# Motley Fool Rule Your Retirement™

Volume 4, Issue 2, February 2007 | Plan Well, Retire Wealthy | www.ruleyourretirement.fool.com



*With*
**Robert Brokamp**
*Editor*


## Quote of the Month

"If you're not losing money somewhere in your portfolio, you're not diversified enough."

— Louis Stanasolovich, wealth advisor

## Inside



## Your Work-to-Retirement Ratio

Back in 1889 when Otto von Bismarck created the first government pension program, the retirement age was 70. Back then, if you reached age 50, your life expectancy was 72. If a typical worker began a full-time career at age 16, he worked for 54 years to fund two years of retirement.

Fast forward to today, and a college graduate begins work at age 22, retires at 62, and lives to 82. That's 20 years of retirement, supported by only 40 years of work.

This "work-to-retirement ratio" is how Alex Pollock, a resident fellow at the American Enterprise Institute, summarizes the challenges faced by today's retirement landscape.

But the work-to-retirement ratio isn't useful just for explaining corporate and government problems. It also helps explain how much one has to save each year throughout a career to fund retirement ("required savings" includes employer contributions to retirement plans):

| W-R Ratio | Required Savings |
|---|---|
| 2:1 | 14% |
| 3:1 | 9.5% |
| 4:1 | 7% |
| 5:1 | 6% |

## Dear Fellow Fools,

Welcome to the New Year! How are those resolutions holding up thus far? If you're like most people, you're probably doing pretty well right now — after all, 2007 is just a few days old. However, as the days turn into weeks and then months, chances are that you'll remember your resolutions about as well as you remember the gifts you received during the holiday season. (My wife and I have considered writing an article in June about how many of our kids' Christmas gifts are still played with. However, we fear the truth will be too depressing.)

So what's the solution to lapsed resolutions? Don't make them a choice; make them automatic. Here's how:

**Save more.** If you're still working and you want to supercharge your savings, make it automatic by asking your employer to direct more of your paycheck to your retirement plan. Increasing your contribution rate by just another percentage point or two won't be too hard on your current spending — the tax breaks will soften the blow — but it could do quite a lot for your nest egg. The same can be done for an IRA; just fill out a request for an automatic transfer from your checking account to your retirement account.

If you've already maxed out your tax-advantaged accounts, consider a direct stock purchase plan. These programs allow you to invest as little as $50 a month commission-free (and automatically) in the stock of blue-chip companies such as Home Depot, Wal-Mart, and Pfizer. Contact the investor relations department of the companies in which you'd like to invest to see if a direct stock purchase plan is available.

**Spend less.** The only reason people spend more than they'd really like is because they can. Cut off the source of funds, and spending more is impossible. The main culprit here is credit cards. If you'd like to cut back on your spending, use cash or debit cards linked to accounts with a pre-set amount of money. Once the cash is gone or the debit account is depleted, spending more isn't an option.

**Allocate your assets (and rebalance).** In the June 2006 issue, I interviewed asset manager and author Rick Ferri. He suggested that while 90% of investors can come up with a good asset allocation strategy, only 5% implement the plan and maintain it over a five-year period. If you have trouble maintaining a plan, then consider one of two options. The first is to choose from among the burgeoning number of "lifecycle" funds being offered by the likes of Vanguard, T. Rowe Price, and Fidelity. These funds automatically allocate your assets according to your age and rebalance regularly, all at a reasonable cost.

The other option is to hire a financial advisor like Ferri. You'll have to pay more, of course, but sometimes it's worthwhile to get a pro to do something that you just don't get around to doing yourself. To find a fee-only advisor in your area, visit www.napfa.org or www.GarrettPlanningNetwork.com.

Save more, spend less, invest wisely — those are three great resolutions that will certainly make 2007 the year you got closer to ruling your retirement.

Rule on!

Robert Brokamp

PERFECT YOUR PORTFOLIO

## Withdraw More Than 4%?

I have really good news, and I have news that is not nearly as thrilling but is still important. Let's start with the latter: This article is about safe withdrawal rates in retirement.

"We already know that," you're thinking. "If you want your portfolio to last 30 years and you want to be able to adjust your withdrawals every year for inflation, then you shouldn't take out more than 4% of your portfolio value in the first year of retirement."

Excellent — I'm glad you've been paying attention. But here's the really good news: 4% might be too low. And that's what we're going to discuss this month.

### Managing Two Risks

The need for a safe withdrawal rate (SWR) is based on the need to protect your portfolio from two events — one bad, one potentially good (though not for your portfolio).

**1. Really bad market performance:** An SWR is one that would have survived the worst market crashes we've seen, including the Great Depression of the 1930s and the crash of the Nifty 50 (and plenty others) in the 1970s. If history is any guide, however, those events happen once in a generation, and the period from 2000 to 2002 *may* have taken care of it for this generation (at least we hope).

**2. Living a really long time:** Most studies on SWRs consider a retirement of 30 to 40 years. However — and I hate to be the one to tell you — if you're in your 60s, odds are you won't make it to your 90s. (If you are in your 80s, the odds look better. If you're in your 90s, your odds are outstanding.) At age 65, a female has an average life expectancy of 22 years; only 23% of 65-year-old females make it to 95. Those figures are 19 years and 17%, respectively, for males.

Of course, you don't know how long you'll live, so it's prudent to plan on outliving the averages. Plus, there are worse things in the world than a long life. But it may not be so good for your portfolio if you've withdrawn too much in the beginning of your retirement.

So this is where the SWR comes in. The SWRs that are usually discussed (such as 4%) really measure the first risk (market performance) and just assume the second risk (that you'll live another three or more decades). The question, then, is what is the combined chance that (1) a withdrawal rate would have depleted a portfolio due to poor market performance *and* (2) you'll live well into your 90s?

I asked John Greaney — founder of the Retire Early Home Page, but you may know him better as **intercst** on our discussion boards — for his insight into quantifying the probabilities. He has kindly allowed us to reproduce some of his research. Using the IRS 2003 Mortality Table, Greaney calculated that:

- A 65-year-old has a 1% chance of living another 40 years to age 105.
- A 60-year-old has a 5% chance of living another 40 years to age 100.
- A 57-year old has a 10% chance of living another 40 years to age 97.

The table below is based on a 40-year payout period and a portfolio that is 79% stocks as measured by the S&P 500 and 21% fixed income investments as represented by three- to six-month commercial paper (based on Yale professor Robert Shiller's 1871 to 2002 database). Combining the probabilities of the portfolio running dry — and the odds that our retiree will actually live long enough to see his portfolio run dry — yields the following table:

**Joint Probability of Portfolio Survivability & Life Expectancy, 40-Year Payout Period**

| | Withdrawal Rate | | |
|---|---|---|---|
| Odds of Living 40 Years Beyond Current Age | 3.90% (99% safe) | 4.13% (95% safe) | 4.26% (90% safe) |
| 65-year-old (1% odds) | 99.96% | 99.76% | 99.47% |
| 60-year-old (5% odds) | 99.8% | 99.2% | 98.6% |
| 57-year-old (10% odds) | 98.3% | 96.6% | 95.3% |

Assumes a 0.20% expense ratio; inflation indexed to CPI-U; January start date; and $1,000 initial balance. Note: The combined probabilities were calculated by examining each of the 92 40-year payout periods from 1871 to 2002, determining the chance that the portfolio would run dry in that year and multiplying that probability by the chance that the retiree would still be alive in the year the portfolio ran dry. The sum of these joint probabilities is the figure reported in the table above.

What does it all mean? Let's start by looking at a 57-year-old who is on the eve of retirement. He may see that a 4.26% initial withdrawal rate had a 90% success rate over the periods examined. However, there's only a 10% chance that a 57-year-old will still be alive and kicking 40 years later. So the combined "success rate" — the chance that the money will survive longer than the retiree — is 95.3%.

Why does it work out that way? Because most of the portfolio failures happened in the last of those four decades — a time when, statistically speaking, not too many former-57-year-olds will still need retirement income (expenses drop dramatically in the afterlife). Of course, these life expectancy numbers are based on current figures; medical breakthroughs over the next few decades could make a 40-year retirement more likely.

Still, the bottom line here is that higher withdrawal rates have a statistically lower rate of failure when you factor in current life expectancies — the actual likelihood that you'll make it to your 90s and beyond.

## But Wait, There's More!

Each study about SWRs comes up with slightly different numbers. This is due to several factors, primarily having to do with which sets of data are used, which asset classes are included in the study, and the conditions under which withdrawals are made. Many studies (such as Greaney's) look at two asset classes and assume a consistent real (inflation-adjusted) income stream.

But what happens when (1) different asset classes are thrown into the mix, and (2) withdrawals are adjusted according to market conditions? Let's briefly look at one such study.

## Adding in Small Stocks, Floors, and Ceilings

Certified Financial Planner William Bengen was one of the first to study sustainable withdrawal rates. (Bengen is also the guest in this month's Expert Corner.) Using the return numbers from Ibbotson Associates' *Stocks, Bonds, Bills, and Inflation Yearbook*, Bengen constructed a portfolio of 40% large-cap U.S. stocks, 20% small-cap U.S. stocks, and 40% intermediate-term government bonds. The addition of small-cap stocks raised Bengen's estimate of the SWR for a 30-year period from 4.15% to 4.42%.

But what about retirees who are willing to let their incomes fluctuate — rising when times are good, and dropping when the market does — but not too much? As a solution, Bengen developed the "floor and ceiling" model. Here is one variation:

» Rather than start with an initial withdrawal rate and adjust it annually for inflation, withdraw a percentage of the portfolio value every year. Thus, the retiree's income will rise and fall with the portfolio.

» To prevent a bear market from causing a dramatic drop in a retiree's income, a withdrawal cannot be lower than 10% below the real (inflation-adjusted) value of the first year's withdrawal.

» To benefit from a bull market, withdrawals are allowed to increase up to 25% above the original withdrawal amount (adjusted for inflation).

According to Bengen's research, such a plan has an SWR of 5.16%. If you're willing to tolerate a lower "floor" — that is, a bigger potential drop in portfolio income — you can start with an even higher withdrawal rate. Here are the initial withdrawal rates that Bengen concluded could be sustained by various floor and ceiling combinations:

### "Floor and Ceiling" Withdrawal Plan

| Floor on Dollar Value of Real Withdrawals | Ceiling on Dollar Value of Real Withdrawals 5% | 10% | 15% | 20% | 25% |
|---|---|---|---|---|---|
| -5% | 4.90% | 4.90% | 4.90% | 4.90% | 4.90% |
| -10% | 5.16% | 5.16% | 5.16% | 5.16% | 5.16% |
| -15% | 5.45% | 5.45% | 5.45% | 5.45% | 5.45% |
| -20% | 5.75% | 5.75% | 5.75% | 5.75% | 5.75% |

Source: *Conserving Client Portfolios During Retirement*, by William Bengen, CFP

Notice that the SWR depends entirely on the floor, not the ceiling. As Bengen writes, "the [floor and ceiling] method achieves its higher withdrawal rates primarily by providing for occasional reductions in the real values of withdrawals." And the higher the potential reduction you're willing to take later on, the higher the withdrawal rate you can take starting out.

**"And the higher the potential reduction you're willing to take later on, the higher the withdrawal rate you can take starting out."**

As you've often heard, there's no free lunch. If you want a steady stream of income from your portfolio, start with a lower withdrawal rate. To move to a higher initial withdrawal rate, you'll have to accept fluctuating income from the portfolio (not to mention more record-keeping). But you may be willing to accept that tradeoff, especially if you have other, more stable sources of income, such as a traditional pension.

## The Foolish Bottom Line

If history is any guide, a 4% withdrawal rate is very, very safe. Thus, most retirees can withdraw a bit more and be reasonably sure they'll make a deposit in that Great Vault in the Sky with money still left in their earthly bank. How much more depends on your circumstances, as well as how much you're willing to allow your income to fluctuate and be dependent on various factors.

For the next *Rule Your Retirement* update — which hits your inbox Thursday, Jan. 18 — we'll review a withdrawal scheme that allows for initial rates closer to 6%. But this scheme requires following several rules and involves occasional decreases in portfolio income.

Until then, you can learn more about Bengen's research by reading his articles at www.fpanet.org/journal or reading his book, *Conserving Client Portfolios During Retirement.* And, as always, bring all your questions to the *RYR* Q&A discussion board.

WEALTH DEFENSE

# A Comfy "Income Cushion"

By David Braze

As a retiree, I maintain a five-year cushion of income that's not invested in the stock market. Like many Fools, I do so because I know I will spend that money within the next five years, and I don't want to sell stocks during a down market when I need that cash. Accordingly, I keep that five-year income cushion in things like money-market funds, Treasury bills, certificates of deposit, and short- to mid-term bonds where it can still earn interest yet avoid most of the volatility found in the stock market.

There are a number of ways you can establish what the size of your five-year pot should be. I simply start with the gross income I want for the first year. From that, I subtract my known income from pensions, wages, Social Security benefits, etc. That establishes the year's shortfall that must come from investments. Then, using an assumed inflation rate, I simply inflate that estimate to determine my shortfall for each of the next four years.

Let's look at an example:

## A Soft Landing

Say I want $35,000 in pretax income for my first year in retirement: $18,000 of that income will come from a company pension, $12,000 from Social Security, and the remaining $5,000 from investments. I expect inflation to average 3% annually over the next five years. My pension won't increase along with inflation, but my Social Security benefit will. Before I take my first year's income, my investment stash is $100,000. Given all that, I can construct the following table:

**Income Cushion (Years 1-5)**

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|---|---|---|---|---|---|
| Income | $35,000 | $36,050 | $37,132 | $38,245 | $39,393 |
| Less: | | | | | |
| Pension | $18,000 | $18,000 | $18,000 | $18,000 | $18,000 |
| Social Security | $12,000 | $12,360 | $12,731 | $13,113 | $13,506 |
| Shortfall | $5,000 | $5,690 | $6,401 | $7,133 | $7,887 |

Note that I have inflated my desired income in the second and subsequent years by the assumed inflation rate. I did the same for my Social Security benefit, which has yet to be denied an inflationary increase by Congress. My five-year income cushion is simply the sum of the shortfalls for the first five years, or $32,110.

I now subtract that amount from my initial retirement stash of $100,000, which leaves me with $67,890 to invest in stocks. From the $32,110 cushion, I take $5,000 (the current year's shortfall) and invest it in a money-market fund until I withdraw it to cover living expenses later in the year. I invest the remaining $27,110 in short-term and intermediate-term bonds. In total, $95,000 remains invested, with 71.5% in stocks and 28.5% in bonds. Does that sound anything like asset allocation to anyone?

At the end of Year 1, I take note of what happened. I see that my actual inflation rate was 2.5% for the year, that my stock portfolio earned 11% to end at $75,358, and that my bond portfolio earned 6.5% to end at $28,872. I would then increase my second year's desired income by 2.5% to keep pace with the actual inflation rate and construct a new table for the next five years based on the new year's desired income. However, I keep future inflation constant at 3%. The new table looks like this:

**Income Cushion (Years 2-6)**

| | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 |
|---|---|---|---|---|---|
| Income | $35,875 | $36,951 | $38,060 | $39,202 | $40,378 |
| Less: | | | | | |
| Pension | $18,000 | $18,000 | $18,000 | $18,000 | $18,000 |
| Social Security | $12,300 | $12,669 | $13,049 | $13,441 | $13,844 |
| Shortfall | $5,575 | $6,282 | $7,011 | $7,761 | $8,534 |

The new shortfall for all years shows my five-year income cushion should be $35,163. The cushion at the end of Year 1 is only $28,872, so I'm short $6,291, an amount I take from the stock portfolio. Had stocks been down for the year, I would not take anything from that portfolio. Instead, I would take only the $5,575 I need as income in Year 2, and that would come from the bond portfolio. I would then replenish the bonds in a later year when stocks were up again.

From the $6,291 taken from stocks, I then withdraw $5,575 (my needed income for Year 2) and again put it in the money-market fund. The remaining $716 is invested in bonds. When all is said and done, at the start of Year 2 I have $69,067 left in my stock portfolio and $29,588 in my bond portfolio, for a total of $98,655. Of that total, 70% is in stocks and 30% is in bonds — a slightly lower ratio of stocks to bonds than the year before.

So there you have it, one Fool's way of determining a five-year income cushion and investing accordingly. It's not the only way or even — except for me — the best way. Your task, should you choose to accept it, is to find the way that works best for you.

*David Braze (**TMF Pixy** on the discussion boards) is a retired financial planner who answers your questions on the* RYR *Q&A board. This article originally appeared as a supplemental article on the* RYR *website, and we refer it frequently in the newsletter. We want to make sure all Retirement Rulers have a chance to learn from David.*

EXPERT CORNER

## Extending Your Portfolio's Life

*Any time the history of safe withdrawal rates in retirement is discussed (you do it all the time, right?) the name William Bengen will certainly come up. Bengen earned a degree in aeronautics and astronautics from M.I.T. and ran his family's soft-drink bottling business before becoming a fee-only financial advisor in 1988 and a Certified Financial Planner in 1990. The author of* Conserving Client Portfolios During Retirement, *Bengen spoke with us about setting up your portfolio for a long life.*

**Robert Brokamp: What do you consider a safe withdrawal rate?**

**William Bengen:** For most people, it is somewhere between 4.5% and 5%. But I can't give you a [definite] answer because it depends upon what the client's income streams look like. If you have a client who has a fixed pension that is not going to go up — the real value of it is declining every year — he is going to have to take more out of his portfolio every year. So he would probably have to reduce his [initial] withdrawal rate.

If a client has a large IRA [that will be subject to] mandatory withdrawals — and as withdrawals grow, the taxes grow — you may have to also be more conservative in your withdrawals early on so that you can pay those taxes later on. So to do a full job for a client, we would have to do a full 30-year projection and make sure it works out and that we are not taking too much.

**RB: Are there stock allocations that are too high or too low for retirees?**

**WB:** Once you go much above 75% in equities, it is too high; much below 40% in equities is too low. There is a sweet spot in there somewhere. Most of my clients are probably in the 60% to 65% range.

**RB: It seems you generally recommend a 30-year investment horizon for people who retire around 65. What do you say to a client who says, "I don't need to plan for 30 years. No one in my family makes it to their 90s"?**

**WB:** If the client really feels that he is not going to live particularly long, it's his decision. It is the client's money, the client's life. I will accommodate him with a plan based on that with probably a much higher withdrawal rate. I will tell him that I really am very reluctant to do so because one never knows how long one can live, and if you make a mistake in guessing that, you are in trouble.

**RB: Along those lines, a client might say, "According to your research, a 6% withdrawal rate has a 71% success rate over 30 years. I'll take those odds." Do you let them do it but you just make sure they know the risks?**

**WB:** Absolutely. There are some people who feel they need the additional money and the risks are acceptable and, once again, it is their life and their money. But there will be a lot of caveats I will be issuing, so they will drag me into this screaming and kicking.

**RB: Should investors reduce their stock allocation as they get older?**

**WB:** My research says probably not — you are better off maintaining 60% to 65% stocks until you get to that point where perhaps you are in poor health and you feel that your life expectancy is very short; you want to protect the wealth of your heirs. But in general, I have people well into their 80s who have those kinds of high stock allocations. They have been glad they did.

**RB: How often should retirees rebalance their portfolios?**

**WB:** That is a good question. My research really surprised the heck out of me. To a certain extent, it depends on the clients. If they are comfortable with the higher level of volatility that might come from a higher equity allocation, even if it is temporary, I would say probably every four to six years, if they can handle that. It also cuts down on commissions and capital gains in taxable accounts.

**RB: Is there any room in a retiree's portfolio for long-term bonds?**

**WB:** My research says that no, they are not necessary; intermediate-term bonds do at least as good a job, maybe a little bit better. This is where volatility comes into play. The long-term returns have been very similar, but the volatility of intermediate-term bonds is quite a bit lower, and that makes them the favorite over the long term.

*For Bengen's views on reverse mortgages and international investing, read the full transcript of this interview, which is available on the* RYR *website.*

*Motley Fool Rule Your Retirement*™ (ISSN: 1552-8073 print version, 1551-7748 online version) is published monthly by The Motley Fool, Inc., 2000 Duke Street, Alexandria, VA 22314. Phone (toll-free): 1-888-665-3665. Website: www.fool.com. Email: membersupport@fool.com. Please email or call if you have any subscription questions. Editor: Jill Ralph, Managing Editor: Roger Friedman, Product Manager: Shaun Dakin, Business Manager: Peter Jacobstein, President: Scott Schedler, Designer: Alison Figueroa, Distribution Manager: Barry Chambers. Subscription $149 per year.

VALUATION MATTERS

# Mutual Funds vs. ETFs

Right now, there are more mutual funds than there are companies listed on the U.S. stock exchanges. Of course, investors don't need that many funds, but when the suits on Wall Street see an opportunity, they exploit the stuffing out of it. And it looks like they're now setting their sights on the world of exchange-traded funds (ETFs).

According to MarketWatch, 144 ETFs were launched in 2006, nearly doubling the number currently offered to 347. There are plans to launch another 343 in 2007. So should you consider one of these newer ETFs over traditional mutual funds? First, let's explain the differences between the two. A mutual fund pools the cash sent in by all its investors and buys as many investments as that cash will allow. Most funds are priced once a day, after the market's close. The total market value of the fund's investments is calculated, the value of liabilities is subtracted, and that amount is divided by the number of shares outstanding. The result is the net asset value (NAV), essentially the fund's share price.

An ETF is a totally different beast. While most mutual funds strive to outperform a benchmark index, the typical ETF attempts to *duplicate* a benchmark index. Major investing institutions assemble a basket of stocks that replicate an index or investing strategy, deposit them with a trust, and receive a number of *creation units* in return. A creation unit is a large block, typically 50,000 shares, of the ETF. These creation units are then split up by the recipients into individual shares that are traded on the market. More creation units (and more market shares) can be made if institutional investors deposit more shares into the underlying trust. Similarly, the pool of outstanding ETF shares can be reduced if big investors swap back creation units for the underlying shares in the basket. Because of this unique structure, shares of ETFs can trade like stocks.

To determine which type of investment is best for you, answer the following questions.

## Are You an Active Trader?

You can buy or sell an ETF any time the market is open. That also means you can place limit orders on ETFs, causing shares to be automatically sold or bought when a certain price is reached. Furthermore, ETFs can be bought on margin (i.e., with borrowed money) and sold short (a bet that the investment will drop in value). You can't do any of that with mutual funds.

## Do You Like Actively Managed Funds?

If you'd like to throw your lot in with the skills of a money manager, hoping he or she is among the minority who can beat the index with their investment-picking skills, you'll have to go with a traditional mutual fund. ETFs are based on indexes or mechanical investing strategies (such as buying stocks that have increased their dividends in each of the past 25 years). Thus, since ETFs aren't employing a management team, they have much lower expense ratios than actively managed mutual funds.

All that said, as the number of ETFs expands — with increased parsing of indexes or attempted exploitation of investment strategies — ETFs are looking more and more like actively managed investments. In fact, many experts predict that it's only a matter of time before actively managed ETFs hit the market.

## Is Your Account an IRA?

As we've discussed, mutual funds have a nasty habit of distributing capital gains every few years (and occasionally every year), which can be a real drag in a taxable, non-IRA account. Sometimes, these distributions aren't even due to excellent investment results but to an exodus of investors (requiring that the fund sell investments to meet redemption requests) or a change of fund manager (just ask Fidelity Magellan investors, who got socked when new manager Harry Lange rearranged the portfolio).

Some ETFs make capital gains distributions, too, but as a group they're considered much more tax-efficient. Make sure you get one of the good ones by comparing the ETF with a similar mutual fund. For example, a Morningstar analysis found that the **Vanguard 500 Fund** (VFINX) is actually more tax-efficient than its main ETF counterparts, the **Spider** (AMEX: SPY) and **iShares S&P 500** (AMEX: IVV). To make your own comparisons, use Morningstar's tax-cost ratio information for your investments.

## Are You Dollar-Cost Averaging?

The biggest knock on ETFs is that you have to pay a commission every time you buy and sell. However, if you invest in a no-load mutual fund, you can invest as much as you like with no extra costs; the same goes if you systematically make withdrawals in retirement. As the cost of commissions drops (to zero, as is the case with brokerages such as Bank of America), this becomes less of an advantage to traditional mutual funds.

## Are You Looking for Dividends?

As longtime readers know, we Fools like stocks that pay dividends. The best dividend-focused funds are found in the ETF universe. See "Digging Up Dividends" from the October 2006 issue for some of our best ideas.

We've reviewed the general differences between the two types of funds. When it comes to decision time, dear Fool, your best bet is to compare a specific mutual fund to a specific ETF and see which has the best cost, tax, and performance advantages for you.

SUCCESS STORY

## Worry-Free Housing

By Akaisha Kaderli

*Akaisha Kaderli and her husband, Billy, retired at age 38. They now travel the world on less than $30,000 a year. You can read about their adventures at RetireEarlyLifestyle.com.*

My husband and I have the best of both worlds. We often leave the United States for months at a time to visit exotic locations. We set up a home base on the other side of the globe and settle into the local community. Then, due to visa restrictions or an overwhelming desire to see family and friends once again, we return home to America's stunning Southwest.

People always ask us how we were able to retire early, and here's a boiled-down list of what we tell them:

- » Determine your expenses
- » Monitor investments and withdrawals
- » Get local by living among the locals
- » Make a list of all you want to see and do
- » Take the leap of faith

While we went into greater detail in the *Rule Your Retirement* article "Retire When You Want" (September 2004), this space is devoted to talking about how we are able to maintain a home, travel as extensively as we do, and not break the bank. You see, before and during retirement, it's all about choices. We chose to live in an active adult community, and while this may not fit everyone's idea of the perfect domicile, it works spectacularly for us.

### Value for Money Spent

I realize that there are some who feel that manufactured houses aren't real homes and that they are inferior places to live, but increased sales tell a different story. The options are endless — you can spend a few thousand dollars or spend millions. You can choose to lease the property or buy the lot and build from the ground up. Because our home is paid for, we are able to roam the world, renting apartments or hotel rooms without worrying about draining our finances.

Some communities offer memberships to country clubs and championship golf courses, and most usually have a long list of amenities that would add up quickly if they weren't covered in our community's "lifestyle fees."

### Tax and Insurance Relief

We have chosen to lease the land on which our home sits. It is a common option that many retirees prefer. Some readers, however, have challenged us directly, asking, "How can you not own the property itself? Don't you feel at the mercy of rent rising without your control? Property values *always* go up!"

Valid issues, yes, but many people don't realize how expensive it is to own a home. The maintenance required and the rising property taxes are expenses that cannot be ignored. We have lived in our current house since the early 1990s, and our lifestyle fees are less than most homeowners' property tax bills. Sure, our lease has increased a couple hundred dollars total, but it is still an excellent value for all of the amenities included. Owning less and being lighter allows us to insure for less.

It is common for developers to attract residents by touting their tax-friendly state. But while some states may have low (or no) income taxes, they might have high property taxes. By not owning a property, you can save thousands of dollars a year — dollars that can be better spent on activities such as travel, gifts for the grandchildren, or hobbies.

### Savings on Everyday Costs

Having entertainment and dining options nearby or within walking distance saves a surprising amount on transportation costs. Granted, we do travel the world, but we have done the math — and we only drive about 1,200 miles a year! We save a huge amount on gas and wear and tear on our vehicle. We have even gotten an insurance discount.

Although we are responsible for the maintenance of our home and personal gardens, we don't worry if the pool heater breaks down or if a piece of equipment in the fitness room needs to be replaced.

### Safety in Numbers

This last one is particularly true for the female readers of *Rule Your Retirement*. In our active adult community, I don't fret about my personal safety. Recently, Billy took off for a trip to Mexico, and I stayed home to catch up on some projects. One morning, I found myself awake at 3:30, and so I decided to take an early walk around the community. I felt completely safe, and it never crossed my mind to feel otherwise. In fact, I met other neighbors who were walking their dogs and waiting to catch the sunrise.

Before I sign off, I want to encourage each and every one of you to open your mind to the options — the possibilities — that are available to you. You may just find that a lighter financial weight appeals to you in more ways than you imagined.

*For more on how Billy and Akaisha Kaderli retired at the ripe old age of 38, visit the* RYR *website and check out the September 2004 issue. You can also check out their audio book,* The Adventurer's Guide to Early Retirement.

IN THE NEWS

## 529s: Not Just for Kids Anymore

### More Tax-Free Retirement Savings

Do your post-work plans involve going back to school? If so, consider saving a portion of your retirement funds in a 529 college-savings account. A recent *Wall Street Journal* article profiled a retired couple who plan to pay for their art classes, music classes, and college-sponsored trips to Costa Rica with the $50,000 they've saved in a 529. The investments grow tax-free as long as the money is used for qualified higher-education expenses, which include tuition, supplies, books, and room and board (don't you want to live in a dormitory again?). Plus, many states allow residents to deduct contributions to an in-state plan on their state income tax returns.

Keep in mind that not just any class is considered qualified. According to the *Journal*, the course must be "accredited at a college or vocational school eligible for student-aid programs administered by the Department of Education." If you end up not taking courses, you can let the account grow (and it'll eventually be part of your estate), transfer it to a relative (grandkids count), or withdraw the money (though you'll pay income taxes on the growth and a 10% penalty).

### A Winning Streak Ends

Bill Miller's 15-year streak has come to an end. Since 1991, Miller's **Legg Mason Value Trust** (LMVTX) has beaten the S&P 500 each and every year — the longest streak on record. But 2006 wasn't kind to the Value Trust, which earned 6.4% versus the S&P 500's 16.4%.

Still, Miller's long-term record is impressive. According to Bloomberg, since 1991 the Value Trust has returned an average 15.8% annually, versus 11.9% for the S&P 500. To get an indication of how rare Miller's streak was, the person with the next-longest active streak, Manu Daftary of the **Quaker Strategic Growth Fund** (QUAGX), had beaten the S&P 500 just eight years in a row. And his streak ended in 2006, too.

What are the lessons for investors? First of all, the expense ratios for these funds — 1.68% for the Legg Mason fund, 1.90% for the Quaker fund (plus a 5.5% load) — are steep, which goes to show that some high-cost funds are worth the money. However, given how hard it is for fund managers to beat the market each and every year, it's more likely that you'll be paying a lot of money for little return.

### The Benefits of Income for Life

If you choose systematic withdrawals from your portfolio in retirement, there's more than a 50% chance that you'll outlive your money. At least that's the conclusion of a recent study published by the TIAA-CREF Institute. The authors calculated that a 65-year-old would receive $7,390 a year in exchange for investing $100,000 in a fixed-income annuity (assuming a 5% interest rate). However, if a retiree chose instead to keep the $100,000 but withdraw $7,390 a year (again, assuming a 5% interest rate), the money would run out in 21 years — two years short of the average life expectancy.

Vigilant Fools will notice that those life expectancy numbers are longer than those cited earlier in this issue. That's because the authors used a different mortality table — even something as "scientific" as an actuarial table has some wiggle room. The study also assumes that the retiree would earn just 5% on her portfolio. However, if she earned 6.8%, her portfolio would last 30 years.

Still, the study emphasizes important benefits of income annuities, namely that the check will be in the mail regardless of how long you live and what happens in the investment markets. This is why we think retirees who won't be able to depend on a traditional pension should consider income annuities. (Visit www.tiaa-crefinstitute.org to read more about the study — or check out "Insurance for a Long Life" from the August 2006 issue of *RYR*.)

FINAL THOUGHTS

## Perfection Is Impossible

P.S.

I have a prediction: You will choose the wrong withdrawal rate in retirement. That's right. You will either choose one that has you running out of money faster than you'd like, or you'll choose one that will leave a lot of money to your heirs — money you could've spent enjoying your golden years.

I know this will happen to you because it will happen to everyone. It is impossible to choose the perfect withdrawal rate — the one that will have you spending your last dollar as you take your last breath ("I'd like to buy this Snickers bar, please … *cough* … *gasp* …"). That's because the withdrawal rate depends on things such as market returns, interest rates, and inflation — things we just can't predict.

But by learning all you can from bright lights such as William Bengen, by keeping an eye on your portfolio, and by remaining open to making mid-course corrections (both to the upside and downside), you can come pretty close to the right withdrawal rate — and ruling your retirement.

Robert Brokamp