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Practice Management

Analyzing cash flow

Money Matters

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Retirement calculations involve difficult, complex decisions

Here are some tips on questions to ask, variables to consider in your planning

Q I am getting close to retirement and I am confused as to how much income I should plan on taking from my investment portfolios. I fear that I will be running out of money too soon and have no idea as to which portfolio I should take income from. Could you please offer some suggestions as to how I might proceed? Attempting to calculate these seemingly unlimited variables is turning out to be one of the most frustrating and confusing ordeals of my career.

We empathize with the confusion and uncertainty that you are currently facing. In fact, we have met doctors who have confessed to us that they have postponed retiring just to avoid these very issues. How to save for and arrange cash flow for retirement is perhaps one of the most difficult and complex decisions that you will have to make. The confusion begins with the savings component, as Alan Greenspan pointed out in his comment at the 2002 National Summit on Retirement Savings: "One of the most complex economic calculations that most workers will ever undertake is, without doubt, deciding how much to save for retirement."

The thought of your recurring earned income abruptly stopping, as retirement becomes your new lifetime profession, is enough to cause anxiety for anyone. Having helped many physicians with retirement cash flow planning for more than two decades, we are happy to say that there are several logical planning strategies for you to consider.

And, you are not the only one worrying, according to the November 2003 U.S. Trust Survey of Affluent Americans, prepared by United States Trust Company. In fact, the survey, which has been performed since 1993, shows that there are more financial worries today than at any other time during the history of this survey. The survey population included families from the top 1% of income in the country ($325,000 annually) and a net worth greater than $5.9 million. (Now you know whether you are in the top 1% of the country as far as your income and net worth are concerned.)

Here are some of the results concerning retirement in general. Almost half of those surveyed reported that, due to the bear market, they will have to live off of a lower retirement income. One-third (32%) of those who have not yet retired said that they have had to push back their retirement plans because of the bear market. And more than half (54%) said that they will work at least 5 years longer than they had previously planned.

The first rule is to be realistic about both expenses and cash flow. All pre-retirees need to be "grounded" in financial reality. Someone who has become accustomed to withdrawing $300,000 per year from his/her practice cannot expect to continue taking $300,000 per year in retirement from a $3,000,000 portfolio. Although you would think it would be simple math, we notice a gap between what would be a prudent withdrawal from corpus and what sometimes is withdrawn. It is important to note that average rates of return have nothing to do with reality.

When is 10% not 10%?

Putting money into a portfolio is quite different from taking money out of a portfolio. A hypothetical example of this would be if you placed $100,000 into a stock index that increased 10% for 30 years, you would have a total portfolio of $1,700,000. And, if that same portfolio went down 10% for the first 2 years and up 11.6% during the remaining 28 years, you would still have $1,700,000. Let us look at how this would have affected a portfolio subject to distributions. If you started with a $1,000,000 portfolio and took out $60,000 per year, increasing this amount by 3% per year, and your portfolio earned 10% per year for 30 years, your ending balance would be $3,300,000. However, if the portfolio had gone down 10% for the first 2 years and then earned 11.6% for the next 28 years, you would run out of money in the 25th year. Please keep in mind, individuals cannot invest directly in any index.

To get a better idea of how much you can spend in retirement as a function of what percentage you should withdraw from a portfolio, the accompanying chart illustrates the likelihood of running out of money over a 25-year period of withdrawals (Table 1).

What this chart clearly displays is that if you chose to withdraw 7% from your portfolio over 25 years and your portfolio were allocated 60% stocks and 40% bonds, you would only have an 18% chance of not running out of money.

This of course leaves an 82% chance of failure. At 5% you have a 79% chance of making those distributions last for the entire 25-year period. If interested, please contact the authors for the 20- and 30-year charts.

Given the sober statistics above, you can see how imperative it is to plan properly for your retirement.

First, you should consider separating your retirement expenses into two categories. The first category would be the "needs" or necessary expense category, such as insurance premiums, mortgage payments, real estate taxes, food, clothing, medical and car expenses, utilities, etc. The second category is a "want" list, which would include gifts, charitable contributions, travel, jewelry, etc. These "needs" and "wants" add up to your net after-tax annual retirement cash flow needs. You can calculate the income tax due (see "Money Matters" column, *Ophthalmology Times*, Sept. 1, 2003 issue, Page 35) and add taxes to your net cash flow needs for a gross annual income need. We will get back later to why you would separate expenses into two categories.

Next, write down all recurring income that you will be receiving during your retirement years. This could include social security, installment sale of your practice, part-time work for an estimated number of

Table 1 Likelihood of not running out of money over a 25-year period of withdrawals

Rate of withdrawals	Stock/Bond Mix 100/0	80/20	60/40	40/60	15/85	5/95
4%	93%	95%	96%	97%	98%	93%
5%	78%	79%	79%	66%	46%	14%
6%	59%	56%	48%	27%	2%	0%
7%	38%	31%	18%	3%	0%	0%

OT Graphic

Ophthalmology Times / Source: T. Rowe Price Associates

years, and any fixed-income pensions that you may have qualified for during your working career. Deduct this from your gross annual income needs and you will have the amount that you will be required to take from your portfolio in the first year. We say first year because each year thereafter you will have to increase your annual expense amount by the inflation rate.

Next, calculate the percentage of your combined portfolios this dollar amount represents. To get this percentage, divide the gross annual income that you need by the amount of your portfolio. If the percentage is more than 5%, you may want to refigure some of your expenses to see if you could cut down on some of them. Also, you will want to look at the asset allocation of your portfolio among equities (stocks), cash, and bonds. The lower the percentage of income needed to your portfolio balance, the larger the amount you can afford to have in fixed-income investments.

Striking a balance

According to the most recent actuarial tables, a couple, both age 65, have a life expectancy, and therefore an investment time horizon, of 32 years. Depending on what percentage of your total portfolio your annual cash flow needs represent, you will have to make the decision of how much exposure you should have in the stock market for future growth. It is perhaps more difficult today to plan for retirement cash flow than anytime during the last 30 years, because at this time bond yields are at 40-year lows and money market funds can be under 1%. If you purchase a long-term bond in order to increase cash-flow, you may be risking erosion of principal if interest rates go up.

On top of this, the stock market has been unsettling, to say the least, thereby making many people reluctant to remain fully invested. To construct an appropriate portfolio will take a blending of cash-generating investments, as well as a well-balanced equity portfolio.

Another challenging decision is where to take cash flow from. Keep in mind that each person's circumstances are unique and there are specific needs and considerations for everyone. There are theories that suggest you first deplete all tax-free portfolios, then taxable portfolios, in an effort to reduce taxes and let all qualified and non-qualified tax-deferred portfolios grow. However, what works in theory is not always practical. From years of working with retirees, we find that it is not a good idea to decimate non-taxable portfolios just to save taxes on distributions from qualified plans. You may need that money someday in a lump sum and you may not want to have to take a large taxable distribution from your IRA. Also, it is ideal to be able to take a certain percentage (say 4.5% to 6%) across the board from all portfolios and accounts.

Remember that under the new tax laws, money left to heirs in a qualified plan or non-qualified tax-deferred annuity can be "stretched" over the beneficiaries' lifetimes. To get help with these decisions, it is always a good idea to get advice from a qualified accountant or tax attorney who has experience in this area.

The logistics of taking money from multiple accounts can be handled in a way that produces one check per month or one check every 2 weeks, similar to when you were receiving a paycheck. All you need to do to accomplish this is to instruct your financial advisor(s) and broker(s) to channel income from your various accounts into one money market account. Income is produced from various sources. It can come in the form of dividends and interest being paid to you, rather than reinvested, and/or systematic monthly withdrawals, if you have a large portfolio of mutual funds, or monthly withdrawals from fixed or variable annuities. The income channeled into the money market account should include the amount set aside for estimated quarterly income tax payments. You can then write yourself a check for your net income needs and let the amount allocated toward future income taxes accumulate in the account, to be available when payments are due.

Your best approach to this complex question is to take advantage of the various sophisticated software services that are available, and input your personal data to run a couple of what-if scenarios. The input would include: your and your spouse's ages; age of retirement; annual cash-flow needs; the current value of your taxable, tax-free, nonqualified, and qualified accounts; assumed rates of return depending on your particular asset allocation among stocks, cash, and bonds; assumed inflation and income-tax rates; social security income; other retirement income; and assumed mortality ages. The report that you receive should give you an idea of whether you would be invading principal or not. Please use both the traditional planning tools that use averages, as well as the Monte Carlo method that draws on probabilities from the past.

Needs and wants

Last, you will recall that in the beginning of our column we asked that you break your expenses into two categories: needs and wants. Assign your needs a dollar amount per year that you know you must have for necessary expenses and calculate your wants as a "percentage amount" of your total investment portfolio. You then can take the "wants" percentage each year based on the value of your overall portfolio at the end of the previous year. This will stop you from decimating your portfolio and invading principal in down years, such as we had in 2000 to 2002. As your portfolio goes up, your "want" income increases, with the opposite being true in a down cycle. This is one way to apply some discipline and keep emotions out of the decision-making process. It also should give you a sense of security in knowing that you are not spending more than you should.

For anyone interested in planning for retirement who may be interested in a no-cost, confidential Retirement Cash Flow Analysis (using traditional averages and the Monte Carlo method), please contact our office and we will e-mail or fax you the necessary questionnaires. This valuable report will help you to evaluate whether you are on target for your retirement cash flow requirements, or if you need either to save more now, consider reducing retirement income expectations, or postpone retirement for several more years. **OT**

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