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MAKE YOUR MONEY LAST

Create a stream of income that will see you through retirement.

You've spent much of your career socking away part of each paycheck in your retirement accounts, carefully choosing your investments and faithfully sticking with your plan. Retirement is near—or perhaps you've recently retired. Now comes the complicated part. How do you make sure your savings will see you through your retirement? And another big question looms: How do you protect your nest egg during a bear market—which will inevitably come roaring back at some point? // To help answer those questions, we take a look at three key decisions for new retirees: how much you can safely withdraw from savings each year, how to protect against having to sell investments in a down market, and how to supplement Social Security to lock in guaranteed income for life.

PHOTO-ILLUSTRATIONS BY C.J. BURTON

PART 1

SET YOUR STRATEGY

How do you tap a nest egg without depleting it too soon? The math is tricky because you don't know how long you'll need the money or whether you'll be hit with big medical or long-term-care bills. And no one can be certain that the stock and bond markets will deliver predictable returns over the next three or four decades.

In fact, many retirees are so afraid of running out of money that they are overly frugal—even when they have plenty of assets or the safety net of a pension, according to a recent study by the Employee Benefit Research Institute. EBRI found that people with $500,000 or more in savings at retirement spent down less than 12% of their assets over 20 years. That's good news for heirs, but it also suggests that retirees are scrimping unnecessarily.

To help new retirees navigate withdrawals, advisers often recommend the "4% rule" as a starting point. This strategy is designed to make a portfolio last at least 30 years—through bear markets and bouts of high inflation.

The rule is simple. Retirees in the first year of retirement withdraw 4% from their 401(k)s and other tax-deferred accounts, where most workers hold their retirement savings. Thereafter, retirees increase the dollar amount of their annual withdrawal by the previous year's inflation rate. For example, if you have a $1 million nest egg, you withdraw 4%—or $40,000—the first year of retirement. If inflation that year is 2%, in the second year of retirement you boost your withdrawal to $40,800. If inflation jumps to 3% that year, the dollar amount for the next year's withdrawal rises by the same rate, to $42,024. And so on.

Research behind the rule. This strategy has been a rule of thumb for millions of retirees, but it was considered radical when it was first proposed in 1994 by William Bengen. Bengen is an MIT graduate in aeronautics and astronautics who later became a certified financial planner.

"I got some hate mail," says Bengen, 71, now retired and living in La Quinta, Calif. Some of it was from financial advisers who had been telling clients they could safely withdraw 6% or 7% annually from their nest egg because the average annual return on a balanced portfolio was 7.5%, he says.

But those high withdrawal rates ignored the impact of bear markets. A bear market can devastate a nest egg if it happens early in retirement. Bengen looked at how portfolios would hold up under actual historical returns, including for someone who retired in the late 1960s and experienced two bear markets (1968–1970 and 1973–74) followed by a decade of high inflation. "That's a lethal combination for a retiree—bad market returns and high inflation," Bengen says. He concluded that a safe initial withdrawal rate from tax-deferred accounts for a 30-year retirement is 4%, with subsequent withdrawals adjusted for inflation.

Bengen recalculated his numbers for a 2006 book and found that by adding small-company stocks (which have greater growth potential than large-company stocks) to a portfolio, a retiree could bump up the initial withdrawal rate to 4.5%. (But 4% is still the recommendation for those Bengen calls his "Methuselah clients"—the ones who will likely have exceptionally long life spans.) When he made changes to the portfolio, Bengen also revised his 1994 recommended asset allocation of as much as 75% in stocks. Today, he recommends that retirees maintain a portfolio of half stocks and half bonds and cash.

Bengen says his rule was not meant to be etched in stone. A resumption of 1970s-style inflation—say, 9% or 10% a year—for a decade could cause the rule to fail, he says. Plus, as a planner, he would never have applied the rule without taking a client's total financial situation into account. For instance, a retiree who is determined to leave money to heirs might withdraw less, while another with a predictable, fixed-rate mortgage could take out more.

Other strategies. Bengen's rule isn't universally accepted. Some critics claim it's too stingy; others say it's too generous. Wade Pfau, a professor of retirement income at the American College of Financial Services, is in the latter camp. He says given how low interest rates have been, 3% would be a safer initial withdrawal rate for a 30-year retirement—or a 2.7% rate if you're planning for a 35-year retirement.

But Pfau says retirees could start

BEN LABROT

FOUNDER & CEO, FLOATING DOCTORS
LOS ANGELES, CA

2000
Graduates from med school in Ireland

2004
While on vacation in Tanzania, spends an entire day treating the residents of a remote Maasai village

2008
Founds Floating Doctors. Regularly travels to Haiti, Honduras and Panama to treat patients in remote coastal areas. Lives without income for 4 years

2010
Breaks free from mooring, and crashes boat onto an island reef. Narrowly escapes with vessel intact

2015
Purchases an annuity

2030
Target retirement date

PROTECT YOUR INCOME. RETIRE YOUR RISK.

While crashing into reefs, navigating hurricanes, and steering clear of pirates are probably not part of your day to day, you may have lived or worked with some amount of risk. But the important thing is to not retire with it.

Retiring with enough money saved isn't always as easy as it sounds. But adding an annuity to your portfolio can provide a protected income stream for the rest of your life and the peace of mind that your money won't stop working when you do.

Find out if an annuity is right to protect and grow your income at RetireYourRisk.org.

Alliance for Lifetime Income

with a withdrawal rate as high as 4.5% with the understanding that they will need to cut spending later, which most people naturally do after age 75. They can also buy an annuity that guarantees income for life to cover their basic expenses—allowing them to invest more aggressively (see "Guarantee Income," on next page).

The 4% rule still serves its purpose, "which is to help people translate a pile of money into a reasonable income stream," says Stuart Ritter, senior financial planner at T. Rowe Price. "And it still serves as a good starting point for the first year of retirement."

Ritter suggests that retirees review their withdrawals annually, because spending doesn't always go up every year at the rate of inflation. And retirees should recalculate their withdrawal rate every five years to see whether adjustments are needed, he adds. If you weren't clawed by a bear market, your portfolio performed well, and you now have five fewer years of retirement to fund, you might be able to give yourself a raise beyond the annual inflation rate, Ritter says. You can run your own numbers—and find out the likely success rate of not running out of money before you run out of time—by using T. Rowe Price's Retirement Income Calculator at www.troweprice.com/ric.

"The rule still works," says Wes Moss, a certified financial planner in Atlanta, who recently updated Bengen's original research to include those retiring at the start of the past two bear markets. He found that 70% of the time, the portfolio lasted 50 years or more. In the worst-case scenario, the money ran out in 29 years. Moss says that if withdrawal rates were slashed to well below 4%, as some suggest, then only rich people could afford to retire. "Retirement is hard enough for most people," he says. "To start making the retirement rules so conservative that it basically prices everybody out of the market, what's the point?" **EILEEN AMBROSE**

PART 2

CREATE A BUCKET LIST

The 4% rule and its corollaries help ensure that your money will last through a 30-year retirement. The bucket system is extra insurance to help make sure you have enough until you kick the bucket.

Most people know that investing at regular intervals means you buy more shares when the market is low and fewer when the market is high. In retirement, you're making systematic withdrawals, which is the evil twin of dollar-cost averaging: You're selling more shares when the market is low and fewer when it's high. Each withdrawal exacerbates the decline when a fund falls in value and reduces the gains when the fund rises. In a severe bear market, pulling money from a tumbling fund can be catastrophic.

The bucket system is designed to keep you from doing just that. You divide your retirement money into three buckets: One is for cash that you'll need in the next year or two, including major expenses, such as a vacation, a car or a new roof. The next is for money you'll need in the next 10 years. The final bucket is for money you'll need in the more distant future, either for you or your heirs. The bucket system "gives you the confidence and peace of mind to stay the course," says Jason Smith, author of *The Bucket Plan: Protecting and Growing Your Assets for a Worry-Free Retirement*.

Now, soon and later. The peace of mind comes from your first bucket—the cash stash—which you fall back on when markets get rough. For most investors, the cash bucket should be equal to one or two years' worth of what Smith calls the "income gap," or the difference between what you get from pensions and Social Security, and what you'll need to cover expenses.

Short-term interest rates are still lower than an ant's ankles. But think of your cash bucket as a hedge against a market decline. "When you take out fire insurance, you don't get upset when your house doesn't burn down," says Harold Evensky, a certified financial planner and chairman of Evensky & Katz/Foldes Financial. "You're not trying to make money with this bucket," he says. "You're making sure it's there when you need it."

Your second bucket should be the one that throws off the most income. Conservative investors might prefer a portfolio of laddered bank CDs or bonds. Investors who can stand a little more risk might toss in some high-yield-bond or preferred-stock funds. Aggressive investors might also mix in equity-income funds, which focus on dividend-producing stocks.

If the first bucket is *now* and the second bucket is *soon,* the third bucket is *later.* It should contain higher-growth, long-term investments, including stocks and alternative investments, such as commodities, real estate, hedge funds and the like.

Separate accounts. As a practical matter, it helps to have a separate account for each bucket, says Mark Paccione, director of investment research at financial planning firm Captrust. "We monitor the split between the three buckets and, depending on what's going on in the market, opportunistically draw down from the income or growth bucket to replenish the cash bucket." Remember that there's a cost—in taxes and transaction fees—to fine-tuning your portfolio too often.

Given sizable bull market gains, it would make sense now to use the

growth bucket as a source for replenishing the cash bucket, says Christine Benz, director of personal finance at Morningstar. "It's the logical place to harvest for the next couple of years or more," she says.

The test of the bucket system comes in years when gains are scarce. Evensky has been a believer for decades. "During the 1987 stock market crash, when it looked like the world was going to end, I was in the office by seven o'clock in the morning, and the phone didn't ring," he says. "I thought all my clients were dead or in the hospital." The reason they didn't call? "All my clients knew where the grocery money was coming from." **JOHN WAGGONER**

PART 3

GUARANTEE INCOME

Those who don't have a traditional pension—and that includes most of us—are frequently envious of those who do. What could be better than a guaranteed paycheck that lasts as long as you live and is unaffected by the vicissitudes of the stock market?

There's another way: Create your own pension with an immediate annuity. Unlike the complex (and usually high-cost) indexed annuities that are sold at free lunches and dinners, immediate annuities (sometimes known as single premium immediate annuities, or SPIAs) are straightforward: You give an insurance company a lump sum and, in return, receive a monthly check, usually for life.

A lot of policymakers and retirement experts believe annuities could go a long way toward improving retirement security in the U.S. But with immediate annuities, security comes at a cost: Once you buy one, you usually can't get your money back. (Some insurance companies allow you to make a one-time cash withdrawal to cover a financial emergency, such as a large medical bill.) But investing some of your savings in an immediate annuity could help you sleep at night, particularly if you're worried about a market downturn. If your monthly payout covers your expenses, you'll have more flexibility to ride out a bear market because you won't have to tap your investment portfolio to pay the bills.

What to look for. If you're interested in buying an annuity, start by tabulating your cost of living. Break down your expenses into mandatory and discretionary categories, says Randy Bruns, a certified financial planner in Downers Grove, Ill. (If you like to live large, you may want to create a third category for luxury expenses.) Once you've completed that exercise, you can buy an annuity that, along with Social Security benefits, will cover your basic expenses, such as groceries, your mortgage, utilities and property taxes.

Next, go to www.immediateannuities.com to get an idea of how much you'll need to invest to generate that amount of income. For example, if you're a 65-year-old man and need $1,500 a month to keep the lights on and food in the fridge, you'll need to invest about $266,000 for a single-premium lifetime annuity. If your wife is also 65 and you want an annuity that will continue to pay as long as one spouse is alive, you'll need a joint-and-survivor annuity. To generate $1,500 a month, you'll need to invest about $316,000.

While immediate annuities are less complex than some of their higher-fee cousins, there are optional features worth considering:

Inflation rider. One downside to immediate annuities is that inflation will erode your monthly payments over time. You can buy an annuity with an inflation rider, either one that increases at a set rate so that your income rises each year by a specific percentage (usually 3%) or one that increases (or decreases) each year based on changes in the consumer

price index. The trade-off is that during the first few years, your monthly payouts will be up to 28% lower than those from an annuity without the rider. If you're using the annuity to cover expenses that won't change much (such as a fixed-rate mortgage), you may be better off skipping this feature in favor of larger payments.

An alternative is to ladder annuities—that is, spread out your annuity purchases over several years. If interest rates go up, the payments on annuities you purchase in the future will be higher. You'll be older, too, and that automatically means your payments will increase.

Survivor benefits. Many people eschew annuities because they hate the thought that they might die before they've spent the money they've invested, says Stan Haithcock, an independent annuity agent in Ponte Vedra Beach, Fla. But it doesn't have to work that way. You can buy an annuity that will pay your beneficiaries a lump sum based on your original investment, minus any income payments made to you. This feature will cost you more. A 65-year-old man who wants to generate $1,500 a month would need to pay about $291,000 for this feature—$25,000 more than he would pay for an annuity that ends when he dies. If he buys a joint-and-survivor annuity with this feature, he'll need to invest about $323,000.

Deferral. Deferred-income annuities don't provide immediate income, but they protect you from the risk of outliving your money. Typically, you purchase them in your fifties or sixties, but payments don't start for at least 10 years. If you die before payments start, you get nothing (unless you opt for survivor or return-of-premium benefits). A 65-year-old man could buy a deferred annuity that pays $1,500 a month in 10 years for about $110,800.

Safety and soundness. When you buy an immediate or deferred annuity, make sure the insurance company has the financial strength to make good on its promise. Look for an insurance company that has a top rating from A.M. Best (www.ambest.com). Comdex is another source: It compiles a composite index of insurers based on ratings from all of the agencies (including A.M. Best, Moody's and others). You can download a free Comdex report at Haithcock's website, www.stantheannuityman.com (click the "Resources" tab). **SANDRA BLOCK**

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