SOUND **INCOME** STRATEGIES, LLC

*The secret to a great retirement is our middle name*

# Investment Allocations for RMDs

## *Satisfy IRS Distribution Requirements Without Cannibalizing Your Original Principal*

### *Inside:*

- How to avoid one of the most common and potentially disastrous financial mistakes made by retirees
- The rate of return required to satisfy distribution requirements without cannibalizing your initial principal
- Conservative investment instruments that generate consistent income—with substantially less risk than stocks

# Are Your Investments Allocated Properly for Required Minimum Distributions?

## *or Will Taxes and Withdrawals from Principal Erode Your Retirement Dreams?*

by David J. Scranton CLU, ChFC, CFP®, CFA, MSFS

Ideally, an asset allocation right for taking IRS Required Minimum Distributions (RMDs) should be able to generate high enough earnings to satisfy IRS required withdrawals without eating away at your initial investment.

There is an ideal order in which to pull from retirement accounts when taking RMDs. The goals, which often go unheeded, are to minimize taxes, minimize taking principal, and earn as much as possible.

These goals are easy enough to understand, but there are many factors to consider. It takes a well-planned strategy to ensure the interest and dividends you're generating from your savings and investments are sufficient enough to cover your RMDs, keep your tax bill at a minimum, and satisfy your other expenses throughout retirement.

Again, RMDs are distributions the IRS requires you to take on your retirement savings each year after you've reached age 70 and a half. The amount changes each year in conjunction with your estimated life expectancy and the balance of your IRAs and other qualified plans as of December 31 of the preceding year.

If your interest and dividend income aren't sufficient to cover your RMDs, then the distributions will most likely have to come from principal. Why is that so bad? Well, with average life expectancy rates higher than ever before, most people will need to plan for 30 or more years of retirement.

That being the case, spending any principal at all, especially during the early years of retirement, can negatively impact all the remaining years. So, how much do you need to earn to avoid eating away at your original principal? I calculate this to be at least 3.7% in combined dividends and/or interest.

## It's Like a 30-year Mortgage, Only in Reverse

A better understanding of this can come from looking at what we know about 30-year mortgages. When you first start making payments, you're not paying back much principal at all. Instead, you're paying back mostly interest along with a little bit of principal.

But, as the years go on, you pay a little less interest and a little more principal, and the balance gets paid down. The process continues until, after 30 years, your mortgage is finally paid off.

Now, let's look at the process in reverse. Take a pool of savings worth $1M, generating 5 percent interest per year ($50,000). If you take even just a little more than the $50,000 each year, just a small amount of principal each year, that sum will be depleted within 30 years in much the same way a mortgage is paid off.

## Watch Out for Portfolio Shrinkage

So, clearly, you want to avoid having to use any principal to cover you RMDs, but it's important to distinguish "principal" from capital gains or capital appreciation because those are things you can't always count on. Sometimes, when you invest for appreciation, you end up getting depreciation. You count on growth but end up getting shrinkage.

Admittedly, this was less of a danger many years ago. During the 1980s and 90s, in the midst of the best long-term secular bull market in U.S. history, investors could have conceivably satisfied their RMDs completely from capital gains, rather than dividends, without encroaching on principal.

However, since the year 2000, the opposite has been true. Since then, the market has seen two major drops. The first, nearly a 40% drop from 2000-2003 and the second nearly a 50% drop from 2007-2009. And, according to the lessons of stock market history, another major drop in the 50-60% range is a strong likelihood within the next 8-10 years.

## Not All Fixed-Income Investments Are Created Equally

In today's uncertain economic environment, it's not easy to generate the kind of interest or dividends you need to satisfy RMDs without touching principal. Interest rates in money markets are well below 3.7 percent, even bond mutual funds aren't generating enough, once you factor in management fees.

It's important here to distinguish between investing in individual bonds and investing in bond mutual funds. Unlike individual bonds, bond mutual funds don't give you a fixed rate or fixed maturity date that guarantee the return of their face value, assuming there have been no defaults.

When something happens in the bond market that causes bond values to drop, a portfolio of individually held bonds and a portfolio of bond mutual funds might drop similarly in value, but for the individual bondholder, it's ultimately only a paper loss. For the bond mutual fund holder, on the other hand, it's a real loss.

### Beware of One of The Most Disastrous Financial Mistakes A Retiree Can Make

Although not ideal, bond mutual funds may still be preferable to a diversified stock portfolio or stock mutual fund portfolio if the dividend you're earning there is less than 3.7 percent annually (which it likely is), and you end up having to sell core shares each year to satisfy your RMDs.

This is actually one of the most common and potentially disastrous financial mistakes made by retirees: the error of **reverse** dollar-cost averaging.

Most people know what dollar-cost averaging is and have used it in the course of saving over the years. The purpose of dollar-cost averaging is to get your average cost or purchase price down to help you buy low and sell high, which is the cornerstone principle of smart investing.

For example, if you were to set out to invest $100 each month in a mutual fund and the first month the fund was worth $10 a share, you would buy ten shares. Now, let's say the market had a horrible month and the following month each share of the fund is only worth $5 per share. Well, if you stuck with your plan, you'd have to buy 20 shares to get $100 worth.

After the second month, your average cost per share would seem to be $7.50, but, it would actually be lower. That's because you bought twice as many shares at $5, and half as many shares at $10. Through dollar-cost averaging, you were able to get your average cost per share down to about $6.65.

This strategy works well when you are in the contribution stage of retirement investing. The problem arises when you reach the point where you're not saving into your fund anymore, and you start drawing funds from your principal balance to satisfy RMDs. The same principles apply but in the opposite direction. You are now **reverse** dollar-cost averaging.

Taking the same example, let's say that in the first month you liquidate $100 and you sell 10 shares. In the second month, the fund's price per share drops in half. Now, to withdraw your $100, you have to sell twice as many shares.

So, now what's your average sales price per share? Again, the math is the same: now instead of taking your *purchase price* down from $7.50 to $6.65, you've taken your **sales price** and pushed it down. You've been forced by the IRS to sell low instead of high.

## Should You Have Any Money in the Stock Market Once You've Retired?

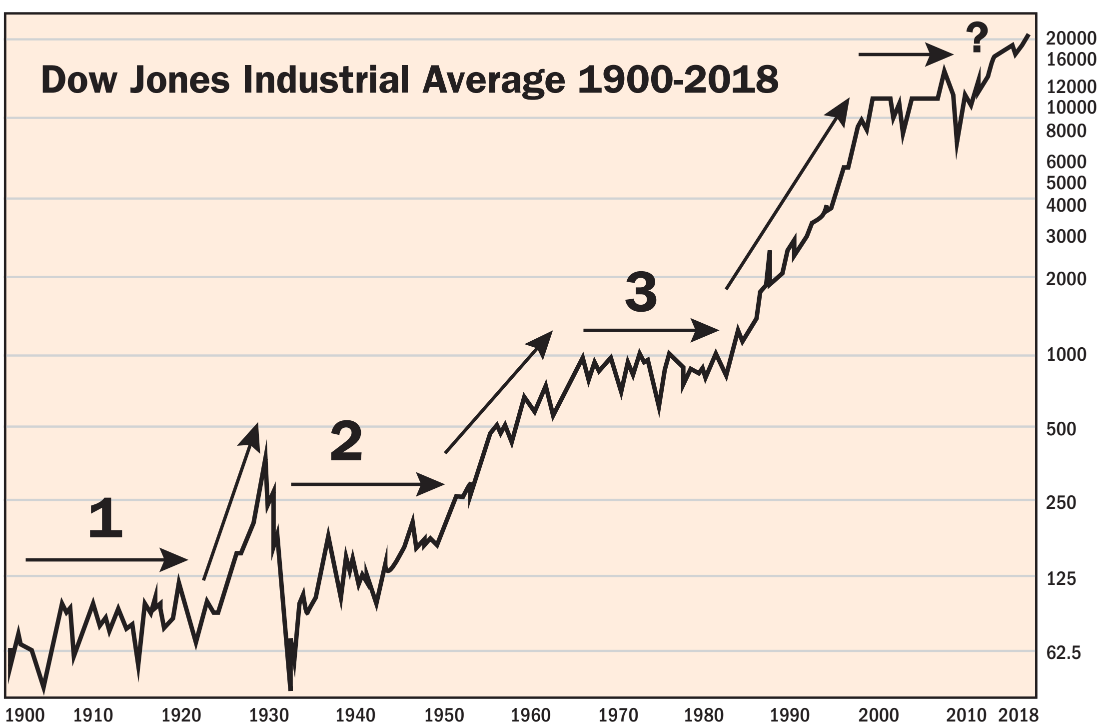
While dollar-cost averaging is a great strategy for saving, **reverse** dollar-cost averaging is one of the most cancerous strategies you could embark on. This goes back to my original point: if you're going to have money in the stock market in your IRA during retirement, you must make sure you're earning enough interest or dividends to satisfy your RMDs.

This is easier said than done in today's market. Such a challenge, in fact, that it begs the question: should you have any money at all in the stock market once you've retired?

This may seem like a radical question based on what most of the experts and textbooks have always said: "Everyone needs to have some money in the stock market as a hedge against inflation."

The unfortunate reality is that the stock market has never really been, on average, a very reliable inflation hedge. In the course of stock market history, there have been long periods when it's been a decent inflation hedge, but even longer periods when it hasn't.

Historically speaking, there are certain periods when an IRA holder can stay invested in the stock market and take their RMDs from gains and capital appreciation, but there are also times when those RMDs would have to come out of principal.




*Source: stockcharts.com*

As the chart above indicates, these periods when RMDs have had to come out of principal seem to have recurred in a somewhat predictable pattern throughout history. So much so that they need to be understood and considered as part of the process for determining whether your allocations are right and sufficient for RMDs.

## Right Now Is A Critical Time for Building and Preserving Your Nest Egg

If you were born in or before 1966, you've lived through the greatest stock market in history as well as some of the biggest declines the market has seen. You've also learned that good times don't always last.

Sound Income Strategies' office in Fort Lauderdale is located a few miles from the Atlantic Ocean. Our office sits on the top floor of an unassuming building with a view of the blue waters of the Atlantic off in the distance.

Port Everglades, one of the world's most active shipping and cruising seaports, opens out to the Atlantic just a few miles south of us. On clear days, large ships are visible on the horizon as they line up and wait to enter the port.

It's interesting that the captains of these large ships have been able to safely navigate their ships through thousands of miles of sometimes treacherous waters only to hand over control of their ships to a Harbor Pilot for those last few critical miles into the harbor.

The Harbor Pilot is a boat captain who is an expert in the specific harbor from which they work. It's their job to gain experience and to know the specific dangers of their home port.

Because the last few miles are filled with dangers that are virtually invisible to the untrained eye, the ship's captain brings the Harbor Pilot onboard and hands over control of the ship to this specialist. Bringing a Harbor Pilot aboard who is familiar with the hidden dangers that lie ahead allows each ship to reach the harbor safely with their valuable cargo intact.

It's similar for anyone who is in or near retirement. So far, you've managed to safely navigate your portfolio through decades of uncertain markets. Now, with so much on the line, it's time to bring an expert aboard who is very familiar with the risks that lie ahead.

## Financial Advisors Who Don't Specialize in The Income Generation May Not Have the Skills to Ensure Safe Passage into Retirement

Although Sound Income Strategies works with a wide range of clients nationwide, we specialize in helping those who are in or near retirement. We have top-tier income specialists who are experienced at investing with methods that maximize income and growth while minimizing risk.

If you were born in 1966 or earlier, visit soundincomestrategies.com or give us a call at (888) 492-0505 to find a local income specialist registered with Sound Income Strategies who can help reduce your exposure to stock market risk and help you generate reliable streams of income you can count on well into retirement.

## About Sound Income Strategies

Our firm specializes in developing workable retirement strategies for The Income Generation, those born in 1966 or earlier. Our founder, David J. Scranton, has gained a level of notoriety during his 30 years in the industry as an advisor who is particularly protective of his clients' assets. For the past 20 years, he has specialized in the universe of income-generating savings and investment strategies.

Until the disruptive and volatile markets that accelerated in 2014, our proprietary way of trading fixed-income securities had been largely kept secret. Prior to 2014, fixed-income markets had provided ample returns for those with assets in this sector. But, as Janet Yellen started to announce the Fed's intent to raise rates, it made it clear that this period of "easy pickings" for fixed-income investors was coming to an end.

Investors without the proper background would need to look to active managers who specialize in income investments to unearth the best opportunities. It was at this time that David J. Scranton decided the time was right to share our methods with those in The Income Generation.

Sound Income Strategies is made up of experienced investment-management specialists who actively manage their clients' accounts with the goal of maximizing income and growth opportunities. Although Sound Income Strategies works with a wide range of clients nationwide, we specialize in helping those who are in or near retirement.

Sound Income Strategies maintains a core belief that clients have the right to conservative, yet innovative, financial advice along with counsel and recommendations that are appropriate for their particular income needs, tax situation, estate goals, and level of risk tolerance.

David Scranton believes education is so important that he hosts the TV show *The Income Generation* on Newsmax TV which airs every Sunday at 10:00 AM. The show is broadcast to more than 50 million households every week.

*The Income Generation* isn't just another show about retirement planning or the financial markets. It's *the only* show that tackles the challenges and concerns unique to hardworking

Americans within 15 years of retirement who need to know how best to protect their money and generate income in today's economic climate.

With guests that include some of today's most respected economists and analysts, David J. Scranton cuts through the media hype, debunks popular myths, and exposes the financial planning secrets Wall Street doesn't want you to know.

Visit soundincomestrategies.com to find a local income specialist registered with Sound Income Strategies who can help reduce your exposure to stock market risk and help you generate reliable streams of income you can count on well into retirement.

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**Other Commissioned Reports You Might Be Interested in:**

- The Income Generation Report: Income-Generating Strategies to Help You Avoid the Perils of the Stock Market
- The Case for Fixed Income: Renewable Income Streams to Keep You a Step Ahead of Inflation
- Pre-Think Your Estate Plan: Your Guide to Saving Your Family and Beneficiaries from Unnecessary Grief and Taxes
- Are Your Allocations Right for Social Security?