

THREE STRATEGIES FOR TAKING DISTRIBUTIONS FROM YOUR INVESTMENT PORTFOLIO TO HELP ENSURE YOUR WEALTH WILL NOT FALL SHORT IN THE LONG RUN

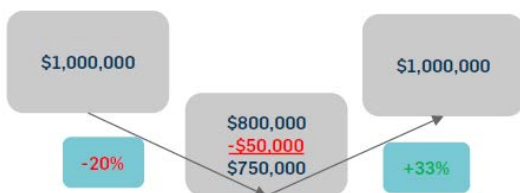
By Chase Conti, CFP®, Senior Investment Analyst

A common, but critical question we have received from our clients who are leaning on their investment portfolio to support their current spending needs is “How much can I withdraw from my investments each year without running out of money or impacting my desired lifestyle in the long run?”

There are numerous guidelines for annual portfolio withdrawal rates, with many in the range of 3% to 4% (guidelines can widely differ depending on your unique goals and financial situation). However, we have found that withdrawal rates tend to fluctuate due to variables one cannot control, such as unforeseen expenses and rising inflation. And during periods of falling markets, making periodic disbursements from your portfolio can be of great concern as such activity may significantly deplete your savings.

In our view, there is no one size fits all approach as it pertains to funding one’s spending needs with their portfolio. For our clients, we monitor their unique spending needs, related tax implications and asset allocation to ensure their savings track remains optimal. The bottom line is, when you are withdrawing funds from your portfolio, the timing and assets you draw from can be acutely impactful to your long-term wealth.

Exhibit 1: If you have a \$1 million investment portfolio and it fell by -20%, then you took a \$50k portfolio distribution, your portfolio would not recover until it gained +33%.



Summarized below are three beneficial strategies to help mitigate the issues related to taking money out of your portfolio during falling markets.

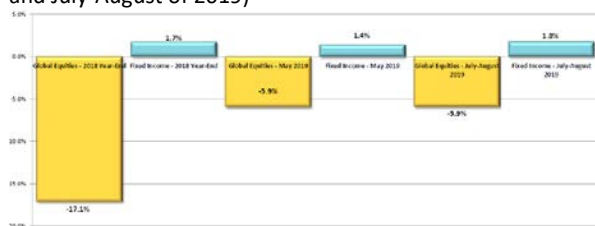
Utilizing a prudent asset allocation mix

For investors approaching their portfolio distribution phase, a change in their asset allocation mix may be warranted (asset allocation describes how much one invests in major market classes). Equities tend to be more volatile relative to steadier asset classes such as fixed income. Investors nearing or who are currently in retirement typically have a heavier reliance upon their portfolio to support their spending needs and may not have as much time to rebound from market losses.

From our experience reviewing new client portfolios, we have seen a recurring theme of equity concentration risk. Let’s assume you have a \$1 million portfolio and your portfolio is invested 100% in equities. And during a market drawdown of -20%, your portfolio fell in line with the equity markets. Also, as bad luck would have it, the value of your portfolio decreased at the same moment when you needed to make a portfolio disbursement to pay for day-to-day living expenses. It would take roughly 4 years to fully recover those losses if your portfolio gained +7% annually, not accounting for any potential income tax liabilities related to raising the cash from your portfolio. If your portfolio gained +3% annually, it would take roughly 8 years to recover the losses.

For the investor to recover more quickly, additional portfolio risk (usually by increasing equity exposure) must be acceptable. However, especially during retirement, taking on more risk is commonly not prudent as there is less time and less capital, due to portfolio spending, to make a recovery. By including diversified asset class exposures in one’s portfolio, such as fixed income, which was broadly positive during the three most recent global equity drawdowns (as illustrated in Exhibit 2 on the following page), losses can be cushioned, requiring less time and more reasonable investment gains to play catch-up and preserve capital.

Exhibit 2: Global equity (MSCI All Country World Index) and fixed income (Barclays Municipal Bond Index) returns during the three most recent global equity drawdowns (2018 year-end, May of 2019 and July-August of 2019)



Source: Morningstar Direct, MSCI and Barclays

Raising cash tax-efficiently; holding exposures to tax advantaged income and inflation protected, dividend paying asset classes

Taxes are one of the biggest drags on investment returns, so what one’s portfolio earns after taxes is paramount. Regarding Federal income taxes, the maximum short-term capital gains tax rate is 40.8% and the maximum long-term capital gains tax rate is 23.8%, as of this writing. And we are currently in the longest U.S. equity bull market in history, and many investors have equity holdings with substantial built-up gains in their taxable accounts.

When raising cash for spending needs from one’s taxable portfolio, one must understand and factor in the tax bill from portfolio outperformers such as equities or concentrated positions. According to a study conducted by the Aperio Group, the average annual tax drag on portfolio performance over a ten year period is approximately -2.0% and is a material concern for investors who are pulling money out of their portfolio periodically. By reviewing all of one’s taxable entities in concert, determining the appropriate asset location, utilizing available tax loss carryforwards and taking advantage of tax loss selling opportunities could provide for a greater after-tax return.

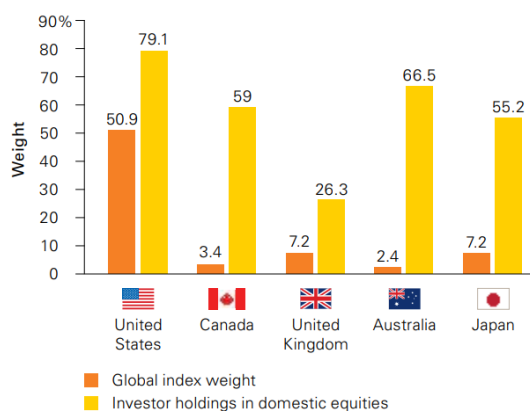
Holding exposures to tax advantaged income investments, such as municipal bonds, can also be beneficial depending on the investor’s Federal income tax bracket. Currently, interest income from most municipal bonds is not subject to Federal income taxes. Also, interest income received from most municipal bonds issued by the state in which the investor resides is exempt from that state’s income taxes. In certain market environments, the after-tax yield on a taxable bond could be less than its municipal counterpart. For investors with

extensive fixed income allocations, the dollar amount difference in after-tax interest income to be used for spending needs can be significant.

Inflation hedging exposures, such as Treasury Inflation Protected Securities (TIPS), can help preserve purchasing power as these assets generally move in lock step with rising prices of goods and services as measured by the Consumer Price Index. Over the past ten years, U.S. inflation has risen by nearly +2% per year. Looking forward, inflation may accelerate for a multitude of reasons. Assuming annual inflation picks up to +2.5% per year (last year’s rate), an investor would need approximately \$2.1 million in 30 years to equal what \$1.0 million is worth today. That is the real-life impact of inflation.

U.S. investors on average tend to own more equities that are U.S.-domiciled relative to the global equity benchmark weighting, which is an investment tendency, and really, a mistake, known as “home country bias”. As shown in Exhibit 3, the average U.S. investor holds nearly 80% of their total equity allocation in U.S. stocks, while the global equity benchmark contains less than 55% in U.S. stocks. For the U.S. investor looking for higher dividend paying equities to help support their portfolio spending needs, a mix between U.S. and international equities more in line with the global equity benchmark may be beneficial, as U.S. large cap equities currently pay out an average dividend yield of 1.8% while developed international equities pay out an average dividend yield of 3.0%.

Exhibit 3: The average U.S. investor is under-allocated in international equities relative to the global equity benchmark (MSCI All Country World Index) and consequently may be missing out on higher dividend paying overseas equities



Source: Vanguard, International Monetary Fund, MSCI

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Funding distributions from less volatile asset classes, such as strategic cash and fixed income positioning

After calculating your ideal portfolio withdrawal rate, establishing a cash or cash equivalent cushion within your portfolio helps to prevent liquidating asset classes that may have recently underperformed in a down market. However, according to a study conducted by Credit.com, only 40% of Americans budget their expenses, meaning that most will not be able to determine their withdrawal rate and may realize too late that they have under-saved. Our multi-disciplinary team employs a comprehensive approach for our clients in reviewing their total financial picture to help determine annual spending trends and the effects of portfolio distributions.

Funding portfolio distributions from volatile, highly appreciation assets, such as equities, can present a tricky situation as equities tend to be either a key leader or detractor by calendar year amongst all asset classes. As shown in Exhibit 4, equity exposures have been key contributors over the past 15 years to portfolio growth for many investors. On the other hand, equities have tended to be either the highest or lowest performing asset class within each calendar year. Employing a diversified mix of asset classes provides smoother portfolio returns and the opportunity to fund cash needs from diversely performing asset classes.

Exhibit 4: Equity exposures tend to provide the highest amount of appreciation over the long-term, however the price of admission is a high degree of ups and downs. Whereas a diversified asset allocation mix with strategic cash and fixed income positioning provides for a steadier ride and more reliable capital for portfolio spending needs during periods of equity market stress.



Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management

In short, gaining an understanding of your spending needs (it is easy to overlook expenses and we frequently see individuals who underestimate their spending, particularly post-retirement) and establishing an investment portfolio allocation that can more reliably support your lifestyle distributions helps to mitigate the issues related to making disbursements from your investment portfolio during a falling market. One cannot control market fluctuations; however, we have found that employing these beneficial strategies helps to ensure your wealth will not fall short in the long run.



CHASE CONTI, CFP®
Senior Investment Analyst

Chase provides due diligence on investment managers, works with financial advisors to construct investment strategies and integrated asset allocations, and oversees all trading activity. He is a frequent contributor to the Waldron quarterly investment commentary, OnePapers and Wealth Insights articles.

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