One Boomer's View on Retirement

Much has been written about the impact of the baby boom generation on the economy as they enter their retirement years. The forecasted accelerating drain on social security reserves has been well publicized, and any way you slice it, it is a ticking time bomb without any serious reform on the immediate horizon to fix the problem. However, this article will not be a discussion on how to fix social security, but instead will focus on the generational distinctiveness of the boomers along with some thought provoking ideas on how best to navigate financially through the difficult and uncharted waters leading up to and living in retirement.

First of all, my credentials as an authority on the subject are limited to the fact that I am a charter member of this generational group, having been born in 1946, the first official year of the baby boomers. Right on cue, I elected full retirement at the age of 66 in the year 2012, and began drawing social security benefits. According to Census Bureau data, there will be some 89 Million boomers following my path over the next 18 years ending with the "Late Boomers" born in 1964 reaching retirement age. So, all you junior boomers, pay attention to your senior brethren and start planning for this stage in your life because it will be here before you knew what hit you.

So what's so special, or distinctive about the baby boom generation compared to previous retirees? First and foremost, there are 79 million boomers in the U.S., which equates to roughly 26% of the population. This 26% controls 80% of the personal assets held in the country. Before we conclude that this staggering statistic means that all boomers are wealthy, it should be noted that the top 1% controls 35% of the wealth, and the next 19% controls 50%. So, in other words, 85% of the boomer wealth is controlled by 20% of the boomer population. That leaves 80% of the boomer population in potential jeopardy of not being able to adequately fund their retirement.

In 1975, 40% of private sector employees retired with a defined pension plan. By 2006, that number dropped to 17%, and continues to fall every year as more employers freeze their pension programs in favor of 401(k)'s. This is a troublesome fact in that most Americans have little or limited knowledge about managing investments. Not only will they struggle in the building of a retirement portfolio, but the task of managing eventual withdrawals and distributions will pose similar challenges.

The earning years immediately preceding retirement are often the peak earning years, which means that they are more than likely the highest tax years as well. So it is important to make the most of this period in the construction of ones nest egg. While conventional advice always recommends maximizing contributions to 401(k) plans and IRA's, one needs to be mindful of other tax advantaged savings and investment strategies.

To Roth or not to Roth? First of all contributions to a Roth IRA are not tax deductible in the year of the contribution. Second of all, anyone can contribute to a Roth IRA (up the statutory limit) as long as their joint filer income is less than $173,000. The most distinguishing characteristics of a Roth compared to a

traditional IRA are, 1) no preset age limits requiring distributions and 2) distributions, when taken, are tax free.

With a traditional IRA, contributions (up to the statutory limit) can be tax deductible during the year of the contribution depending on 1) your participation in a retirement plan such as a 401(k) at work, and 2) your income level during the year of the contribution. However, no contributions can be made after age 70 ½ and distributions must commence at the same age, and they will be taxed as ordinary income during the year of such distribution.

The above is not intended to be the complete primer on Individual Retirement Accounts but rather its purpose is just to point out the major differences between the two options. In most cases, one's taxable income, tax rate, and the deductibility of the contribution in the contribution year will dictate the choice between the two.

According to the Social Security actuarial tables, a 66 year old male retiring in 2013 will live to be 84 years old. To minimize the effects of outliving retirement resources, it would be prudent to add an additional 6 years to this period, which results in the need to provide a 25 year retirement income stream. It goes without saying, that the earlier one begins the process of planning for retirement, the higher the chances are that the goals will be achieved.

For the rest of this article, I will focus on a fictional character that I will call Dexter. Dexter is 60 years old and currently employed in the private sector. His annual salary is $150,000 a year. His employer does not offer a defined pension plan, but does offer a 401(k) with matching contributions up to 4% of his income. Dexter has elected to make the maximum contributions allowable by law to his 401(k). Finally, Dexter has been married for 35 years and his wife currently does not work outside the home.

Over the course of his working career, Dexter has managed to accumulate a net worth of $1.0 Million not including equity in his personal residence. The breakdown is as follows.

Personal Savings	$200,000
Traditional IRA	$300,000
Traditional IRA (Spouse)	$100,000
401(k) balance	$200,000
Taxable Brokerage Account	$200,000
Total Net Worth	$1,000.000

Dexter figures that he will need to amass a total of $2.0 Million by age 66 in order for him to provide the retirement income he desires. Looking out 6 years, he figures that he will need an inflation adjusted income of $115,000 during retirement. He is projecting first year social security benefits to be $36,000 per year, leaving $79,000 to be funded from other sources. Beyond Year 1, Dexter assumes an inflation rate of 3% a year and calculates his yearly draw accordingly. Optimistically, he is assuming that his combined social security benefits will increase 1% a year. The table below lists the results which assume a 3% return on the balance of his investment portfolio throughout retirement.

Beginning Balance	Social Security*	Investment Earnings	Withdrawal Amounts**	Total Income	Ending Balance
$2,000,000	$36,000	3.0%	$79,000		
Year					
1	$36,000	$60,000	$79,000	$115,000	$1,981,000
2	$36,360	$59,430	$81,370	$117,730	$1,959,060
3	$36,724	$58,772	$83,811	$120,535	$1,934,021
4	$37,091	$58,021	$86,325	$123,416	$1,905,716
5	$37,462	$57,171	$88,915	$126,377	$1,873,972
6	$37,836	$56,219	$91,583	$129,419	$1,838,609
7	$38,215	$55,158	$94,330	$132,545	$1,799,437
8	$38,597	$53,983	$97,160	$135,757	$1,756,260
9	$38,983	$52,688	$100,075	$139,058	$1,708,873
10	$39,373	$51,266	$103,077	$142,450	$1,657,062
11	$39,766	$49,712	$106,169	$145,936	$1,600,604
12	$40,164	$48,018	$109,354	$149,519	$1,539,268
13	$40,566	$46,178	$112,635	$153,201	$1,472,811
14	$40,971	$44,184	$116,014	$156,986	$1,400,981
15	$41,381	$42,029	$119,495	$160,876	$1,323,516
16	$41,795	$39,705	$123,079	$164,874	$1,240,142
17	$42,213	$37,204	$126,772	$168,985	$1,150,575
18	$42,635	$34,517	$130,575	$173,210	$1,054,517
19	$43,061	$31,636	$134,492	$177,554	$951,660
20	$43,492	$28,550	$138,527	$182,019	$841,683
21	$43,927	$25,250	$142,683	$186,610	$724,251
22	$44,366	$21,728	$146,963	$191,329	$599,015
23	$44,810	$17,970	$151,372	$196,182	$465,613
24	$45,258	$13,968	$155,913	$201,171	$323,668
25	$45,710	$9,710	$160,591	$206,301	$172,787

As stated earlier, Dexter has accumulated $1.0 Million at age 60. But he figures he will need double that at age 66 to accomplish his retirement goal of providing a twenty five year income stream that will grow by 3% a year. Accumulating $1.0 Million in six years will be no easy task. However, if he can accumulate an additional $500,000, bringing his nest egg up to $1.5 Million, he will be able to preserve his desired income stream for twenty years instead of the desired twenty five. Other variables certainly play into this, including the rate of return on the existing portfolio. The MS Excel version of the table above can be downloaded here where you can experiment with different scenarios by adjusting the various inputs.

There are any number of strategies one can employ to increase the net value of a portfolio. Risk tolerance will be one overwhelming modulator. Further, tax efficiency should be at the top of the list for those investment instruments that are not in a tax deferred account.

Among publicly traded investment classes, one that stands out for its tax deferred feature is the Master Limited Partnership. MLP's are concentrated in the energy sector and have drawn increased investor attention due to their high yields and tax deferred status. Most of the distribution is classified as return of capital which is why most of the income is tax deferred. It should be noted that distributions are not tax free, just tax deferred. Distributions typically lower your cost basis which will result in additional capital gains upon the eventual sale of the asset. Click here for a detailed description of Master Limited Partnerships.

One note of caution and advice when entering a new MLP position is to leg in over time. The very nature of the Master Limited Partnership requires them to distribute most of their cash flow to their unit holders. As such, they frequently need to raise new capital through the debt or equity markets in order to continue their growth and increase their overall cash flow generation. More often than not, the price will drop as new units are offered to the public. This dilutive effect frustrates many investors when instead it should be viewed upon as a buying opportunity. If the fundamentals that drove you to the issue are still in place, take advantage of this sale to add to your position.

There are times when it might make sense to sell some or all of your position. While your Yield on Cost (Distributions ÷ Cost) are attractive, the current yield may have declined (Distributions ÷ Market Price) due to a run up in the issue price. If you see better higher yielding opportunities on the horizon, you may want to take some profits. If you do, make sure you match your sale units with your purchased units to so that your gain is a long term gain rather that a short term gain.

Staying with the publicly traded equity theme, there are two other high yielding classes that merit consideration; REIT's (Real Estate Investment Trusts) and BDC's (Business Development Companies). Both REIT's and BDC's are exempt from Federal Income Tax as long as they distribute 90% of their otherwise taxable income to shareholders. This doesn't mean that the income is tax- free, it just means that it avoids the double taxation of traditional C-Corporations. The investor or recipient is responsible for paying the tax on the distributed income. While MLP's are most efficient when held in a taxable account, REIT's and BDC's should be held in a tax deferred account whenever possible.

Lastly, no discussion of retirement income would be complete without mentioning annuities. In the recent low interest rate environment, the purchase of new annuities has been a non-starter. However, once the current Fed Policy of easy money changes, we are bound to see higher rates down the road, which could make the annuities option more attractive as a supplement to income.

And finally, one rule of thumb and piece of advice regarding the withdrawal of funds during retirement; make an effort to tap your taxable accounts first before touching your tax deferred accounts. At age 70 ½ and beyond, you will be required to begin taking distributions from a traditional IRA and will be taxed at ordinary income rates in the process. However with a Roth IRA, it makes no difference because the taxes were paid at the time of the contribution.