underlying portfolio. In this example, the gross return is assumed to be 7 percent. Costs are 2.1 percent to 2.3 percent so net performance is a little below 5 percent. What can we learn from this chart?

First, because the monthly payouts projected over 15 years for the two companies are relatively close, we can conclude that these two products have a similar design. The selection of one company over the other would, then, depend on other factors such as the underlying investment choices, the credit rating of the insurance companies, and the quality of service the companies provide. Second, the payouts for both drop over time. This implies that the gross return on the funds will need to be higher than 7 percent to maintain the original payout. Costs are slightly higher than 2 percent, the difference between the 7 percent predicted gross return and the 5 percent AIR, and thus, with a net return below 5 percent, the payout drops over time.

Figure 14.2 shows the initial payout (\$559 to \$568 per month), a cash return of 6.7 percent, is considerably higher than could safely be withdrawn from a traditional portfolio. No surprise there; this is a characteristic of an immediate annuity. What's interesting is that the payouts from the immediate variable annuity are approximately the same as the \$554 per month from the riskless immediate fixed annuity (Figure 14.1). A retiree should think pretty hard about whether he or she wants to take the additional risk inherent in these immediate variable annuities, because they require at least a 7 percent return to match the guarantee of the immediate fixed annuity.

This multiyear analysis technique also can be used to compare the performance of a base policy against a policy with enhanced provisions to show the cost of the enhancements. A client might question whether an enhancement with 3 percent in total costs requiring at least an 8 per-

cent gross return to maintain a 5 percent AIR is worth purchasing.

Writing about immediate annuities in *The Investment Think Tank*, edited by Harold Evensky and Deena Katz (Bloomberg Press, 2004), Ibbotson, Henkel, and Chen used efficient-frontier software to integrate the asset-allocation question and the question of how much of a portfolio should be annuitized (both fixed and variable). They concluded that immediate annuities are an effective way to address longevity risk and that their use reduces the odds of prematurely exhausting principal. This should not come as a surprise, because managing longevity risk is the function of immediate annuities.

Managing Cash Flow

Using financial-management tools can make a dramatic difference in a retiree's life. Those entering retirement with portfolios that are smaller than they would like will find these tools particularly helpful, as they provide ways to maximize the retirement cash flow from their limited resources. Those with limited resources have little room for error and have the most to benefit from sound planning. Using the tools to increase a retiree's cash flow, however, doesn't complete the job of retirement planning. By dividing the retiree's cash flow into several pools—each managed to help the retiree meet a specific goal—an adviser can help that retiree successfully achieve multiple objectives.

Pools

The pools system is a method for using the tools described earlier to structure and manage a portfolio to meet a client's multiple retirement objectives. Creating an investment portfolio strategy when there are multiple and often conflicting objectives is challenging, and it's frequently impossible for an adviser to create an optimum strategy. Segregating a retiree's different objectives and dedicating a separate pool of assets to each objective make this problem manageable.

Clients like the pools system. Psychologists have found that people are comfortable segregating their assets based on the expected use, and using the term "buckets" or "pools" to describe the system has widespread appeal. Financial planners can use the pools concept to create financial plans that are not only more likely to meet multiple objectives but also easier for clients to understand.

Identifying the Pools

Creating a separate pool for each of the retiree's objectives is the start of the process. The investment strategy for each pool is then customized for

its objective. No longer does an adviser have to struggle to make a single portfolio strategy meet multiple objectives.

Creating pools is a very flexible technique. To develop the optimal mix of pools for the individual, advisers need to help each client articulate his or her goals and concerns. Each individual will be different, but there are five pools that I find cover most retirees' basic objectives.

Pool 1: Lifetime income. This pool is designed to provide guaranteed income for life, with the capital depleted at death. Maximizing income with the guarantee that the retirees can't outlive their capital is the primary objective. Nothing is left for heirs. Social Security, pensions, and immediate annuities are in this pool. Any guarantees are by the issuing entity.

Pool 2: Preserved capital. Pool 2 is a traditional investment portfolio, typically holding stocks and bonds, which is designed to provide income for life. Retirees usually do not intend to exhaust the capital in this pool and desire to leave it to heirs.

Pool 3: Medical reserve. This pool contains the asset reserve designed to meet medical expenses that may be incurred late in life. The funds may be in a portfolio, or the retiree may have purchased long-term care insurance.

Pools 4 and 5: Capital consumption. These pools provide ways to increase cash flow by consuming capital. Because distributions include not only income but capital being depleted, pools 4 and 5 increase cash flow considerably (typically by 30 to 50 percent or more) compared with the amount the assets would generate in a traditional portfolio.

Pool 4 provides additional guaranteed lifetime income typically by taking capital from pool 2 to purchase immediate annuities. The benefits are increased cash flow and income for life guaranteed by an insurance company.

Pool 5 contains surplus capital that remains after all other financial needs have been covered using pools 1 through 4. These surplus funds can be spent for such things as travel, home improvements, or gifts to family and charity. Creating a surplus pool that generates increased distributions is the retiree's reward for successfully accumulating assets over his or her lifetime.

Using pools increases the importance of life planning and helps reduce the need for estate planning, a change that most clients welcome.

Creating an Investment Strategy

An investment strategy must be created that will dictate how each pool will be invested and how the pool will generate cash flow. Although specific for each pool, the strategies for each pool must also work together as a whole. I prepare an overall strategy for each client that contains separate sections for each pool. The strategy for each pool must cover:

- Cash distributions
- Asset allocation
- Use of qualified versus nonqualified money
- The amount to be invested in immediate annuities (and thus consumed)
- Use of fixed versus variable immediate annuities

Creating this strategy is the work financial advisers are paid to do. Much of it is art, and there is no simple formula.

Pool 1: Lifetime income. This is the easiest pool to manage. Typically, there are no investment decisions to make because Social Security, company pensions, and annuities have already been put in place. The retirement decisions required include questions such as when to start receiving payments, how to treat a surviving spouse, and whether the retiree wishes a time-certain option (guaranteeing payment for a certain number of years) should the retiree or spouse die prematurely.

Pool 2: Preserved capital. Pool 2 is the traditional portfolio with stocks and bonds and holds the assets that the retiree intends eventually to leave to heirs. These also are the assets the retiree can turn to if the assets in the other pools do not provide sufficient cash flow. Because pool 2 is not the primary source of income (pools 1 and 4 are the retiree's primary sources of income) and the time horizon is long, with the assets eventually expected to pass to heirs, its investment strategy may be more aggressive than is usually considered prudent for a retiree. The strategy may use a higher allocation to stocks and seek a higher long-term rate of return. There is no reason to be aggressive in setting the cash-distribution rate. Distributions can be based on dividends and interest or be set at a conservative 2 percent to 3 percent of the portfolio's value. Because the assets in pool 2 will likely be passed on to heirs, it's the logical location for IRAs, which can be passed to another generation tax efficiently.

Pool 3: Medical reserve. This pool holds the asset reserve designed to meet medical expenses. If a long-term care insurance policy is the primary source of funds to meet these costs, no assets are held and no investment management is required. Medical costs in excess of what is covered by long-term care insurance would be covered from other pools. If medical expenses are to be funded from the pool, the number of years expected to elapse before the funds are needed will dictate the asset allocation. If pool 3 assets are never used, they can be merged with pool 2 and passed on to heirs using "stretch" IRAs.

Pools 4 and 5: Capital consumption. Pool 4 is used to increase monthly distributions to supplement distributions from pool 1. Clients who want additional guaranteed cash flow for life can take money from

pool 2 to buy an immediate annuity, thereby increasing cash flow without the risk of exhausting principal prematurely. If they want to control the investment decisions, they can buy an immediate variable annuity. Otherwise they should purchase an immediate fixed annuity or some combination of fixed and variable. Buying annuities over time (for instance at ages 65, 70, and 75), like dollar-cost averaging, reduces the risk of locking in at the wrong time. Additionally by staging purchases at five-year increments, the retiree can buy immediate annuities at older ages and benefit from significantly higher payouts that come with shorter life expectancies. Using taxable money to buy an immediate annuity may be the preferred

FIGURE 14.3 *Sample Investment Strategy*

BALANCE SHEET

		65	66
Pool 1	Lifetime Income	—	—
Pool 2	Preserved Capital	\$ 500,000	\$527,500
Pool 3	Medical Reserve	250,000	270,000
Pool 4	Immediate Annuities		
	Fixed	125,000	—
	Variable	75,000	—
Pool 5	Surplus Account	50,000	45,000
Total		\$1,000,000	\$842,500

CASH FLOW

		65	66
Pool 1	Lifetime Income	\$22,000	\$22,880
Pool 2	Preserved Capital	12,500	13,188
Pool 3	Medical Reserve	—	—
Pool 4	Immediate Annuities		
	Fixed	7,500	7,500
	Variable	3,000	3,165
Pool 5	Surplus Account	5,000	5,000
Total		\$50,000	\$51,733

approach because a portion of the distribution is the nontaxed return of principal. Immediate annuities purchased with IRA funds retain their character as IRAs, and the distributions are fully taxed.

Pool 5 is for surplus assets that are to be spent down. Since this spending is probably going to be done in the next five to 15 years, the funds should be invested conservatively so that the money will be available when needed. A laddered bond portfolio might make sense, with maturation dates tied to periods when the retiree plans to spend the money. This pool is a logical place for taxable money, because accessing it will have fewer tax consequences than distributions from IRAs.

	70	75	80	85	90
	—	—	—	—	—
	\$ 653,480	\$ 854,072	\$1,116,238	\$1,458,879	\$1,906,696
	367,332	539,731	793,042	1,165,239	1,712,119
	—	—	—	—	—
	—	—	—	—	—
	25,000	—	—	—	—
	\$1,045,812	\$1,393,803	\$1,909,280	\$2,624,118	\$3,618,815
	70	75	80	85	90
	\$26,766	\$32,565	\$39,621	\$48,205	\$ 58,648
	16,337	21,352	27,906	36,472	47,667
	—	—	—	—	—
	7,500	7,500	7,500	7,500	7,500
	3,921	5,124	6,697	8,753	11,440
	5,000	—	—	—	—
	\$59,524	\$66,542	\$81,724	\$100,930	\$125,256

A Trial Portfolio

Once advisers have spent time listening to clients, helping them define their retirement objectives, and discussing the available tools for creating retirement cash flow, the next step is to put together a proposed investment strategy that includes a pool for each objective. They should review this with the retiree and present a table similar to the one in **FIGURE 14.3**, which shows how the retiree's assets are allocated to the various pools and how much income is projected from each pool. I find clients provide the best guidance when they have something concrete to respond to.

With a table like the one in Figure 14.3 at hand, an adviser can review questions similar to those suggested below to determine how well the draft investment strategy fits the client's objectives:

- 1 Are you comfortable with the guaranteed monthly income? Do you want more?
- 2 Are you comfortable with the asset allocation of each pool and its expected volatility or risk?
- 3 Have we adequately protected against inflation?
- 4 Are we making too many irreversible decisions?
- 5 Have we reserved adequate resources to cover long-term health care expenses?
- 6 Have we kept sufficient emergency reserves?
- 7 Do we have the right trade-off between consuming capital and leaving assets to heirs?

Based on the client's answers and reactions, the adviser can change or fine-tune the overall strategy or the strategy of an individual pool to meet the client's objectives more closely. Seeing the strategy on paper may also help indecisive clients become clearer about their objectives. Combining the available tools with the concept of pools gives advisers the means to dramatically improve the quality of their clients' lives in retirement.