Fidelity Investments

Beyond Conventional Wisdom: New Strategies For Lifetime Income

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Overview

In the ’60s, baby boomers lived by the slogan, “Question authority.” Today, with 76 million boomers nearing retirement, a more appropriate slogan might be, “Question conventional wisdom.”

As boomers shift their focus from making money to spending it, they will need to ask – and answer – many questions: When should they retire? How much should they withdraw from their retirement accounts each year? Which accounts should they withdraw from and when?

How retirees answer these questions will determine whether their savings last throughout their lifetime, how much they pay in taxes and whether they can maintain the standard of living they’re accustomed to.

PART 1
How Much Can You Spend?

In the not-too-distant past, people usually retired at 65 and were lucky to live to 70. Today, retirement can last 20 or even 30 years – but even living longer has a down side. Retirees must plan carefully to ensure that they will not outlive their retirement savings.

Most boomers don't have a traditional pension to rely on. Even if they saved diligently and invested wisely, they will need to spend cautiously.

Conventional wisdom suggests retirees can withdraw 4% of savings each year and be reasonably assured income will last throughout retirement. However, every situation is different. A sustainable withdrawal depends on:

- Age
- Planning time horizon
- Asset allocation

Changes to any of these variables, not to mention market volatility, can affect how much retirees can spend safely.

Impact of Age

Consider just the first factor – age. What's the difference between retiring early and retiring later in life?

Based on results derived by running 10,000 market simulations, a hypothetical 65-year-old couple with a balanced portfolio has a 90% probability of their savings lasting until age 92 if they withdraw 4% a year[1].

However, lower the retirement age to 55 and the couple can withdraw only 3% of savings a year. Delay retirement to age 75 and the couple can withdraw 5.51% of savings a year with 90% confidence income will last to age 92 (*see Chart 1.*).

Retirement Age	Probability Savings Will Last Until Age 92	Withdrawal Rate
55	90%	3%
65	90%	4%
75	90%	5.51%

Chart 1. The Impact of Age on Retirement Funding

A difference of 1% or so may not seem like much, but consider the difference in dollars. If 4% of savings is $50,000, 3% is 25% less ($37,500). An increase to 5.51% is 37.75% more ($68,875).

There are many reasons why delaying retirement can have a significant impact on what you can spend. Let's consider some of them.

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[1] For more details, see Fidelity Research Institute's *Research Insights Report*, "Beyond Conventional Wisdom" New Strategies For Lifetime Income."

PART 2
Timing Retirement
Americans are living longer, but they aren't working longer. According to the Employee Benefit Research Institute, the average American retires at 62, and only 27% wait until age 65 or older.

Should we work to a later age just because we're living longer? Not necessarily, but it's important to be aware of the tradeoffs involved with retiring early.

Delaying retirement by even a few years can result in:
- Higher Social Security benefits
- Additional retirement plan contributions
- Added growth potential for savings

Delaying Social Security
One reason many Americans retire at 62 is because that's the earliest age for collecting Social Security.

However, retirees must delay retirement to age 65 to be eligible for "full" benefits – and the eligibility age will gradually rise to 67 for those born in 1960 and later. Even higher "delayed" benefits are available for those who wait until age 70.

The earlier retirees begin collecting Social Security, of course, the longer they will be able to collect, since payments continue for life. However, annual cost-of-living increases are calculated using the initial year's Social Security income as a base, so delaying the start of Social Security for even a few years can raise annual income significantly.

The main driver for increased annual benefits is the starting age for Social Security, not the retirement age, so even someone retiring early can receive more annual income by delaying Social Security. For example, a person who begins receiving Social Security at 62 and receives $15,888 at age 66 would instead receive $21,181 simply by delaying payments until age 66.[2]

So will your total Social Security income be higher if you retire early and collect for more years? Or will it be higher if you delay retirement and collect more each year?

The answer depends on how long you live. A hypothetical person who retires at 62, but delays payments to age 70 and lives to 100 would receive $260,000 to $280,000 more in total payments than if payments began at age 62. Conversely, if the person begins collecting Social Security at age 62 and lives to 70, he or she will collect $127,104 in total payments in today's dollars – or nothing if he or she delays Social Security payments to age 70.[3]

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[2] Ibid.
[3] Ibid.

Retirement Age	Age SS Begins	Age At Death	Total SS Income
62	70	100	$864,618
62	70	70	$0
62	62	70	$127,104

Chart 2. The Impact of Delaying Social Security

This example does not take the time value of money into consideration.

Before delaying Social Security, retirees should consider whether they have sufficient retirement income and the impact that using that retirement income will have on their savings. Early withdrawals combined with a bear market could deplete savings quickly.

Individuals should weigh both financial and non-financial factors when deciding when to retire, including family, health and quality-of-life considerations.

PART 3
Don't Scramble Your Nest Egg
Social Security is, of course, just one source of retirement income. A boomer's retirement nest egg may include funds from 401(k) plans, IRAs, Roth IRAs and 401(k)s, brokerage accounts and more.

The order in which retirees withdraw money from these sources can have a dramatic impact on their taxes and on ongoing returns from investments. Lower taxes and higher earnings can help retirees ensure that their savings will last.

So how can retirees keep from scrambling their retirement nest egg? While everyone's situation is different, the following guidelines can help keep a nest egg sunny side up:

1. Take minimum required distributions.
To avoid financial penalties, retirees 70½ or older need to track which accounts require minimum distributions and how much must be withdrawn.

2. Liquidate loss positions in taxable accounts.
For federal tax purposes, retirees can use up to $1,500 in losses in taxable accounts ($3,000 for couples filing jointly) to offset gains. Unused losses can usually be carried forward.

3. Liquidate assets in taxable accounts that will generate neither capital gains nor capital losses.
Withdrawing funds from taxable accounts means you can keep money longer in tax-deferred and tax-exempt accounts. When you withdraw funds from cash-equivalent accounts, such as money market funds, be certain to keep enough liquid assets to cover financial emergencies. Also consider the impact on your asset allocation.

4. Determine whether to withdraw money from taxable or tax-deferred accounts.
It is usually better to withdraw funds from tax-deferred accounts than from taxable accounts when:
- The tax-deferred accounts are funded with at least some nondeductible (or after-tax) contributions (e.g., variable annuities, traditional IRAs).
- Leaving assets to beneficiaries is not a priority.
- Withdrawals are from accounts that have losses or small gains*.

Also consider liquidating assets with long-term capital gains first, because they should be taxed at a lower rate than assets with short-term gains. Finally, consider liquidating assets that are likely to generate smaller taxable gains when expressed as dollars.

5. **Withdraw money from tax-deferred accounts funded with pre-tax contributions (401(k) plans, traditional IRAs) or from tax-exempt accounts (Roth IRAs, Roth 401(k)s).**

If leaving assets to beneficiaries is the primary concern, retirees may avoid an unnecessary tax liability by holding on to assets in taxable accounts that have increased in value significantly. Sell them now and taxes will be due on the gains. Pass them on to heirs and they will not have to pay taxes on the gains.**

Those who expect to spend all of their retirement income may be better off withdrawing from the tax-deferred accounts before withdrawing from the tax-exempt accounts, or withdrawing some from each (*see Part 4*). Taking withdrawals from the pre-tax account long-term may reduce estate taxes, because larger pre-tax withdrawals will be needed to end up with the same amount of after-tax income.

These five guidelines are just that – they should guide your decisions. Consult with a tax advisor, and be sure to consider both tax and non-tax issues.

Also remember that regular rebalancing is needed to maintain an ongoing asset mix. Before taking withdrawals, retirees should be certain they can rebalance their portfolio without generating significant taxable capital gains.

**Consider withdrawing from tax-deferred accounts when the basis-to-value ratio of the tax-deferred accounts is higher than it is for the taxable accounts. Calculate the basis-to-value ratio by dividing the tax basis of each account by the current asset value. Assets with the highest ratio have generated the smallest gain or the largest loss as a percentage of their basis. It may be preferable to liquidate these assets first. If the basis-to-value ratio of the tax-deferred accounts is low, it may be preferable to liquidate assets from the taxable accounts first.*

***Assets will be inherited on a stepped-up cost basis (i.e., the assets' market value when the owner dies).*

PART 4
Retiring Is Hard Work

Even after they retire, retirees who want to get the most out of their retirement income will have plenty of work ahead of them.

As discussed, when and how retirees distribute their retirement income can have a great impact on how long their savings will last and whether they will be able to leave a legacy. Retirees need these decisions to work together to form a retirement planning strategy.

Retirees should have their advisors work out several scenarios – and should assume nothing. Here are a few examples.

Guaranteed Income
A couple with $1 million in savings may think that's plenty to live on, even if they retire at 62[4]. However, consider three different scenarios:

- Collecting Social Security immediately and withdrawing just 3.4% of savings a year, they would likely have a shortfall by age 84. The probability of their savings outliving them is 50%.

- Delaying Social Security until age 67, the same couple could increase Social Security income 44% and future payments would compound from this higher base. They would initially have to withdraw 7% of retirement savings, climbing to 11% by age 66, but they could reduce the percentage to 5% once Social Security payments begin. With higher Social Security income, there is a 90% probability their savings would last through age 89.

- Better still, the couple could convert a percentage of assets into a guaranteed income product, such as an annuity. Doing so, they could guarantee that Social Security and annuity payments would provide them with income for life. An annuity can also be used to provide income to a surviving spouse.

The Mix Strategy
In many cases, retirees can reduce their federal taxes by withdrawing a carefully calculated mix of income from both tax-deferred and tax-exempt accounts.

Withdrawing a mix of funds takes advantage of the progressive features of the tax code. For example, a couple could rollover pension funds into a taxable IRA and withdraw a total of $78,200 from it over the next five years. The amount would include $16,900 taxed at 0% because of deductions and personal exemptions, $15,100 taxed at 10% and $46,200 taxed at 15%. Withdrawals

[4] Ibid.

above that amount would be taxed at 25%, so the couple could instead draw remaining funds from their Roth IRA.[5]

This mix strategy can also help reduce taxes on Social Security income. Social Security income is tax-free if a person's income is below $25,000 ($32,500 for a couple filing jointly). Roth IRA income above that amount would be excluded from taxation.

Retirees who do not have Roth IRAs may consider converting some of their tax-deferred accounts to Roth IRAs, but they should discuss tax consequences with an advisor first.

Gradual Withdrawals

While conventional wisdom calls for keeping funds in tax-deferred accounts as long as possible, in some cases gradual withdrawals over a period of years can reduce taxes. For example, a couple that wants to fund a new business in three years after retiring from a corporation may be better off withdrawing some funds each year rather than withdrawing the entire amount in three years.

[5] Ibid.

Conclusion

Retirement means it's time to stop working, but it doesn't mean it's time to stop planning. Planning distribution of retirement income is as important as planning wealth accumulation before retirement.

Those approaching retirement should consult tax and financial advisors and consider a variety of scenarios before withdrawing funds. Tactics such as delaying Social Security and withdrawing funds from tax-deferred accounts before you need to are contrary to conventional wisdom, but can reduce taxes and result in more retirement income.

While this summary considers strategies for funding retirement, retirees should keep other issues in mind, too, ranging from estate planning to charitable giving. They should also consider non-financial issues. While it's important to ask, "What's the optimal retirement date for minimizing my taxes?" they should also ask, "What makes you happy?"

Unconventional questions can lead to unconventional answers. No one strategy will work for everyone, but unconventional wisdom sometimes trumps conventional wisdom.

Potential call outs:
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