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401(k) Adviser: Plan your retirement strategy; 3D

Plan your retirement strategy

401(k) ADVISER

MICHAEL FRANCIS

Developing your retirement income strategy is a high stakes endeavor.

While accumulating savings for retirement is no walk in the park, if you miscalculate, you can always work a little longer to get back on track.

Planning a strategy for spending your retirement savings is every bit as complicated, but if you miscalculate you might live the final years of your life on some form of government assistance.

To maximize your retirement income, while not outliving your assets, consider the following:

Projected expenses. Estimate your projected retirement expenses and separate them into two categories: necessities and discretionary. Most studies show that discretionary expenses such as travel and other forms of recreation are much higher in the early years of retirement and begin to taper off as you age. Conversely, expenditures on certain necessities, especially health care, can grow at a rate of two to three times inflation throughout retirement. Be sure to consider changes in living arrangements, because downsizing or relocating can have a dramatic impact on your liquid assets as well as living expenses.

Life expectancy and legacy. Face the fact that people are living longer these days. It’s not unreasonable to use age 95 or even 105 as a planning target, especially if you’re in good health and have a family history of people living into their 90s. Also consider what happens to your assets if you die prematurely. Creating a will is a must for everyone, and if your estate is substantial (more than $1 million), a trust could save your heirs tens of thousands of dollars in inheritance taxes.

Develop a new investment strategy. When you stop contributing to your retirement assets and begin to spend them, the laws of compound interest begin to work against you. This means a large decline in the value of your retirement assets in your early retirement years could wipe out a significant amount of compound interest you were counting on in later years.

Diversify to avoid a large decline in the value of your retirement savings and still keep up with inflation.

True diversification means investing your retirement assets across multiple asset classes. This means preparing your portfolio to withstand rapid economic growth and recession, inflationary periods as well as deflationary times. Such asset classes include: "financial assets" such as U.S. and foreign stocks and bonds, as well as "hard assets" such as real estate, and commodity interests. The safest asset class on this list is high-quality U.S. bonds, which should be an important component of every retiree’s investment portfolio.

Consider setting up your own monthly income stream by arranging monthly fixed withdrawals from your portfolio.

The industry standard portfolio withdrawal rate for retirees is 4% per year, or 0.33% a month. Four percent is widely considered an appropriate annual withdrawal amount because it provides a meaningful stream of income, while leaving enough behind to allow your portfolio to grow with inflation.

An alternative solution is a "lifetime income" annuity offered through an insurance company. These products turn a lump sum investment into a monthly check that is guaranteed for life.

Be careful not to jump too quickly at this offer. Such products usually come with a low rate of return if you live to a normal life expectancy; they can also include a loss of control, forfeiture of potential upside, and the inability to pass wealth on to your heirs. These shortcomings are exchanged for the "sleep at night" promises of a lifetime of guaranteed income.

A third strategy attempts to combine the best attributes of both approaches.

Start by obtaining a quote from an insurance company for the lump sum necessary to fund an immediate annuity that covers your projected necessities throughout retirement. Ideally, this will represent only a fraction of the total amount of money you have saved for retirement.

Make this dollar amount your baseline for portfolio volatility. Then invest your entire savings in a diversified portfolio and hope for reasonable markets and steady growth. If the market goes against you and you approach that baseline number, purchasing the annuity to ensure that your necessities are covered represents your worst case scenario.

As you enjoy your early retirement years, the investment returns you earn above the 4% withdrawal rate will grow your assets while the cost of the guaranteed annuity declines as your life expectancy declines. Ten to 15 years into retirement, consider purchasing the annuity to cover your necessities and you and your heirs will hopefully be left with more than if you had purchased the annuity early on in retirement.

Michael J. Francis, CIMA, JD is president and senior investment consultant of Francis Investment Counsel LLC, a registered investment adviser based in Pewaukee, WI. Mike Francis can be reached at michael.francis@francisinvco.com. The information contained herein is provided for informational purposes only. The preceding information has been obtained from sources Francis Investment Counsel believes to be reliable, but Francis Investment Counsel cannot guarantee its accuracy or completeness. Neither the information nor any opinion expressed constitutes investment advice or a solicitation for the purchase or sale of any security. Past performance does not guarantee future results. Francis Investment Counsel does not offer personal tax or legal advice.