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Where Do IRAs Fit in Your Retirement Distribution Plan?

Investing success during the pre-retirement years hinges on getting a few key things right: saving enough, diversifying, and avoiding big behavioral mistakes, such as chasing performance.

But successfully managing during retirement? That is more complicated, unfortunately. First you have to determine whether you have enough money to retire, and that is no small feat in and of itself. You will also have to reposition your assets for draw-down mode, staking at least a portion of your investment portfolio in stable, liquid assets to avoid tapping securities when their prices are gyrating wildly. Finally, you will need to think about asset location and the appropriate sequence to use when tapping your retirement accounts for cash.

Why is sequencing withdrawals a key component of successful retirement portfolio management? Because it helps you save on taxes. To the extent that a retiree has both taxable and tax-sheltered assets like IRAs and company retirement plans, it is best to spend the taxable money first. The assets with the most generous tax treatment, meanwhile, should be last in a retiree's spending queue, thereby stretching out the tax benefit for the longest possible period of time.

IN THIS EDITION

There is not a one-size-fits-all sequence of withdrawals; your age and your tax rate when you take withdrawals also play a role. But assuming that you have more than one pool of assets to draw on during retirement, the following sequence makes sense for many retirees.

1. Take Required Minimum Distributions
If you are over age 70 ½, your withdrawals should come from those accounts that carry required minimum distributions, such as traditional IRAs and company retirement plans. RMD assets go first in the withdrawal queue because you will pay penalties if you do not take these distributions on time.

2. Turn to Your Taxable Accounts
If you are not required to take RMDs or you have taken your RMDs and still need cash, turn to your taxable assets. Relative to tax-deferred or tax-free assets, money in your taxable portfolio carries the highest tax costs. You will pay ordinary income tax on income from taxable bonds and cash, and you will also owe taxes on dividends and capital gains—year in and year out. When liquidating assets from your taxable accounts, start by selling assets with the highest cost basis first and then move on to those assets where your cost basis is lower (and your tax hit is higher).

A key exception to the rule about selling taxable assets early, however, is if you have highly appreciated assets and plan to leave money to your heirs. If, for example, you own stock that has appreciated significantly since you bought it (and you have no way of offsetting that gain with a loss elsewhere in your portfolio) you may be better off leaving that position intact and passing it to your heirs. The reason is that your heirs will receive what is called a "step up" in their cost basis, meaning that they

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Is Instinct Eroding Your Financial Health?

As humans we have an innate need to evaluate our worth and position in society. When we lack an objective measure to do so, we look to "similar others" to judge our progress. Recent research from Morningstar shows that this normal human instinct may be causing us more harm than good when it comes to our money.

In a survey of several hundred people, they found the following:

- People in every income group were more likely to compare themselves to people they see as better off than those they see as worse off.
- Frequent, upward comparisons such as this were associated with higher financial stress, lower satisfaction, lower savings and overall more negative feelings about one's own financial life.

Social comparisons were strongly correlated with financial well-being. In fact, when looking at the relative effect sizes of the things we typically associate with financial stability (age, income, education, and financial literacy) they found that the effect size of social factors was greater. This suggests that the way we compare ourselves to others might be a very important part of overall financial health.

However, one small group of people in the study reported feeling positive about their money regardless of whether the people they compared themselves with were better or worse off. Unlike the rest of the population surveyed, this group did not compare themselves with peers, family, friends, or colleagues. Instead, this little group of 27 people reported comparing themselves to a financial role model or mentor.

Could it be that choosing a financial role model is a way to direct our natural need to compare into a form that is aspirational rather than evaluative?

Could it be that choosing a financial role model is a way to direct our natural need to compare into a form that is aspirational rather than evaluative? Is this a cure for our financial ills? In a follow-up study, several hundred people were asked to participate in a short exercise in which they identified a financial role model and thought a bit about that person's behaviors and the qualities that led to their success. A second group was asked about who they compared themselves to normally, and a third was not given any comparison task. All three groups were then asked a series of questions about their financial confidence, and other emotions with respect to their money.

The people who chose a role model were significantly more likely to report being confident about their ability to reach their financial goals than those who made their normal social comparisons. They were also more determined to reach those goals and reported feeling more in control of their financial future than those who did not choose a role model. The results of these studies show that, while we cannot avoid the instinct to compare ourselves, we may be able to improve our financial well-being by directing our attention to a specific financial role model.

One may choose to emulate their mother. While she may earn less, she may also live more simply. They may admire her resourcefulness and her contentment. By turning their attention away from neighbors and colleagues, and focusing on their mother as a financial mentor, they are able to improve their own quality of life and reduce their financial stress in a short amount of time.

Consider asking yourself, whose financial decisions do you admire? What is one thing you can do today to be just a bit more like them? ■

The Short Answer: Bonds in a Rising Rate Climate

Q: Can I just buy individual bonds and hold them to maturity, and not worry about rising rates?

A: The short answer is yes, you can. But there could be drawbacks.

Buying an individual bond gives you a fixed rate of return, or yield, and if you hold the bond until maturity (provided you buy a bond that does not default), you will receive your interest and principal regardless of interest-rate fluctuations.

Bond fundholders, by contrast, will not necessarily be assured that their principal value will not decline, and the interest they receive from their bond fund (a basket of securities that can fluctuate in value from day to day) could also fluctuate.

In a period of rising interest rates, which tends to make already-existing bonds with lower coupons less valuable than the new bonds with higher rates, bond-fund shareholders can see a reduction in their principal values. The upside, however, is that sometimes the manager is able to partially offset some of those price declines by swapping into higher-yielding bonds.

Thus, a crucial difference between a bond fund versus an individual bond held until maturity is that, with bond funds, there is a greater chance that your principal value when you sell will be different—for better or for worse—from the amount you put into the bond fund in the first place.

In an effort to "normalize" the interest-rate environment following its $4 trillion economic stimulus plan, the Fed has raised its benchmark interest rate six times since December 2015. This means it is possible that the bonds in a bond portfolio will decline in value over the time that you own a fund. Individual bondholders will not have to contend with that same issue and if their bond issuer makes good on its debt, the amount they put in is the amount they get back.

At the same time, it is unwise to derive a false sense of security from investing in individual bonds. Even if individual-bond buyers are able to circumvent interest-rate risk by holding individual bonds until maturity, they may court risk on other fronts, including: a lack of knowledge in the absence of professional management, the inability to diversify without a significant amount of assets, and the impact of trading costs on take-home yield and total return.

Smaller investors can safely buy individual Treasury bonds and high-quality corporates but might want to consider a fund if they are delving into municipal bonds and lower-quality corporate bonds. And even TIPS, which are high quality but have trading peculiarities, may be better held in a fund than individually. ■

IRAs *Continued from page 1*

will be taxed only on any appreciation in the security after you pass away.

3. Move On to Company Retirement Plans and IRA Assets

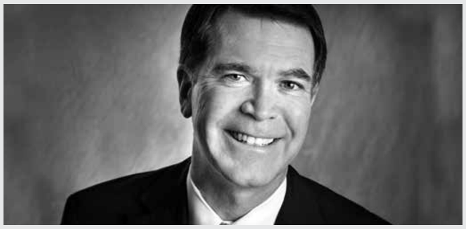
Unlike taxable accounts, you will not pay taxes on your company retirement plan and IRA assets from year to year (at least on the money that remains in the accounts), so the ongoing tax costs are relatively low. Thus, tapping those assets last is usually a good idea because it helps stretch out those tax-savings benefits.

For those with both a traditional company retirement plan and IRA assets as well as those who are eligible for Roth treatment, the decision about which pool of money to tap first is a bit complicated. Intuitively, it seems to make sense to save Roth IRA assets for last because they are less costly from a tax standpoint. In contrast with traditional IRA and 401(k) assets, your distributions are not taxable and you are not required to take distributions at age 70 ½. And if you expect your heirs to inherit part of your IRA, Roth assets will be the most valuable to them because distributions will be free of income taxes. However, a study by Baylor University professor William Reichenstein argued that saving Roth assets for last is not always the best course of action. For example, if a retiree is in a particularly high tax bracket in a given year, tapping the Roth assets to meet living expenses may be preferable to paying ordinary income tax on traditional IRA or company retirement plan withdrawals.

Impact on Asset Location

The sequence in which you tap your accounts should help you determine how to position each pool of money. The money that you will draw upon first—to fund living expenses in the first years of retirement—should be invested, at least in part, in highly liquid securities like certificates of deposit, money market accounts, and short-term bonds. The reason is pretty common-sensical: Doing so helps ensure that you are taking money from your most stable pool of assets first, and therefore you will not have to withdraw from your higher-risk/higher-return accounts (for example, those that hold stocks or more risky bonds) when your account is at a low ebb. That strategy also gives your stock assets, which have the potential for the highest long-term returns, more time to grow. ■

Summer 2018 Economic Outlook



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Recent market volatility brought us our first correction in a couple of years, and has curbed some of the excess valuation, and optimism from U.S. equity markets. The economy remains quite solid; confidence is very high, small businesses are bullish due in large part to the regulation tide moving out, and excess inflation is largely absent. The Fed is of course now practicing quantitative tightening as well, now having bumped the Federal Funds Rate six times. We are in late innings, but the economy itself is not flashing any red lights.

U.S. equities charged sharply higher across the board during January, boosted by record consumer and business confidence numbers. By late January, however, volatility had resurfaced and the S&P 500 Index suffered its first correction since early 2016. Tariff and trade war jawboning have led to continued volatility and pressure on the market as we closed the first quarter with modest losses on most headline U.S. equity indexes.

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Investors reacted cautiously to firmer interest rates as the yield on the 10-Year Treasury rose from 2.40% to almost 3% in February, finishing the quarter at 2.74%. Global markets were mixed. Latin America gained almost 10%, Russia was up 7%, and Emerging Markets as a whole were up 2.5%. The MSCI EAFE Index was in line with U.S. markets, losing about 1%; the U.K. and German markets both declined 3% while the Indian market fell 6%. Crude oil prices gained more than 7% and closed the quarter at about $65/barrel. Natural gas lost more than 10% as cold January temperatures gave way to warmer-than-normal weather across much of the U.S. The U.S. dollar lost about 2% in value against a basket of currencies, with the Japanese Yen (+6%), British Pound (+4%), and Euro (+2%) all gaining. Cryptocurrencies were hammered, as Bitcoin lost almost half of its value in the quarter.

Investors have a lot to ponder in the current environment. The economy is growing at a reasonable rate, the job market is healthy, and wage growth may be picking up. We believe corporate profit growth will be solid in 2018, in part due to the impact of the Trump tax cut. Interest rates appear poised to go a bit higher, though the flatness of the yield curve suggests concerns of slowing economic growth. ■

ESTIMATED ECONOMIC VARIABLES AND INTEREST RATES

	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Real GDP	2.80%	2.80	2.70	2.70	2.70
Consumer Price Index	2.30%	2.60	2.60	2.30	2.20
3-month Treasury Bill	2.25%	2.41	2.54	2.72	2.87
10-year Treasury Note	2.97%	3.07	3.15	3.25	3.33
Unemployment	4.00%	3.90	3.80	3.80	3.70

Source: Bloomberg

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