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With
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Six Rules for Smart Withdrawals

So you're at that stage in your retirement when you need to crack into your hard-earned piggy bank (we hope it's a big one). So how do you do it? We've compiled some of the best insights from our *Rule Your Retirement* team to help you successfully walk this path.

When it comes to tapping into that nest egg, the conventional wisdom is that you should first start with your taxable (i.e., non-retirement) accounts, permitting your IRAs and 401(k)/403(b)/457/SEP to continue benefiting from tax-deferred growth as long as possible. Like all conventional wisdom, it's good general advice — but perhaps not so good for every individual. To see why, let's review the six steps you should take to determine the strategy that will trim your taxes and prolong your portfolio.

1

Know how much income you'll need and where it will come from.

A smart withdrawal strategy starts with knowing how much you'll need to withdraw. If you plan on needing $50,000 a year in retirement and you'll receive $25,000 from your pension and Social Security, then that other $25,000 will have to come from your investments. Next, estimate how much the income-producing investments (e.g., bonds and dividend-paying stocks) outside your retirement accounts will provide. If those will provide another $5,000 a year, you know you'll need to withdraw $20,000 from your retirement accounts. Knowing exactly how much you need to withdraw lowers the chance that you'll take out too much. Withdrawals from retirement accounts are a one-way street: Once you withdraw money, you have just 60 days to put it back. After that, the door is closed, and you'll lose the tax advantages on any growth that money earns.

How much will you actually need to retire? You've probably heard that you'll need about 70% of your pre-retirement paycheck to maintain the lifestyle to which you're accustomed.

But is that true? Will it be enough to pay for your cross-country jaunts and your surgically replaced joints?

To answer that question, let's see what real retirees do. The good folks at the U.S. Census Bureau ("You're more than a number ... except to us") collect household income and spending data every year, and publish the national averages in the riveting Consumer Expenditure Survey. The information is broken down into many categories, including by age. I've put some of the highlights from 2002 in the chart below.

AVG. HOUSEHOLD	45-54	55-64	65-74	75 AND OLDER
INCOME BEFORE TAXES	$64,974	$53,162	$35,118	$23,890
ANNUAL EXPENDITURES	$48,748	$44,330	$32,243	$23,759
FOOD AT HOME	$3,528	$3,114	$2,877	$2,195
FOOD AWAY FROM HOME	$2,700	$2,445	$1,602	$1,107
HOUSING	$15,476	$13,831	$10,052	$8,257
APPAREL AND SERVICES	$2,029	$1,791	$1,252	$674
TRANSPORTATION	$9,173	$8,449	$5,731	$3,178
HEALTH CARE	$2,550	$3,007	$3,588	$3,584
ENTERTAINMENT	$2,565	$2,297	$1,371	$896
INSURANCE AND PENSIONS*P.4	$5,323	$4,838	$1,853	$696
PERSONAL TAXES	$4,051	$2,856	$1,556	$479

Now, what are the most important conclusions we can draw from this data?

1. **The income drop-off.** If you're in your late 40s or early 50s, enjoy it while you have it, because it seems those are the peak earning years. Perhaps most shocking

is that the average household led by someone 75 or older lives on $23,890 a year. Is that due to an inability to do part-time work, or depleted savings? The survey doesn't say, but I guess it is both. According to some studies, more than half of the people who retire are forced to do so because of health problems, not because they want to.

2. Annual expenditures as a percentage of income jump significantly. Seventy-five cents of every dollar in income in the 45-54 age group goes to covering annual expenses. This percentage jumps to 92% for the 65-74 group and to almost 100% for those 75 and older. So there isn't too much of a cushion. A failed jalopy, damage from a string of hurricanes, or out-of-pocket medical expenses could easily cause expenditures to exceed income.

3. Expensive body work. It's no surprise that health-care expenditures increase, on both relative and actual terms. As the cost of health care keeps rising, this will prove to be the Achilles heel of many retirement plans.

As for how your spending will affect your retirement, many expenses do drop in retirement as a natural consequence of not working, such as Social Security taxes, commuting costs, and wardrobe upkeep. As for other costs that are more discretionary, such as entertainment and dining out, I suspect those drop primarily out of necessity, rather than choice. If your income is just $23,890 a year, something has to go.

Of course, these numbers are national averages. The important numbers are what you will spend in retirement. Look over those categories again. How much change do you expect? Do you think your entertainment budget will drop 65%? Do you want it to? Knowing exactly how much you will spend and comparing it with the income you expect will answer whether you're ready to retire.

2

Estimate required minimum distributions.

Uncle Sam gave you the gift of tax-deferred growth in your retirement accounts, and now it's payback time. By April 1 of the year following the year you turn 70 1/2, you must begin taking withdrawals from your traditional IRA and employer-sponsored retirement account. (You might be able to leave the money in the latter if you're still working.) If the combined balance in those accounts is large,

Making Your Portfolio Last

How much retirement income will your portfolio provide? Here to answer that question is John Greaney, founder of www.retireearlyhomepage.com and a longtime Fool. John worked for several Fortune 500 companies in the oil and gas and chemical industries before he retired at age 38. He is a recognized expert on keeping your portfolio working long after you've quit your job.

When I retired in 1994, it wasn't uncommon to find well-dressed, impressively credentialed financial advisors telling folks they could safely withdraw 7% per year from an all-stock portfolio without running out of money. Even Fidelity's legendary mutual fund manager, Peter Lynch, wrote just that in a September 1995 *Worth* magazine article, "Fear of Crashing."

One problem: Depending on how the market performs after you retire, spending 7% of your portfolio each year might leave you short.

After "Fear of Crashing" was published, *Dallas Morning News* financial columnist Scott Burns shared the bad news. During at least one period since 1960, a retiree could burn through a portfolio invested entirely in the Dow Jones Industrial Average in 15 years under the pressure of 7% annual withdrawals. (To his credit, Lynch quickly withdrew the article when presented with Burns' analysis.)

Obviously, that's the worst-case scenario, but if you want to be certain your retirement nest egg will survive the worst stock and bond markets we've seen (and you want to increase your withdrawal to keep up with inflation), limit your first-year take to about 4% of a well-diversified portfolio. That's just $40,000 from a $1 million portfolio, perhaps not as much as you hoped.

You might be thinking, "Hey, if the compound average annual return of the stock market since 1926 is 10%, how come I can only take 4%?" One word: volatility. The market doesn't go up 10% every year. It goes up 20% one year, drops 15% the next, and can be essentially flat for more than a decade. All that zigging and zagging can produce a sequence of returns that severely reduces what you can withdraw from your portfolio.

Who Says 4%?

One of the first people to arrive at that 4% figure was financial planner William Bengen, who studied safe withdrawal rates using long-term stock market data in a groundbreaking series of articles back in 1994. Several analysts confirmed Bengen's research, among them researchers at Trinity University and Texas-based financial planner Jaye Jarrett.

However, these studies used raw stock market indexes and bond yields in their analysis, ignoring the fees, commissions, and other expenses incurred by real-life investors. To remedy this, in 1998 I put together a spreadsheet using the Trinity study's methodology along with what they missed. The most recent update of my study, using Yale University Professor Robert Shiller's monthly stock market data, examined the 102 overlapping 30-year periods from 1871-2002 to determine the largest initial inflation-adjusted withdrawal that would have still left $1 in the account at the end of 30 years. Retirees using low-fee index funds could safely make an initial withdrawal of about 4%. If you increased the withdrawal to 5%, you ran out of money in 26 of the 102 periods; at a 6% withdrawal, more than half the 102 periods examined.

Asset Allocation Is Key

Having a mix of both stocks and fixed-income securities in your retirement portfolio improves its long-term survival. Most of the safe retirement withdrawal studies found that a simple mix of 60% stocks (a broad-market index such as the S&P 500 or Wilshire 5000) and 40% fixed-income securities (usually bonds with five-year maturities) fared the best.

An initial 4% withdrawal rate would mean withdrawing $40,000 from a $1 million portfolio in the first year. If the annual rate of inflation were 3%, your second-year withdrawal would be $40,000 x 1.03 = $41,200. If inflation were again 3% in the third year, you'd withdraw $41,200 x 1.03 = $42,436. You'd withdraw that same amount whether your portfolio declined or increased in value from year two to year three.

How you actually withdraw the money depends on your choice of investments and accounts. Start by spending the dividends and interest you receive from your investments in taxable (i.e., non-retirement) accounts. Then, factor in any required withdrawals you make from your retirement holdings. After that, you'll have to decide between selling assets inside or outside your retirement accounts. That decision will depend on tax considerations and the individual investments, but consider selling whichever asset class needs to be reduced to get you back to the 60/40 allocation.

It's crucial to keep fees low. A retiree holding mutual funds with an annual expense ratio of 1.5% (the average for a domestic stock fund) and trading costs of an additional 1.0% couldn't even safely withdraw 3% per year. In fact, a retiree holding the average mutual fund is likely paying far more to his mutual fund manager than to the IRS.

A married couple taking $40,000 in ordinary income from a $1 million retirement portfolio and electing the standard deduction only paid about $3,000 in federal income taxes in 2003. At a 1.5% expense ratio, the couple's mutual fund manager took $15,000 from their $1 million nest egg. Had they invested in a low-fee index fund with a 0.18% expense ratio, they would have paid only $1,800 to their fund manager.

The Foolish Bottom Line

Keep in mind that 4% is the worst-case-scenario withdrawal rate — the rate that would have enabled a portfolio to survive any 30-year period (including the worst markets) of the past 133 years. If you don't happen to retire on the eve of the next Great Depression, there's a good chance you'll be able to increase your spending beyond any increases in the rate of inflation. Also, if you don't expect to need your portfolio for 30 years (no one can predict life expectancies, but an 85-year-old chainsaw juggler should be realistic), you can bump up your withdrawal rate.

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delaying withdrawals could mean you must take very large withdrawals later, pushing you up into a higher tax bracket.

Project the value of your 401(k) and IRA account balances now to get an idea of how much you'll have to begin taking out once you become a septuagenarian. If those withdrawals will knock you up a couple of brackets, consider tapping those funds earlier. It may not cost you much in taxes as long as you …

3

Never leave a low(er) tax bracket unused.

When you retire, you get to decide when to recognize income and by how much — the exact opposite of your working years. By selectively recognizing income, you can take advantage of the tax system's progressive nature (i.e., higher incomes get taxed at higher rates). Plus, due to exemptions and standard deductions that everyone receives, some income is essentially tax-free. Try to smooth out your earnings so that you can consistently stay in the lowest tax bracket possible, ideally 15%. Big bubbles of income recognition and zero-income tax years can cost you more over the years.

4

Start with your employer plan over the traditional IRA.

Withdrawals from these accounts are generally taxed the same way. However, some employer-sponsored plans have tougher withdrawal rules. For example, some 401(k)s limit withdrawal frequency to once a year or even force you to adopt a fixed multiyear withdrawal schedule. Unless there are overriding reasons to the contrary (such as lots of materially appreciated company stock or stellar investment choices), you're usually better off rolling over the money in an employer plan to an IRA.

5

Save your Roth IRA for last.

Since the distributions from a Roth IRA are tax-free, Uncle Sam doesn't have a vested interest in your withdrawals, so you're not forced to take out the money at a certain age. For most people, then, it's best to leave the Roth alone and get that taxless growth as long as possible. Plus, there are estate-planning benefits to Roths because they usually pass to heirs tax-free. In fact, you might want to make selective Roth IRA conversions when your taxable income is otherwise low. (For more Foolish information on the Roth, check out our article on Why We Love the Roth IRA.)

Footnote from Chart, page 01

*Non-workers no longer have to pay Social Security taxes, which are considered an insurance expense. After all, those taxes are known as FICA taxes, named after the Federal Insurance Contributions Act.

Withdrawals From a 401(k)/403(b) Vs. an IRA

As far as the IRS is concerned, when you retire from work in the year you reach age 55, you may make withdrawals from your 401(k) or 403(b) plan free of any penalty. All that's required is for you to pay regular income taxes on those withdrawals in the year you take them. The only withdrawal restrictions you will encounter are those required by the plan itself, so contact the administrator to learn the rules for your plan. You can continue to make withdrawals even if you later take on a part-time job or start your own company, because you will be taking the money from the plan sponsored by a former employer, from whom you retired at age 55 or older.

Generally, we recommend that money be transferred from a 401(k)/403(b) to a self-directed IRA as soon as possible. Why? Employer-sponsored retirement plans usually offer limited, mediocre investment choices — and charge too much for them, to boot. Chances are you'd pay less in fees and have many, many more investment options by moving your money to a low-cost mutual fund family or discount brokerage.

There are also estate-planning benefits to having money in an IRA vs. an employer-sponsored plan. When someone inherits a 401(k)/403(b) from a person who wasn't his or her spouse, for example, the inheritor might be required to withdraw all the money from the account immediately, and count the entire amount as ordinary income. That will lead to a hefty tax bill, and thus a lower after-tax inheritance. (Contact your plan sponsor to find out the rules for your plan.) However, withdrawals from an inherited IRA can be spread out over the beneficiary's lifetime. This provides more flexibility and allows most of the money in the account to continue growing on a tax-advantaged basis.

For someone 55 to 59 1/2 years old, however, there's an extra wrinkle. While you can take money out of your employer-sponsored plan free of restrictions if you retire in or after the year you turn 55, you don't have such freedom with an IRA until you turn 59 1/2. The same is true of SIMPLE IRAs and Simplified Employee Pensions, a.k.a. SEPs. If you want money from an IRA before that magic age, but you don't want to pay the 10% penalty on early withdrawals, you must take distributions that are a part of a series of "substantially equal periodic payments" (SEPPs). The Internal Revenue Service allows three ways to calculate your SEPs.

Once you've selected a method and resulting withdrawal amount, you must take that much out of your IRA each year for five years or until you turn 59 1/2, whichever is later. In other words, if you transferred your money from an employer-sponsored plan to an IRA and began taking SEPs at age 57, you would have to take that amount each year until you turned 62. So anyone between the ages of 55 and 59 1/2 who wants to begin withdrawing money from an employer-sponsored plan should weigh the benefits of transferring assets to an IRA vs. the reduced flexibility of SEPs

6

Use software as a planning tool.

It's tough to keep straight all the factors that determine the final number that appears at the bottom of your tax return. TurboTax, TaxCut, or any other tax-preparation software is your best friend when managing your tax bill. Though Congress changes the rules every once in a while, this year's tax software is still the best way to project what your tax situation will look like next year.

Now, let's look at the withdrawal strategies of three hypothetical retirees.

Example No. 1

Let's start simple by looking at Francine, who has $100,000 in her brokerage account and $100,000 in her IRA. She's 65 now, so she figures that her accounts will be worth about $150,000 each by the time she reaches her required minimum distributions (RMDs). We calculate the $150,000 by using the handy-dandy tools section of the *Rule Your Retirement* website. Go to http://www.fool.com/newsletters/13/tools/index.htm and scroll down to the calculators. Click on "How much will my savings be worth?" and fill in the blanks. The savings rate is the return you expect on your investments. Put zeroes into the tax and inflation blanks because we're looking for pre-tax numbers not adjusted for inflation.

Francine then divides the projected amount in her IRA by the distribution period of 27.4 years (essentially a person's life expectancy: At 70 years old this is 27.4 years) and gets an estimated RMD of $5,474. That's not a huge amount of income and not likely to push her into another tax bracket, unless she were right on the cusp. So in her situation, it would probably be best to live off the investments in her taxable account and let the money in her IRA grow tax-deferred as long as possible.

Example No. 2

Now, let's get a bit more complicated. Meet Frank. He retired five years ago at age 60 with a $1,000,000 portfolio, divided equally into a traditional IRA, a 401(k) account, a Roth IRA, and a regular old brokerage account. Frank thought he would outsmart Uncle Sam by keeping his taxable income close to zero in the last five years by living off municipal bond interest, offsetting capital gains with losses, and tapping his Roth IRA (which provides tax-free distributions). Unfortunately for Frank, his withdrawal strategy will actually cause him to pay Uncle Sam $50,000 more than necessary. How? By delaying withdrawals from his traditional IRA and 401(k), he will have to take large distributions once RMDs kick in — sending him to the higher tax brackets.

Frank ignored his exemptions (about $6,000 per year for himself and his wife), his standard deduction (about $10,000 per year), and the 10% and 15% tax brackets (up to about $15,000 and $60,000 of taxable income, respectively). Sure, taking some money out of his tax-deferred accounts would have meant that Frank would pay some taxes each year. But by not tapping his 401(k) and traditional IRA, he is now destined for the 25% to 28% tax brackets over the long term.

He could have made a withdrawal from his 401(k) plan or IRA of $30,000 and paid just $1,400 in federal income tax — an average rate of 4.7%. Or, he could have made withdrawals of $50,000 and paid $4,400 in tax — an average rate of 8.8%, with the last dollars being taxed at a 15% marginal rate. Frank is better off paying a little tax earlier because those same dollars might be taxed at 25% to 35% sometime down the road.

Example No. 3

A study published by the American Association of Individual Investors assumed a retiree needed to withdraw $20,000 a year from a $300,000 portfolio, which is divided equally between taxable and tax-deferred assets. The authors approached the withdrawals question from another angle: Which strategy would prolong the life of a portfolio? The conclusion: When the person tapped the taxable accounts first, the portfolio lasted as much as 2.4 years longer than had the person started with the tax-deferred accounts. Again, we come back to the general advice that using the money in taxable accounts first is a good strategy.