Financial Planning **Update**

# Five Keys to Managing Cash

## Today and Through Retirement

Most investors share three goals: build wealth, maintain a steady income (particularly during retirement), and ensure their assets last a lifetime. Creating and maintaining this type of durable family lifestyle requires advance planning as well as follow-up. Following are five keys to effectively managing your portfolio.

### 1 Differentiate Basic Needs From Enhanced Lifestyle Goals

While many affluent individuals have their basic needs met, it's important to understand the difference between basic versus enhanced needs. Your basic needs include your essential costs, such as food, mortgage, real estate tax, auto payments, and other important expenses. These are expenses that would detract from your quality of life if you had to skimp on them. Your enhanced lifestyle goals (i.e. your wants) include everything beyond the basics—they are what you want in life, assuming everything goes well for you financially. What do you want to do with each additional dollar? Buy a vacation property that the entire family can enjoy or make a gift to a charity. The options are almost endless but should fulfill what you want to see happen and when.

Consider the economic "law of diminishing marginal utility." The first expense dollar spent is a need, while the last dollar is a want. The wants have less value than the needs. We want you to have enough money throughout retirement to cover both.

Some investors face a competing dynamic: They want to avoid spending money too soon, but also want to enjoy life while they have good health. How do you find the best balance? It starts by understanding your cash flows and building in a mechanism to cover your basic lifestyle needs with fixed sources of income, such as Social Security, pension or annuities. Some investors choose to cover more than 50% of their basic needs in this way. The most successful investors will cover an even greater percentage. This provides an important floor of support.

### 2 Remain Flexible With Your Annual Withdrawals

Once you are in retirement, the challenge becomes maintaining your lifestyle while extending your assets. Many investors are familiar with the 4% rule, which proposes you withdraw 4% of your assets each year in retirement. While the 4% rule is a good place to start, it is not necessarily a place to stay. Some financial planners use a more aggressive 5% benchmark or a more conservative 3%. While such rules can provide a good base in your first year of retirement, your ongoing withdrawals should reflect a number of variables, including:

- The rate of inflation
- Changes in your expenses
- Gains or losses in your portfolio

Strictly speaking, if you start with $1,000,000 cash and take out 10% of the outstanding balance annually, you would not run out of money in 10 years. In fact, after 30 years you would still have approximately $42,000 left. The problem is that by year 30, your 10% distribution amounts to only $4,200. Clearly, this is an unrealistic way to meet your needs over time.

The first expense dollar spent is a need, while the last dollar is a want.



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The system of required minimum distributions (RMDs) offers a more dynamic approach. In the first year, at age 70½, Traditional IRA holders must withdraw a factor of 27.4, or 3.65% of their retirement account assets. (Note that a different factor would apply if the Traditional IRA holder spouse is the sole beneficiary and is more than 10 years younger than him or her.) With each successive year, the minimum percentage increases. At the same time, the value of the account decreases with each year's withdrawal. While the formula is designed to make the distributions last, the withdrawal amount will change over time.

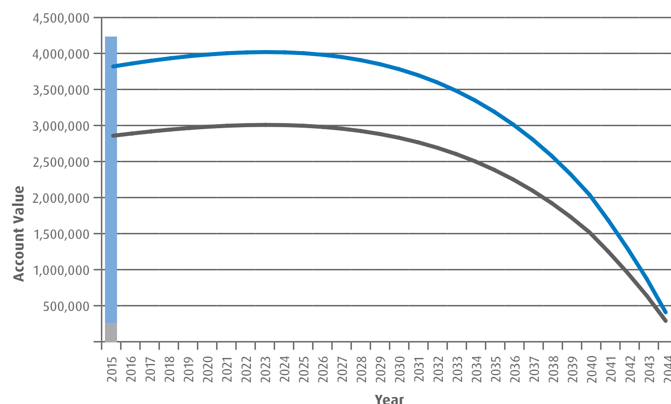
Successful foundations have adopted a different approach known as "max-spend." They limit their fixed expenses and donations (similar to your "basic lifestyle") to 50–60% of their overall 5% annual distribution. In other words, they set a maximum spending limit and always maintain a sizeable variable component to their annual gifts. This gives them ongoing flexibility.

Translating that into an approach for individual investors goes back to our previous point. Match basic lifestyle needs as closely as possible with a fixed, reliable source of income. This creates a two-tiered system where you can use variable sources of income to pay for variable expenses.

> Importantly, if you effectively track your portfolio, you can avoid making frequent revisions.

## 3 Know and Manage Your Glide Path

FIGURE 1. CAPITAL GROWTH (AGE 95)




In Figure 1, the bottom line represents the basic lifestyle, while the top line conveys the enhanced lifestyle. The shape of the curve is based on Monte Carlo confidence intervals (a statistical based technique that uses variable annual returns instead of a constant annual rate of return). It provides a glide path to help you measure your current resources along with the present value of any future income (see the stacked bar in 2015 on the left).

This approach enables you to separate the assets needed to support your basic lifestyle from the additional assets required to support your enhanced lifestyle. Surplus amounts (those above your enhanced lifestyle curve) can be held to protect against market movements, or used for extra spending or gifting.

Importantly, if you effectively track your portfolio, you can avoid making frequent revisions. You can also circumvent the need for a major overhaul, as you'll make modest adjustments as needed.

Tracking your portfolio does not mean running a new "max-spend" calculation every time the market moves more than 2-3%. Tracking should provide you with information that enables you to make decisions, without getting lost in endless "what-if" scenarios.

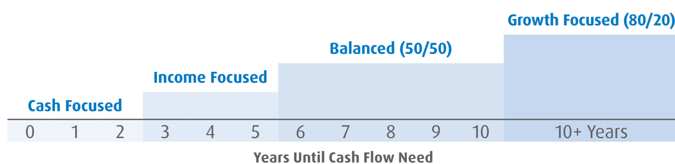
Continued

## 4 Allocate Assets and Manage Risk Based on Your Cash Needs

The way you divide assets among the main asset classes (stocks, bonds and cash equivalents) is based on your tolerance for risk and cash flow timing. If you will need to generate cash from your investments in one year, you would invest differently than if you need cash flow 10 years from now.

For a short-term goal, safety of principal is key, as is the ability to access cash quickly and easily, with no liquidity restrictions. For a long-term goal (10 or more years out), however, the priority becomes growth, rather than cash or income.

**FIGURE 2. INVESTMENT FOCUS OVER TIME**




You can use this in your retirement investment portfolio by building in a cash buffer that you draw upon for several years. In Figure 2, the suggestion is two to three years of cash-focused investments (liquid money market-type or actual cash in a bank account) and two to three years of income-focused investments (bonds and other fixed-income, including some dividend-paying stocks).

For the 5- to 10-year range, a balanced approach of roughly 50% bonds/50% stocks can provide a blend of income and growth. And beyond 10 years, a more growth-oriented allocation of 80% stock/20% bonds will generally support strong long-term returns.

This is just a general guideline. Investors who are more conservative can provide for additional years with assets that are less volatile.

## 5 Proactively Lock in and Harvest Investment Gains

In addition to taking regular withdrawals from your portfolio in retirement, there are other times when it may make sense to sell investments and invest the proceeds elsewhere. For example, if the stock market rose considerably, you have the opportunity to harvest your gains and secure future cash flow needs by reallocating those assets to less volatile investments. This not only builds up your cash reserve for future needs but also provides a cushion for those times when the market may decline.

Consider putting a system in place to do this regularly or automatically. For example, you could determine to take gains in any stock or mutual fund position that rises by 20%. This removes the emotions around the sell decision and makes it a discipline instead. In addition, this approach enables you to harvest when the “fruit” of your investment labor is ripe, rather than forcing you to sell when you need the cash—and when the investment’s price might be down rather than up.

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## Summary

As you look for ways to maintain your family’s lifestyle and wealth throughout retirement, the keys presented in this paper can help ensure you have cash when you need it. The key is covering your basic needs with fixed sources of income, and remaining flexible about pursuing your enhanced lifestyle goals.

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