

# How to Bulletproof Your Nest Egg

Whether you're approaching -- or already in -- retirement, these strategies can help safeguard your savings in tough economic times

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When Tom Hitzges watched the market start to tumble last fall, he got nervous about his nest-egg withdrawals. He had retired as a consumer-products manager for Panasonic six years ago, investing his lump-sum retirement payout with a financial planner whose "philosophy was basically to track the market."

Mr. Hitzges had used a 6% withdrawal rate for several years with no problems. But "I realized," he says today, "that in a protracted down market I was going to get hurt, and I wasn't going to have any way to recover." In February, the 70-year-old Mr. Hitzges, who lives in Lehigh County in Pennsylvania, bought a variable annuity that pays back 6% of his original investment each year. He pays higher fees than before, but "it gives me a good safety net," he says.

Increasingly, financial planners and researchers are warning clients that the timing of retirement - - in other words, the luck of the draw -- will largely determine how a nest egg will fare in the future. If you're fortunate enough to retire at the beginning of a strong bull market, such as the early 1990s, your savings might easily last for three decades. If you're unlucky enough to retire at the start of a bear market or recession -- say, early 2000 or late 2007 -- you could find yourself struggling financially for years to come.

To find out how people approaching retirement, and those already retired, can safeguard their savings from tough economic times, we surveyed strategists throughout the financial-planning community. While there's no single best way to tap your nest egg in later life, the following techniques can help minimize any damage to your investments -- regardless of when you retire.

## Creating a Cash Reserve

Harold Evensky and Deena Katz, who run their own advisory firm in Coral Gables, Fla., are authors of several books about investing and are among the most prominent figures in the financial-planning industry. The couple (they're married) have used their "cash-flow-reserve strategy" to create regular paychecks for retirees since the 1980s, and they've successfully weathered difficult markets in 1987 and 2000-2002.

The approach was born out of the pair's dissatisfaction with two commonly used strategies for generating cash from a nest egg. Strategy No. 1, relying solely on income from dividends and/or interest, simply "makes no sense," Mr. Evensky says. Such a nest egg requires a hefty percentage (typically 50% or more) of bonds or bond funds to generate needed cash, and, thus, limits one's stock holdings. Stocks, of course, have historically provided the growth needed in a portfolio to guard against the loss of purchasing power.

Strategy No. 2 -- steady withdrawals from a nest egg regardless of market conditions -- can result in "reverse" dollar-cost averaging. With traditional dollar-cost averaging, a fixed schedule of

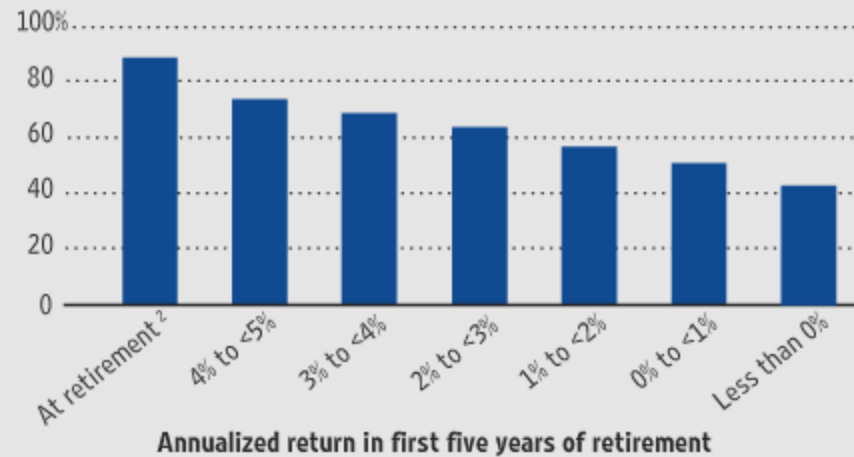
## A Strong Start—or a Weak One?

This chart shows the probability of not running out of money over the course of a 30-year retirement, based on a nest egg's performance in the first five years of retirement.

As the numbers indicate, those five years are critical. If portfolio returns are weak early in retirement—and if the investor doesn't cut back on the amount withdrawn—the chances of a nest egg surviving begin to fall significantly.

For example, if a portfolio's annualized returns in the first five years are between 4% and 5%, there's a 74% chance that a person's retirement savings will last 30 years, based on 10,000 potential scenarios of market outcomes after the first five years. But if returns in the first five years fall somewhere between 0% and 1%, the chances of a nest egg surviving three decades are only about 50-50.

### Projected probability of success <sup>1</sup>



Note: Figures assume the investor withdraws 4% of his portfolio the first year and increases the withdrawal amount 3% annually for inflation. Portfolio is composed of 55% stocks and 45% bonds.

<sup>1</sup> Chances of not running out of money over a 30-year retirement period assuming different annualized rates of return in the first five years of retirement.

<sup>2</sup> Returns and fees at initial retirement: U.S. large-cap stocks, 10% with 1.21% fees; investment-grade bonds, 6.5% with 0.73% fees. Example doesn't take into account income taxes or required minimum distributions.

Source: T. Rowe Price Group Inc.

*purchases* can spread out (theoretically) the cost of an investment over several years, providing protection against market fluctuations. But if you're following a fixed schedule of *withdrawals* from your savings, and if markets are falling, that money is gone for good. It won't be there when markets begin to rise, and any growth in your nest egg will be based on a smaller starting figure. That's "reverse" dollar-cost averaging.

Initially, Mr. Evensky and Ms. Katz came up with a "five-year" plan for their clients. Let's say a retiree has \$1 million in savings and needs \$40,000 a year to supplement other income (like Social Security). With that in

mind, \$200,000 (five years x \$40,000) would be set aside in say, a money-market account. The remaining \$800,000 would be invested in a well-diversified portfolio. The money-market account would be used to pay monthly bills, and the account would be "refilled" (periodically) from gains in the investment portfolio.

The thinking: The "real risk" with a nest egg, according to Mr. Evensky, is having to sell holdings when markets are falling in order to meet spending needs. (Remember: reverse-dollar-cost averaging.) Carving out five years of living expenses would all but eliminate that risk; if markets were falling, the five-year cushion would provide funds to buy groceries, etc., and the client could wait until markets rebounded before refilling the money-market account. The problem: Setting aside a full five years of cash in a vehicle with relatively low returns (like a money-market account) put a significant damper on the nest egg as a whole.

So, the couple tinkered with their formula, and today provide clients with three accounts. The first is a simple checking account. The second is a "cash-flow reserve portfolio" with approximately *two* years of spending money. Half of that money (or one year of spending) is placed in money-market funds; the other half is invested in a low-cost bond fund, with high-quality short-term (meaning one-year duration) municipal bonds. Once a month, the client transfers a "paycheck" from the reserve account to his or her checking account.

The rest of the nest egg goes into the third account: a long-term investment portfolio. Here, about 70% of the money is invested in stocks and 30% in bonds -- typically divided among those with one- to three-year maturities, three to five years, and five to 10 years. When it's possible to sell stocks without significant losses, a client moves money from the investment portfolio into the cash-flow reserve to bring the balance back up to two years of spending power.

What happens if there's more than a year with significant losses in stocks? At that point, Mr. Evensky explains, the client turns to the bonds in the investment portfolio, which function as "second-tier emergency reserves." No matter how bad the markets get, bond investments are unlikely to have significant losses; thus, you could refill the cash-flow reserve by liquidating some bonds, and buy time to defer the sale of stocks in a bear market.

In practice, a client with a \$1 million nest egg -- where that client needs income of \$50,000 a year -- would have about \$100,000 in a cash-flow-reserve account (two years of spending) and about \$900,000 in a long-term portfolio. Again, about 30% of that \$900,000, or about \$270,000, would be invested in bonds of varying maturities. The rest would be invested in stocks. In all, the client would have more than five years of spending money in relatively safe vehicles (money-market funds and bonds) -- enough to ride out the worst kinds of storms the stock market has seen during the past century.

Starting retirement in this fashion helps head off panic when markets fall, Mr. Evensky says. "You need to design a portfolio to weather all kinds of economic environments," he says, "since we don't know which one is coming next."

## **Collaring Retirement Risk**

Moshe Milevsky, an associate finance professor at York University in Toronto and a leading figure in retirement-income planning, sees three big risks to your nest egg: poor investment performance in the first years of tapping your savings, extended life spans (which means your money needs to last longer) and steep inflation. Indeed, the government's consumer price index for the elderly regularly outpaces that for the general population.

To combat these risks, he recommends creating a "retirement collar" -- sacrificing some potential gains in your portfolio in exchange for protection from losses. Traditionally, "put" and "call" options are used for this purpose. That strategy, though, "comes at a high cost of complexity and option fees," Prof. Milevsky says. "Also, you certainly don't want to try this yourself at home unless words like 'volatility skew' mean something to you."

As such, he advises using one of three alternatives to create the same sort of downside protection. Two are insurance products that generate income: a variable annuity with guaranteed living benefits, and longevity insurance. The third is called a managed-payout fund, a product marketed by large mutual-fund companies. Each of these risk-management solutions, Prof. Milevsky notes, works better if adopted five to 10 years before you plan to start spending and withdrawing money in retirement.

Here's how the strategies work:

A variable annuity with guaranteed minimum benefits promises a base level of annual income, typically 5% to 6% of the original amount you invested, even if the investments inside the variable annuity (typically, mutual funds) perform badly. But if they do well, the annuity may let you reset your guaranteed income to a higher level.

Take Ohio National Financial Services' "ONcore Lite" variable annuity, a product that Mark Cortazzo, a Parsippany, N.J., certified financial planner has been using. If a 69-year-old man invested \$100,000 this year with a guaranteed income benefit of 6% annually, he would get \$6,000 a year for the first 10 years. Even if his investments lost money, the minimum income he would start getting after year 10 -- when the annuity benefit kicks in -- would be \$8,280, guaranteed for life or a minimum 10 years. The catch: Total fees and expenses amount to 2.29% annually. And variable annuities are extremely complicated.

Longevity insurance, a type of annuity that kicks in at an older age, has been around for at least three years and is now offered by MetLife Inc., New York Life Insurance Co. and Hartford. You invest a (relatively) small sum now, which isn't refundable, in exchange for a promise of guaranteed lifetime payments at a later age, such as 85, when large numbers of retirees typically start feeling the cash crunch. So, for example, if a 65-year-old man made a \$100,000 lump-sum payment for MetLife's Longevity Income Guarantee annuity (the maximum income version without a death benefit), he would get \$83,800 a year starting at age 85.

There are trade-offs: Inflation protection and return-of-premium benefits, which are popular features, can bump up the initial premium needed by as much as 50%. If you don't pay for a return-of-premium rider and you die before the benefit kicks in, your heirs wouldn't get your investment back.

A third option is a "payout" fund, offered by large mutual-fund companies such as Fidelity Investments, Vanguard Group and Charles Schwab. These products, which automatically generate a monthly payout, are actively managed with a goal of reduced volatility, and are designed to provide you with a steady paycheck for a set time period (though some try to return at least some of your initial investment and others don't). The fees, ranging from about 0.5% to 1.9% of the portfolio's value each year, are generally cheaper than those charged for annuities. But there's no guarantee that the investments won't lose value, or that the corresponding monthly checks will stay the same size. One other hassle: If you hold such a fund in a taxable account, you have a capital gain or loss to report each month shares are sold.

For example, if you invested \$100,000 in Fidelity Investments' Income Replacement 2028 Fund, the monthly payment for the first year would be \$543. If the fund's returns are higher than 10%, the second year's monthly payments would rise to \$580. But if the fund loses more than 10% in its first year, the monthly payments for the second year would drop to \$471. Those monthly payments may or may not keep pace with inflation, and will result in the gradual liquidation of the investment by its end date.

Again, none of these products offer the large potential returns associated with stocks alone; rather, they offer lower, but safer, returns -- protection against longevity, inflation and market turmoil, particularly if that turmoil occurs early in your retirement. And how much of your nest

egg should you devote to such options? About 15% to 35%, depending on your individual situation, Prof. Milevsky says. If you don't have a traditional defined-benefit pension and your income needs exceed your Social Security benefits (which is likely), you should invest closer to 35%; if you expect a "substantial" income from pensions and Social Security, or if you have "sufficient financial resources so that you will never run out of money," you can get away with a lower percentage.

## **Pre-Annuity Testing**

Buying an immediate fixed annuity is one of the simplest techniques to guard against bad luck in the timing of retirement. You hand over a pile of money to an insurer, which hands you a monthly check for life. Period.

But many people don't like the idea of parting with a big chunk of their nest egg. If you die suddenly, the insurer could end up with your money. And yet, if you're unlucky enough to retire at the start of a bear market, annuity payments could soften -- for as long as you live -- any blows to your savings. All of which raises the question: How do you know whether, or when, to buy an annuity?

Jim Otter has some benchmarks.

Mr. Otter, an engineer, author and certified financial planner in Thornhill, Ontario, is a frequent speaker about retirement income at financial conferences across the U.S. He believes more people should look to annuities to safeguard their retirement finances, and he has developed a series of "warning signals" to gauge the health of your investments, and to give you a better idea of when it's prudent to shift assets into an annuity.

The signals are tied, in large part, to a person's rate of withdrawal from his or her nest egg and the condition of that nest egg after several years in retirement. After researching stock-market returns since the year 1900, Mr. Otter found that a first-year withdrawal rate of 3.6% or less -- coupled with an asset allocation of 40% stocks and 60% bonds -- would give a nest egg "about a 100% success rate" of lasting indefinitely. (Subsequent withdrawals, he adds, could be adjusted for inflation.)

Thus, with a \$1 million nest egg, a person could withdraw \$36,000 the first year and, if inflation were running at 3.5%, approximately \$37,260 the second year, etc.

Most clients, though, don't want to limit themselves to a 3.6% withdrawal rate, Mr. Otter says. Typically, they talk about retiring at age 65, with about \$1 million in savings that needs to last 30 years, and a desired withdrawal rate of 6%. At the same time, they assume their savings will earn about 8% a year, on average.

The problem: "The 8% 'average' growth rate doesn't exist," Mr. Otter says. You could have the bad luck to retire into 20 years of "sideways" stock-market performance, as happened from 1964 to 1982. Mr. Otter's research shows that a person who retires at age 65 and begins withdrawing

6% a year from a nest egg of 40% stocks and 60% bonds has only about a 22% chance of having any money at age 95.

So, what if you're one of those people who needs to, or would like to, withdraw more than 3.6% from your savings each year? How can you determine if your particular withdrawal rate will leave you with an empty bank account, say, 20 years after retiring? Here are some of Mr. Otar's warning signals:

For starters, on the fourth anniversary of your retirement, take a look at your retirement-account balance. Do you have more money -- or less -- than when you first retired? If you have more money, "don't worry, be happy," Mr. Otar says. Even at withdrawal rates as high as 8%, a nest egg that has increased in value after four years of retirement has more than a 90% chance of lasting an additional 20 years, according to Mr. Otar's research.

But, if your nest egg is smaller than it was the day you retired, your chances of running out of money within the next two decades are substantial. Here's a look at some of the probabilities -- again, based on Mr. Otar's market research stretching back to 1900.

First, the probability of depletion: Is your portfolio's value higher on the fourth anniversary of your retirement than when you stopped working? Match your answer with your initial withdrawal rate to see your chance of running out of money within 20 years.

<b>INITIAL WITHDRAWAL RATE</b>	<b>YES</b>	<b>NO</b>
5%	0%	7%
6	2	38
8	6	72

Next, Mr. Otar compares a person's chosen withdrawal rate with what he calls "sustainable withdrawal rates" -- those rates that, based on his research, give a nest egg a 90% probability of survival. Here are some examples:

<b>TIME HORIZON</b>	<b>ASSET MIX (S&amp;P 500/FIXED INCOME)</b>	<b>SUSTAINABLE WITHDRAWAL RATE</b>
10 years	15/85	9.3%
15 years	30/70	6.4
20 years	30/70	5.1
25 years	40/60	4.4
30 years	40/60	3.8
35 years	40/60	3.5

Let's say you have just retired at age 65 with \$1 million in assets. You estimate that you need \$50,000 from savings each year -- a 5% withdrawal rate -- and you want your money to last 30

years. According to Mr. Otar's research, the sustainable withdrawal rate for a 90% chance of survival at the 30-year mark is 3.8% -- or \$38,000. Thus, at a 5% withdrawal rate, it's likely you will run out of money before age 95.

The next warning signal: If your current withdrawal rate is larger than the payments you could get by buying an immediate, single-premium fixed annuity using all of your savings, you likely will run out of money within 15 years, Mr. Otar says. (You can get quick quotes for annuity payments at [www.immediateannuities.com](http://www.immediateannuities.com).) For example, if you're a 65-year-old retiree in Georgia withdrawing \$30,000 a year from a \$300,000 nest egg, you're in trouble: The most a plain-vanilla annuity would pay you is about \$2,025 a month, or \$24,300 a year.

Finally, if you're withdrawing more than 10% of your nest egg's value each year, "never in history" has a portfolio lasted more than 19 years in that situation, Mr. Otar says. To find out the maximum remaining years for your savings, you would divide 160 by your withdrawal rate. To find out the minimum remaining years, divide 80 by the withdrawal rate. So, if your withdrawal rate is 12%, you'd have six to 13 years of savings left.

If you come up with ominous answers using any of these gauges, Mr. Otar recommends buying an annuity with all or part of your assets. What portion of your savings should go into an annuity? Probably more than you think. Although financial planners routinely suggest that retirees without pensions annuitize one-quarter or so of their savings to cover basic living costs, you probably need to annuitize closer to 100% of your savings if you're in danger of running out of money in a couple of decades, Mr. Otar says.

To learn more about calculating the needed size of an annuity in retirement, and how price/earnings ratios can help gauge your portfolio's life expectancy, visit [retirementoptimizer.com](http://retirementoptimizer.com). Go to "My Publications," and click on "Articles." Look for articles 92, 93, 103 and 106.

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