



**Financial
Management**
Integrity • Trust • Independence

March 2015 Vol. 5 No. 3

Retirement Distribution Pitfalls: Tax Consequences

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Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement, which can be even more complicated.

Pitfall: One of the big mistakes of retirement distribution can be neglecting to consider tax consequences of some distributions. Distributions from traditional IRAs and 401(k)s are fully taxable at your ordinary income tax rate, so if you're not paying taxes at the time you're pulling money out, remember that the distribution is smaller than it looks because you'll be paying taxes on it at a later time.

Workaround: It may be a good idea for retirees to pay quarterly estimated taxes to avoid a penalty from the Internal Revenue Service. Also, retirees should

consider the tax effects associated with IRA and 401(k) distributions when assessing their portfolio's long-term viability. Spreading assets among various account types can help lessen the tax shock, as can carefully sequencing withdrawals to lessen the drag of taxes and preserve the tax-saving features of IRAs and 401(k)s for as long as possible.

401(k) plans and IRAs are long-term retirement savings vehicles. Withdrawal of pre-tax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult with a financial or tax professional for advice specific to your situation. This article contributed by Christine Benz, Director of Personal Finance with Morningstar.



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Advisor Corner

Mr. Kennedy's investment philosophy is the same that he has practiced over the last decade: securities markets are efficient and advisors primarily add value by coordinating the asset allocation for clients based upon risk tolerance, objectives, and time horizons. The firm has constructed 5 models for clients that vary in risk to meet the goals of each client. The firm primarily uses passive mutual funds in

each model and uses select actively managed funds for bond, commodity, and real estate exposure. ITI uses several research resources, including many that were used over the last 20 years, to assist with the recommended asset allocation and the appropriate funds to utilize in each model. Mr. Kennedy is an Investment Advisor Representative of ITI Financial Management, LLC.

Investment services are offered through ITI Financial Management, LLC, a registered investment adviser with the state of Missouri

Success Factors for Retirement, Part 1

ITI Financial Management/Troy E. Kennedy

► ITI Financial Management is a fee only, non commissioned registered investment advisory firm headquartered in Springfield, Missouri. We presently manage approximately \$65 million for over 175 accounts. In November 2009, Springfield Trust & Investment Company sold to a large out of town bank holding company. After 17 years as a shareholder/executive vice president with Springfield Trust & Investment Company, Troy Kennedy founded ITI Financial Management to continue to provide the highest level of personalized investment management and financial planning services. There are no fees to hire ITI nor are there any fees to terminate the relationship. It is truly a partnership with each client.

OK, folks, here's what we're asking you to do. First, save as much money as you can while you're working, despite ongoing expenses. Next, figure out how to invest the money and, once you've gained critical mass on your savings, determine if it's going to be enough. Is it any wonder so many pre-retirees are overwhelmed by retirement planning?

However, there is good news, as well. Some of the key success factors that have the power to make or break a retirement plan can be simple if understood correctly. While investors don't need to hit the mark on every last one of them, handling the majority of them correctly increases the chances of a successful retirement plan.

Success Factor 1: A Flexible Retirement Date. For investors who analyzed the numbers on their retirement plans and found that their nest egg could come up short, one option to consider is working longer. Doing so can be advantageous on a few different levels. Investors will have more years to save and fewer years to draw from their portfolios. They may also be able to defer Social Security, which can be profitable, especially for people with a longer-than-average life expectancy. Another option to consider is a hybrid strategy, shifting into a lower-paid, but more rewarding and/or less stressful, career. Alternatively, investors could stay put in their current positions but spend (rather than bank) additional retirement-plan contributions. Such a strategy could allow some people to pay for retirement dreams, such as exotic travel, while still working. Additional retirement-plan contributions in your 60s benefit less from tax-deferred compounding than do contributions made earlier on. Of course, working longer isn't always a possibility: Health considerations (for oneself, a spouse, or a parent) may interfere, or aging employees may not be able to hang on to their jobs. That's why working longer can't be the only fallback plan; investors need to make sure they have other success factors working in their favor, too.

Success Factor 2: A Well-Considered Social Security Strategy. Deciding when to file for Social Security is one of the most consequential financial decisions most Americans will make about their retirement. The

1980s and 1990s were all about maximizing portfolio returns. But the specter of twin bear markets in the 2000s, as well as ultra-low interest rates, shone a light on more mundane matters, including trying to get the most out of Social Security. Even casual students of Social Security planning have heard the admonition to not take Social Security at age 62, when they're first eligible, as doing so will result in a permanent cut to benefits. And for people who have longevity on their side, it may be better to delay benefits for as long as possible, because benefits increase for every year from full retirement age until age 70. Keeping those rules of thumb in mind is a great first step toward getting a Social Security plan moving in the right direction, but retirement planners can also take advantage of more sophisticated strategies, especially if they're part of a married couple. More and more financial planners are focusing on Social Security maximization, and there are also a number of online tools that can help craft a prudent Social Security plan.

Success Factor 3: A Large Enough Stock Allocation. The traditional lifetime glide path calls for accumulators to hold very high weightings in stocks, and then gradually peel back equity exposure as the years go by. But make no mistake: Pre-retirees and retirees may need plenty of stocks, too. The key reason is purchasing-power preservation. If inflation runs at 3%, it's hard to see how a portfolio of nominal bonds and cash yielding 2% to 3% is going to be able to hold up. Of course, there are other ways to hedge inflation risk, but stocks are the asset class with the highest probability of out-earning inflation over time. That argues for most retirees holding at least half of their assets in stocks coming into retirement.

Success Factors for Retirement, Part 2

ITI Financial Management/Troy E. Kennedy

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Of course, holding a higher equity weighting also means higher short-term volatility, but that may be an acceptable trade-off when considering the bigger risk of running out of money prematurely.

Success Factor 4: A Sensible (and Dynamic) Spending Strategy. The size and composition of a retirement portfolio are just one side of the ledger. On the other side? The strategy used for extracting the cash needed from that portfolio on an ongoing basis. Even very large portfolios aren't big enough to last for an entire retirement if the withdrawal, or spending, rate is too high. That's why financial-planning researchers have been focusing so much energy on this area in recent years. Many experts think that the old 4% rule, which involves taking 4% of a portfolio's balance in year one of retirement and inflation-adjusting that amount thereafter, still gives a person with a 60% equity/40% bond portfolio good odds of not outliving their money over a 30-year retirement. But there's also widespread agreement that retirees can greatly improve their portfolios' longevity if they're willing to be flexible about withdrawals, reducing spending in lean years for the market and potentially taking a bit more in good ones. In addition to being willing to adjust their withdrawal rates, retirees may also want to be flexible about withdrawal strategies, using an income-centric approach in more yield-rich eras and relying more on rebalancing proceeds in others.

Success Factor 5: Flexibility on In-Retirement Living Expenses. Even people who aren't in the habit of driving 16-year-old cars (and don't plan to) can make their retirement finances better if they're willing to contemplate a less costly in-retirement lifestyle. One of the easiest ways to bring costs down without throwing quality-of-life considerations out the window is to consider downsizing homes. Like working longer, downsizing can have a positive impact on a few different levels. Even if you own your home free and clear, you're apt to have lower outlays for taxes, utilities, and maintenance costs than you did in your larger home. And the sale of a home that realizes a profit means more money for retirement.

Success Factor 6: Vigilance on Portfolio Costs. As a portfolio's asset allocation gets more conservative over

time, its return potential declines as well. This means that investment-related costs, on a percentage basis, will extract an even bigger toll than they did when the portfolios was younger and earning a high return. Let's say a 50% stock/50% bond portfolio earns a 4.5% annualized return, on a pre-expense basis, over the next few decades. Assuming a 3% inflation rate, that's just a 1.5% real return. And unless investors are careful, nearly all of that return could disappear in investment-related and tax costs. After all, it's not unusual for funds to have expenses over 1%, and they're just one piece of the expense pie. The good news is that investment costs are one of the easier factors for investors to control. Another area to focus on is tax management. Retirees may want to hang on to tax-advantaged accounts for as long as possible. When it comes time to pull money out, investors should carefully consider which accounts to withdraw from, with an eye toward staying in the lowest possible tax bracket.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than other asset classes. Investing does not ensure a profitable outcome and always involves risk of loss.

Asset allocation is a method used to help manage risk. It does not ensure a profit or protect against a loss. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

This article contributed by Christine Benz, Director of Personal Finance with Morningstar.

Bond Versus Equity Fund Flows

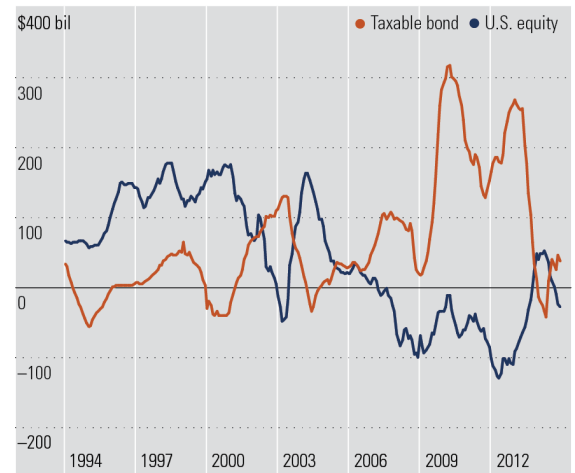
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Fund-flow data can be a useful for analyzing where investor money is going and how fund-flow trends are correlated with asset-class performance. Between 1994 and 2001, equity flows were higher than bond flows, but all that changed after the dot-com crash when investors started losing confidence in stocks.

The 2007–2009 crisis on the graph illustrates how investor behavior is tied to market performance, even though the timing may not always be right. In 2009, as the stock market hit bottom, investors should have been buying cheap stocks, but instead bond flows increased. In 2012, stock inflows started to climb again. The upswing was short-lived, however, and stock flows have once again been on the decline since April 2014.

Rolling 12-Month Fund Flows



Source: Morningstar Direct. Funds analyzed include U.S. open-end mutual funds. Data as of December 31, 2014.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. *Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should be read the prospectus and consider this information carefully before investing or sending money.*

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than bonds.

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