

Replacing Your Paycheck in Retirement

Those nearing retirement may find themselves asking: “How do I actually get at my money once I’ve retired?” After decades of receiving a regular paycheck—and allocating a portion of it to retirement savings—the prospect of losing a consistent source of cash flow can be daunting. Fortunately, there are a number of ways to access the funds in your investment portfolio to support your spending needs in retirement.

Changes in Retirement Savings Landscape Demand New Approach to Income Needs

You may recall hearing stories about your parents’ or grandparents’ retirement experience. Americans of one or two generations ago often were employed by the same company for the majority of their working lives; in return, these companies frequently provided their employees with a substantial pension that promised income payments for life, with the company assuming the associated investment risk. In some instances these pensions were enough to cover a large portion of a retiree’s monthly expenses, which were supplemented by Social Security, as well as interest and dividend payments from the portfolio. Even retirees who did not have significant pension income but had accumulated substantial assets were often able to subsist solely on the interest and dividend payments thrown off by their investment portfolio. They would make withdrawals from the principal in their portfolio only in the event of an atypical expense, such as a large vacation or an unexpected medical cost.

Things have changed significantly in the last few decades. First, traditional pension plans—also called defined benefit plans—are on the decline, largely replaced by defined contribution vehicles such as 401(k) plans, a transition that effectively has shifted the burden of investment risk from the plan sponsor to the individual. Second, dividend yields from stocks have on the whole declined compared with yields prevalent a few decades ago. Third, we currently find ourselves in a prolonged low interest rate environment, in which interest payments from bonds and other fixed income instruments are below their historical norms.

This confluence of events means that baby boomers retiring today need a modified approach to meeting their retirement income needs. Encouragingly, there are a number of ways to effectively access the funds in your investment portfolio. While multiple factors will play into your choice of strategy, the primary driver may be your tolerance to risk.¹

¹ Of course, it is important to review your finances well in advance of retirement, ideally by working with a professional to produce a personalized financial plan and to ensure you will have sufficient assets to last for the remainder of your life. This article assumes that an analysis of this kind already has been performed and that the remaining question is how best to tap your investments during retirement. While no one can guarantee that an individual will not run out of money, as too many factors—such as longevity, changing expenses and stock market risk—are in play, most financial planners will be able to derive a probability of success for a client’s retirement goal.

Three Strategies for Funding Your Expenses in Retirement

The first step in determining the withdrawal method right for you is to calculate how much cash you will need from your portfolio annually. To do so, add up all of the income you will receive from sources other than your investment portfolio—social security, pensions, rental income and earned income—if you plan to work during your retirement years. Estimate how much each of these sources of income will be taxed so you can approximate the income you will receive net of taxes. Subtracting this figure from your forecast expenses enables you to approximate the amount you'll need to withdraw from your portfolio. Remember that these numbers may fluctuate from year to year as income sources or expenses change.

Strategy #1: The Bucket Approach

In this strategy, you divide your investment portfolio into categories, or “buckets.” The first bucket consists of your cash reserve. Whereas for employed individuals we typically recommend keeping three to six months of expenses in cash, this number may be much higher for those in retirement. In fact, it's not uncommon for retirees employing the bucket approach to keep one to two years of expenses in cash. Needless to say, there is an opportunity cost to holding a lot of cash, particularly in this low interest rate environment. One benefit of this strategy, however, is that individuals will not be compelled to realize losses during a bear market in order to pay their bills.

The second bucket consists of money that may be needed in the intermediate term and is typically allocated to bonds. If this money is invested in individual bonds, as opposed to fixed income mutual funds, assets from maturing bonds can either be reinvested into new bonds or deposited into the cash bucket to replenish the funds used to pay your ongoing expenses.

The third bucket consists of your longer-term investments and typically would be allocated primarily to equities; any alternative investments, such as hedge funds or private equity, would also fall into this category. As with the second bucket, dividends from these investments either can be reinvested or deposited into cash reserves.

The key to the bucket strategy is to have enough funds in your short- and intermediate-term buckets to avoid realizing losses on stock positions to pay for your living expenses in a down market. However, following this strategy does require the discipline to realize gains on an ongoing basis in order to maintain buckets one and two at appropriate levels. The proportion of your overall investment portfolio allocated to buckets one, two and three will differ significantly from one individual to another, and should be discussed with your trusted advisors.

Strategy #2: Regular Remittance

With this strategy you simply request from your money manager a regular remittance—perhaps monthly or quarterly—of the amount needed to cover expenses. Typically the remittance is made up of a combination of interest income from bonds, dividend income from stocks and growth from the portfolio.² Money managers likely will be sensitive to tax consequences in a client's account and, to the extent possible, will take steps to avoid realizing excessive short-term gains in order to fulfill the remittance.

While qualified retirement accounts such as IRAs and 401(k)s are accessible without penalty after age 59½, individuals under age 72 typically choose not to tap those accounts unless they have no other sources of funds. If you do set up a regular remittance from your portfolio, remember that you may need to recalculate this amount once your required minimum distributions begin. You may choose to have the required minimum distribution paid directly to your checking account, or you may route the required minimum distribution to your taxable account and leave the remittance unchanged.

One of the benefits of setting up a regular remittance is that it takes some of the guesswork out of liquidating investments. Rather than selling positions once or twice a year, which might lead to attempts to time those withdrawals around market movements, money managers close out positions with regularity throughout the year. Another benefit of this strategy is that you can maintain a smaller cash reserve than in a bucketing strategy. As noted, however, regular liquidations subject you to the possibility of having to do so during a down market, when your investments have lost some of their value.

Remember that if you follow the remittance approach, you will need to factor in the monthly amount needed after taxes. If the source of your monthly income is a taxable account, the tax implications of the liquidation will be different than if the source of the income is an IRA or 401(k).

Strategy #3: Interest, Dividends and Occasional Liquidations

Following this strategy, you may request to have interest and dividends distributed rather than reinvested. Depending on an individual's expenses relative to his/her asset base, these distributions may be sufficient to cover the bulk of the living expenses. In the event that additional funds are needed, the individual can liquidate holdings on an ad hoc basis.

One of the benefits of this strategy is that holdings can be allowed to grow undisturbed for longer periods. One of the drawbacks, however, is that it could encourage attempts at market timing and would therefore require a disciplined approach. Further, this strategy may prove challenging to some retirees given the low rate/low yield environment that prevails today.

In Summary

None of the strategies outlined above is inherently superior to the others; your tolerance for risk should drive the decision. Regardless of the option you choose, a disciplined approach that enables you to effectively tap the funds in your accounts while being thoughtful about the timing of liquidations is key to the success of any retirement income strategy.²

² Clients are often concerned about taking principal from their portfolio, believing this to be synonymous with depleting the portfolio. That is not necessarily the case, however. It is important to focus on whether the withdrawal rate is sustainable in the long term, irrespective of whether it is made up of interest, dividends or principal. The 4% rule is one of several rules of thumb that attempts to guide investors' approaches to taking annual withdrawals from their portfolio.

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