ARE YOUR ALLOCATIONS RIGHT FOR RMDS?

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Are Your Allocations Right for RMDs?

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There is an ideal order in which to pull from retirement accounts when taking IRS Required Minimum Distributions (RMD). The goals, which often go unheeded, are to help minimize taxes, try to 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 to cover your RMDs, keep your tax bill at a minimum, and satisfy your other expenses throughout retirement.

As you may know, RMDs are distributions the IRS requires you to make on your retirement savings each year after you've reached age 73. The amount changes each year in conjunction with your life expectancy and the balance of your IRAs and other qualified plans as of December 31 of the preceding year.

The Reverse Mortgage Analogy

Ideally, an asset allocation for taking RMDs should be able to generate high enough earnings to satisfy your required withdrawals without eating away at the initial investment. This calculates to be at least 3.7% in combined dividends and/or interest.[1] 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 today higher than they've ever been, most people need to plan for 30 years of retirement. That being the case, spending any principal at all, especially in the early years of retirement, can negatively impact all the remaining years.

A better understanding of this can come from looking at what we know about a 30-year mortgage. When you first start making payments, you're not paying back much principal at all. Instead, you're paying primary interest and just a small amount of principal. But, as the years go on and the balance gets paid down, you pay a little less interest and a little more principal. The process continues until, after 30 years, your mortgage is thankfully paid off. But consider this process in reverse. Take a pool of savings worth $1M, generating 5% interest per year — meaning $50,000. If you take even a little bit more than that $50,000 each year, just a small amount of the principal, that sum will be depleted within 30 years in much the same way a mortgage is paid off.

Today's Challenges

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

Admittedly, this was less of a danger many years ago. During the 1980s and 1990s, amid the best long-term bull market in U.S. history, investors could have conceivably satisfied their RMDs completely from capital gains, rather than dividends, without encroaching on principal. But the financial markets have changed drastically since the turn of the century.

Unfortunately, it's also true that in today's market, it's not easy for everyday investors to generate the kind of interest or dividends needed to satisfy their RMDs without touching the principal. Interest rates in money markets have been historically low for most of the years since the Financial Crisis. What's more, bond mutual funds can also be tricky because, unlike individual bonds, they are not a contractual investment that gives you a fixed, guaranteed rate of interest return.

Reverse Dollar-Cost Averaging

Still, those options are probably preferable to having a diversified stock portfolio or stock mutual fund portfolio earning less than 3.7% annual dividend, and selling core shares each year to help satisfy your RMDs. This is one of the most common and costly financial mistakes made by retirees: the error of reverse dollar-cost averaging.

Most people know what dollar-cost averaging is and have wisely used it while saving over the years, typically by investing in a 401(k). 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 foundation of good investing. For example, if you were to buy $100 per month of a mutual fund and the first month the fund was worth $10 a share, you would buy ten shares.

But, what if in the second month, the fund dropped to $5 a share? Well, if you stuck with your plan, you'd have to buy 20 shares to get $100 worth. So, after two months, your average cost per share would seem to be $7.50, but in actuality, it would be lower: $6.65. That's because you bought twice as many shares at $5, and half as many shares at $10. Dollar-cost averaging helps you get your average costs down.

The problem, however, is that once you're at a point where you're not saving into your fund, and you're drawing from it instead to help satisfy RMDs, the same principles apply but in the opposite direction. You start reverse dollar-cost averaging. Taking the same example, let's say that in the first month, you liquidate $100 and you sell 10 shares, and in the second month, the fund drops in half. Now, to withdraw your $100, you must sell twice as many shares, therefore you sell 20 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 to sell low.

Take Action Today!

So, while dollar-cost averaging is a great strategy for saving, reverse dollar-cost averaging is one of the most cancerous strategies you could embark upon. This goes back to the original point: if you're going to have money in the stock market in your IRA during retirement, you want to help ensure that you're earning enough interest or dividends on your allocation overall to satisfy your RMDs.

Once again, that can be challenging in today's market, so don't try this at home! Contact a qualified financial advisor who specializes in financial strategies designed to help protect your principal while generating more consistent and reliable income — generally in the 3-5% range. This is income that can provide cash flow for your retirement or that can be reinvested to obtain growth organically, or "the old-fashioned way"!

Source:

1. https://www.marketwatch.com/story/dont-let-hidden-costs-destroy-your-retirement-savings-2016-02-24

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