Kiplinger's

RETIREMENT PLANNING 2023

YOUR GUIDE TO A SECURE RETIREMENT

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Shield Your Retirement Income *From Inflation*

A SECURE RETIREMENT DOESN'T HAVE TO BE THREATENED BY RISING COSTS AND A BEAR MARKET.

BY SANDRA BLOCK

If you're a retiree (or near retiree) who isn't worried about inflation, you're either fabulously wealthy or not paying attention. Even for super savers, inflation is retirement kryptonite. To keep up with rising costs, you may be forced to take larger withdrawals from your portfolio, increasing the risk that you'll outlive your nest egg. And if inflation is accompanied by a bear market, withdrawals can leave a permanent hole in your portfolio.

More than 70% of individuals age 50 and older are concerned that inflation will cause serious economic hardship during their retirement, according to a recent national poll Kiplinger conducted with Athene, a retirement services company. Although you can't control the inflation rate—or the stock market—you can take steps to protect your retirement security.

BE WILLING TO BREAK THE 4% RULE

One of the most perplexing questions facing retirees is this: How much can I withdraw from my savings each year without running out of money? For many, the answer has been to use the 4% rule, developed by William Bengen, an MIT graduate in aeronautics and astronautics who later became a certified financial planner.

Here's how it works: In the first year of retirement, withdraw 4% from your IRAs, 401(k)s and other tax-deferred accounts (which is where most workers hold their retirement savings). For every year after that, increase the dollar amount of your annual withdrawal by the previous year's inflation rate. For example, if you have a $1 million nest egg, you would withdraw $40,000 the first year of retirement. If inflation that year is 2%, in the second year of retirement you would boost your withdrawal to $40,800.

Although the 4% rule has held up well since it was introduced in 1994, Bengen acknowledges that a period of high inflation could threaten his formula. And this past year illustrates why: Using the above example, if you retired this year and withdrew $40,000 from your $1 million nest egg, you would increase your 2023 withdrawal to about $43,200 (assuming Kiplinger's year-end forecast of 8%). That's a significant amount under any circumstance, but such a sizable withdrawal during a bear market exposes you to what's known as sequence-of-returns risk. If your account balance shrinks significantly during the early years of your retirement, you have fewer assets to create returns during market recoveries, posing the threat that you'll run out of money

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in a retirement that could last decades.

Investment firm Morningstar recently recommended a 3.3% withdrawal rate for new retirees who have a portfolio mix of 50% stocks and 50% fixed-income investments and a 30-year time horizon. Morningstar based its recommendation on an analysis that suggests that the above-average returns investors enjoyed before the recent bear market are likely to be lower in the next 30 years.

Financial planners say retirees should view the 4% rule as a guideline, not something that's engraved in stone. Cecil Staton, a certified financial planner in Athens, Ga., sets up guardrails for his clients that reflect their individual circumstances, with withdrawal rates ranging from 3% to as high as 6%. "Somebody in their early sixties is probably going to have a different guardrail than somebody in their seventies," he says. "The longer money needs to last, the more conservative you should be with withdrawal rates."

Reducing withdrawals when everything costs more can be a challenge. But in the early years of retirement, trimming withdrawals by even a small amount—say, from 4% to 3.8%—will reduce the risk that you'll run out of money, says Wade Pfau, professor of retirement income at the American College of Financial Services.

MONITOR INVESTMENT FEES

High investment costs can put an additional drag on your portfolio at a time when you can least afford it. A recent report from Pew Charitable Trust found that workers who roll their 401(k) plans into an IRA often end up paying higher fees for mutual funds than they paid when their money was in a 401(k). Workplace retirement plans can use their purchasing power to offer institutional-class shares, which are usually less expensive than the retail-class shares sold by IRA providers.

Leaving your savings in your employer plan is one option, but there are drawbacks to this strategy. You may want to consolidate accounts left with several former employers into one IRA, and your former employer may limit the number of withdrawals you can take from the plan. If you decide to move your money, shop around for low-cost funds before rolling over your 401(k), or roll over funds that are already in an IRA into an account with a lower-cost provider.

DON'T OVERFILL YOUR CASH BUCKET

Many retirees use a strategy known as the bucket system to protect themselves from market downturns. With this system, you divide your savings among three buckets. The first is designed to cover living expenses for the next one to three years, after you tap a pension or annuity (if you have one) and Social Security. Because you need to be able to access the funds at any time, money in this bucket is typically stashed in an ultra-safe investment, usually a bank savings account or money market fund.

The second bucket contains money you'll need over the next 10 years and can be invested in short-and intermediate-term bond funds. The third bucket is filled with money you won't need until much later, so you can invest it in assets that are riskier but offer potential for long-term growth—mainly stocks, and possibly real estate and commodities.

The amount you should keep in your cash bucket depends on your individual circumstances—other sources of income, for example, and your tolerance for risk. During unsettling times like these, it may be tempting to increase the amount of money stashed in this bucket, where it won't be buffeted by market turmoil or global conflicts. But keeping too much of your savings in cash will amplify the risk that you'll run out of money, says Jamie Hopkins, managing partner of wealth solutions at the Carson Group, a wealth management firm. Although interest rates have been moving higher, the rates on most bank savings accounts and money market funds still average less than 1%, significantly lower than the current inflation rate.

TAP YOUR HOME FOR INCOME

A sharp rise in home values, combined with a shortage of single-family homes, has driven up home prices around the country, leaving senior homeowners with more than $11 trillion in home equity. If you're planning to downsize, you can tap that equity right away and add the proceeds to your savings. But if you want to stay in your home, there's another option: Take out a reverse mortgage line of credit as early as possible—homeowners are eligible at age 62.

The line of credit will create a buffer during market downturns, providing a source of funds to pay expenses until your portfolio recovers, says Pfau. You won't have to pay the money back as long as you remain in your home.

Where reverse mortgages are concerned, the lower the interest rate, the more you can borrow. If you're contemplating a reverse mortgage, you may not want to put it off much longer, because rates are expected to continue to rise as the Federal Reserve moves to squelch inflation. In addition, home prices have been moderating, which means the appraisal you get a few months from now, which will determine the size of your loan, could decline. Taking out the loan now would in effect lock in your current home value, Pfau says. If your portfolio bounces back and you determine you don't need the money, your credit line will increase as if you were paying interest on the balance.

While some TV ads may lead you to believe that every senior needs a reverse

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mortgage, there are definite downsides. Up-front costs are high, so you shouldn't take out a reverse mortgage unless you plan to stay in your home for at least five years. The loan will come due when the last surviving borrower sells, leaves for more than 12 months due to illness or dies. If your heirs want to keep the home after you die, they'll need to pay off the loan.

A HECM reverse mortgage is a "nonrecourse" loan, which means the amount you or your heirs owe when the home is sold will never exceed the value of the home. As long as you remain in the home, you retain ownership, but you're responsible for paying taxes and insurance and maintaining the property.

GET THE MOST OUT OF SOCIAL SECURITY

If you're anywhere near retirement, you probably know that you're eligible to file for Social Security benefits at age 62. And you're probably also aware that you can increase the size of your benefits by waiting until at least full retirement age (FRA)—66 for beneficiaries born between 1943 and 1954, gradually increasing to 67 for beneficiaries born in 1960. If you wait until age 70, you'll maximize your benefits.

Inflation makes the case for delaying your benefits even more compelling. Social Security benefits are adjusted annually, based on the cost of living. In 2023, the cost-of-living adjustment will be 8.7%, the largest increase since 1981. You don't forgo those cost-of-living increases by waiting to claim benefits; in fact, they'll compound the amount in benefits you'll ultimately receive. If you're able to continue postponing benefits after you reach full retirement age, you'll receive an 8% retirement credit for every year between FRA and age 70.

Not everyone can afford to postpone filing for Social Security benefits, but if you're married, you may be able to have it both ways. The lower-earning spouse could file before full retirement age, even though that will mean a reduction in that spouse's benefit (up to 30% if the spouse files at age 62). Use that income, along with income from other sources, to pay expenses while the higher earner's benefit—which will get the biggest boost from delayed-retirement credits—continues to grow until age 70. This strategy also increases survivor benefits. A surviving who is at least full retirement age can receive 100% of the deceased spouse's benefit.

CONSIDER TAKING A LUMP SUM INSTEAD OF A TRADITIONAL PENSION

If your employer provides a traditional pension, you may be offered two options at retirement: monthly payments for life or a lump sum. In these uncertain times, it's tempting to choose the monthly check, because who doesn't want guaranteed income for life? But the decision isn't as straightforward as it seems.

First, most traditional pensions aren't

Prepare for Medical Costs

Although you have some control over your costs in retirement—for example, you can postpone vacations when your portfolio is down—health care costs are difficult to predict or avoid. Those costs have risen so quickly that senior advocates say the annual Social Security cost-of-living adjustment doesn't account for how much seniors pay for doctor visits, prescription drugs and hospital stays. Fidelity Investments estimates that the average 65-year-old couple will spend $315,000 in after-tax savings to cover their health care expenses in retirement.

If you're still working, investing in a health savings account is one of the most-effective ways to stay ahead of health care inflation. Contributions are pretax (or tax-deductible, if your HSA is not employer-sponsored), the funds grow tax-deferred in the account, and withdrawals are tax-free for qualified medical expenses, without a time limit to use them. Many HSAs allow you to invest contributions, so if you don't need the money for medical expenses, you can allow it to grow tax-free until you retire.

In 2022, you can contribute up to $3,650 to an HSA if you have an individual health insurance policy or up to $7,300 for family coverage. If you'll be 55 or older at the end of the year, you can put in an extra $1,000 in "catch up" contributions. In 2023, maximum contributions will rise to $3,850 for individuals and $7,750 for family plans (these amounts are adjusted annually for inflation).

In order to be eligible for an HSA, you must be covered by a high-deductible health insurance plan, which in 2023 is defined as a plan with a deductible of at least $1,500 for individual plans and $3,000 for a family plan. Once you enroll in Medicare, you can no longer contribute to an HSA. However, you can use the money you've saved in your HSA for a wide variety of medical expenses, including co-payments, deductibles and premiums for Medicare parts B and D, and even a portion of long-term-care insurance premiums.

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Where reverse mortgages are concerned, low interest rates are beneficial: The lower the interest rate, the more you can borrow.

adjusted for inflation, so the buying power of your monthly checks will erode over time. A lump sum, however, can be invested, providing the potential for growth that will keep pace with rising costs. And the market downturn offers the opportunity to buy stocks and stock funds at lower prices than you would have paid a few months ago, Staton says.

Another factor to take into account: interest rates. Lump-sum payouts are calculated based on the present value of guaranteed monthly payments, using mortality tables and interest rates published by the IRS and updated monthly. Basically, the lower the published rates, the higher the lump-sum payout. Interest rates are still low but moving higher, so if you're leaning toward taking a lump sum and have an offer on the table, this may be as good as it gets.

A final factor to take into consideration is the financial health of your employer. Are you confident that your company will be around for the next 30 years (or more)? Your employer is required by law to honor your pension contract, and the federal Pension Guaranty Benefit Corp. provides a backstop if your company is no longer able to fulfill that obligation. But if your employer files for bankruptcy and the PBGC takes over the plan, you may not receive 100% of the pension you were originally promised.

There are still, of course, strong arguments in favor of taking guaranteed monthly payments, particularly if you're confident your employer will be around to pay them. If you expect to live a long time, you won't have to worry about running out of money in your later years. If you opt for the joint-and-survivor option, the surviving spouse will also receive lifetime income (although your payments will be lower). And if guaranteed income is important to you, you'll likely receive a bigger monthly payment than you could purchase by investing in an immediate annuity.

Your tolerance for risk matters, too. Many retirees will sleep better at night if they know they'll receive a monthly paycheck, even if it's not adjusted for inflation. And as is the case with immediate annuities, which we discuss below, having a source of guaranteed income to cover your regular expenses could allow you to take more risks with funds you've saved in IRAs or other non-pension sources.

DON'T RULE OUT ANNUITIZING A PORTION OF YOUR NEST EGG

By allowing you to convert a chunk of your savings into a guaranteed monthly check, immediate annuities are a DIY pension for retirees who may not receive one from their employer. But annuities also suffer from the same disadvantages as traditional pension payouts in an inflationary cycle. Unless you buy an inflation rider, which could reduce your initial payouts by up to 28%, your payments won't keep pace with the rising cost of living.

Advocates of annuitizing a portion of your nest egg say that doesn't mean you should dismiss this financial option. If you invest enough in a single-premium immediate annuity to cover most of your nondiscretionary expenses, you can reduce withdrawals from the rest of your portfolio during market downturns, thus lowering sequence-of-returns risk, Pfau says. Plus, with your expenses covered, you can invest the rest of your portfolio more aggressively—which means those funds stand a better chance of staying ahead of inflation, he says.

Rising interest rates will make immediate annuities more attractive. Payouts are typically tied to rates for 10-year Treasuries, which currently range from around 3.8% to 4%—up from 1.6% earlier this year. With that in mind, you may want to postpone buying an annuity until Treasury rates are higher. Or, if you need income now, consider an annuity ladder. With this strategy, you spread out the amount you want to invest over several years.

Indexed annuities offer the potential to earn higher returns than you'll get from most fixed-income investments and can be converted to a guaranteed stream of income later in retirement. Buffered annuities, also known as registered index-linked annuities, or RILAs, are tied to a stock market index, but they have a floor, or buffer, that limits how much you can lose. For example, if the annuity has a buffer of 10% and the index it's linked to falls 4%, you'll lose nothing. If the index falls 30%, though, you'll lose 20%. Another option is to invest in a deferred-in-

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come annuity, which provides guaranteed payments when you reach a certain age.

REDUCE EXPENSES

When it comes to things you can control to protect your savings from inflation, reducing spending is at the top of the list. "That doesn't mean you have to change your lifestyle—just be a little more strategic," Hopkins says. Paying attention to discretionary expenses is particularly important during the early years of retirement, when studies show that many retirees spend more than they do in their seventies and eighties. While that's understandable—you're still in good health and ready to have some fun—that's also the period the sequence-of-returns risk is greatest. If you're willing to be flexible about withdrawals during the early years of retirement, Hopkins says, you can always boost them later.

LOWER YOUR TAXES (LEGALLY)

While reducing the amount of money you must hand over to the IRS is always important, it's even more critical when inflation and a market downturn are shrinking the size of your portfolio.

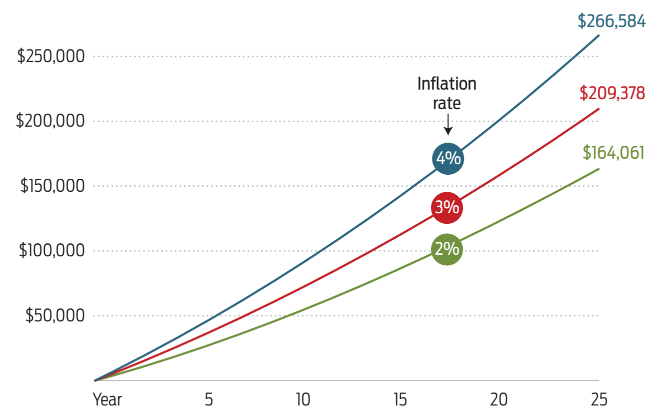
If you've saved diligently over the years, there's a good chance you've stashed a lot of money in tax-deferred accounts—primarily IRAs and 401(k) plans. On April 1 of the year after you turn 72, you generally must start taking required minimum distributions from those accounts. You'll pay taxes on those withdrawals, and if they're sufficiently large, the income could push you into a higher tax bracket.

That isn't the case with Roth IRAs: Withdrawals are tax-free as long as you're 59½ or older and have owned the account for at least five years, and you're not required to take RMDs. And in this instance, the bear market could be your friend.

When you convert a traditional IRA to a Roth, you must pay taxes on all deductible contributions at your ordinary income tax rate. The tax bill is based on the value of your IRA at the time you convert. Suppose, for example, that your IRA was valued at $300,000 in January and is now worth $250,000. If you convert before your portfolio rebounds, you'll pay taxes on the lower amount.

How Inflation Hits Savings

Even low rates of inflation will increase your retirement expenses over time. If you start retirement by withdrawing $100,000 a year, here's what your lifestyle will cost after 25 years at three different rates of inflation.



SOURCE: Fidelity

You don't have to convert your entire IRA (or IRAs) at once, and if your account is large, you probably shouldn't. You'll have to pay taxes on the conversion for the year you convert, which could push you into a higher tax bracket and trigger other unpleasant consequences, such as the high-income surcharge on Medicare Part B premiums. Consider converting a specific amount every year, ideally just enough to remain within your tax bracket. Make sure you have enough money in your cash bucket to pay the tax bill next year.

Depending on how much you've saved in IRAs, 401(k)s and other tax-deferred accounts, you may not be able to afford to convert the entire amount to a Roth. A tax-smart strategy to deal with the remaining funds in tax-deferred accounts is to take calculated annual withdrawals before RMDs kick in, even if you don't need the money, says Rob Williams, managing director of financial planning, retirement income and wealth management at Charles Schwab. Otherwise, you could find yourself forced to take a very large, taxable withdrawal at age 72. As is the case with Roth conversions, ideally you'll want to keep those withdrawals small enough that you're not bumped into a higher tax bracket.