Investment planning throughout retirement

Investment planning during retirement is not the same as investing for retirement and, in many ways, is more complicated. Your working years are your saving years. With luck, your income increases from year to year as you receive promotions and/or pay raises; those increases offer some protection against rising costs caused by inflation. While you're working, your retirement objective generally is to grow retirement savings as much as possible, and investments that offer higher potential reward in exchange for greater potential for volatility and/or loss are often the focus for those retirement savings.

When you retire, on the other hand, spending rather than saving becomes your focus. Your sources of income may include Social Security, employer pensions, personal savings and assets, and perhaps some income from working part-time. Typically, a retiree's objective is to derive sufficient income to maintain a chosen lifestyle and to make assets last as long as necessary.

This can be a tricky balancing act. Uncertainty abounds—you don't know how long you'll live or whether rates of return will meet your expectations. If your income is fixed, inflation could erode its purchasing power over time, which may cause you to invade principal to meet day-to-day expenses. Or, your retirement plan may require that you make minimum withdrawals in excess of your needs, depleting your resources and triggering taxes unnecessarily. Further, your ability to tolerate risk is lessened—you have less time to recover from losses, and you may feel less secure about your finances in general.

The following discusses two important factors you should consider: withdrawing income from retirement assets, and balancing safety with growth.

Choosing a sustainable withdrawal rate

A key factor that determines whether your assets will last for your entire lifetime is the rate at which you withdraw funds. The more you withdraw, the greater the likelihood you'll exhaust your resources too soon. On the other hand, if you withdraw too little, you may have to struggle to meet expenses; also, you could end up with assets in your estate, part of which may go to the government in taxes. It is vital that you estimate an appropriate withdrawal rate for your circumstances, and determine whether you should adjust your lifestyle and/or estate plan.

Your withdrawal rate is typically expressed as a percentage of your overall assets, even though withdrawals may represent earnings, principal, or some combination of the two. An appropriate and sustainable withdrawal rate depends on many factors including the value of your current assets, your expected rate of return, your life expectancy, your risk tolerance, whether you adjust for inflation, how much your expenses are expected to be, and whether you want some assets left over for your heirs.

Withdrawing first from taxable, tax-deferred, or tax-free accounts

Many retirees have assets in various types of accounts—taxable, tax-deferred (e.g., traditional IRAs), and tax-free (e.g., Roth IRAs). Given a choice, which type of account should you withdraw from first? The answer—it depends.

Retirees who will not have an estate

For retirees who do not intend to leave assets to beneficiaries, the answer is simple in theory: Withdraw money from a taxable account first, then a tax-deferred account, and lastly, a tax-free account. This will provide for the greatest growth potential due to the power of compounding.

In practice, however, your choices, to some extent, may be directed by tax rules. Retirement accounts, other than Roth IRAs, have minimum withdrawal requirements. In general, you must begin withdrawing from these accounts by April 1 of the year following the year you turn age 70½. Failure to do so can result in a 50 percent excise tax imposed on the amount by which the required minimum distribution exceeds the distribution you actually take.

Retirees who will have an estate

For retirees who intend to leave assets to beneficiaries, the analysis is more complicated. You need to coordinate your retirement plan with your estate plan.

If you have appreciated or rapidly appreciating assets, it may be more advantageous for you to withdraw from tax-deferred and tax-free accounts first. This is because these accounts will not receive a step-up in basis at your death, as many of your other assets will, and your heirs could face a larger than necessary tax liability.

Balancing safety and growth

When you retire, you generally stop receiving income from wages, a salary, or other work-related activity and start relying on your assets for income. To ensure a consistent and reliable flow of income for your lifetime, you must provide some safety for your principal. This is why retirees typically shift at least a portion of their investment portfolio to more secure income-producing investments, and this makes a great deal of sense.

Unfortunately, safety comes with a price—reduced growth potential and erosion of value due to inflation. Safety at the expense of growth can be a critical mistake for some retirees. On the other hand, if you invest too heavily in growth investments, your risk is heightened, and you may be forced to sell during a downturn in the market should you need more income. Retirees must find a way to strike a reasonable balance between safety and growth.

How, then, should you manage your investments during retirement given the above complications? The answer is different for everyone. You should tailor your plan to your own unique circumstances, and you may want to consult a financial planning professional for advice.

For more information, please contact your Key Private Bank Advisor.