

Reavans Newsletter July 2009 Issue

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How Much Can You Withdraw in Retirement?

How much to withdraw annually from your retirement assets is probably one of the most important decisions you'll make when you retire. Several factors need to be considered when calculating your withdrawal rate, including your life expectancy, expected long-term rate of return, expected inflation rate, and how much principal you want remaining at the end of your life. Unfortunately, life expectancies, rates of return, and inflation are difficult to predict over a retirement period that can span decades. Keep these points in mind:

- **Your life expectancy.** While it's easy enough to find out your actuarial life expectancy, life expectancies are only averages. Approximately half the population will live longer than those tables suggest. How long close relatives lived and how healthy you are can help you gauge your life expectancy. Just to be safe, you might want to add five or 10 years to that age. After all, you don't want to run out of money at age 75 or 80, when you might not be able to return to work.
- **Rate of return.** Expected rates of return are often derived from historical rates of return and your current investment allocation. Historical rates of return are averages of returns over a period of time. You might want to be more conservative than that, assuming a rate of return lower than long-term averages. Even if you get the average return correct, the pattern of actual returns can significantly affect your portfolio's balance. For instance, if you experience higher returns in the early years of retirement when your portfolio balance is higher and lower returns in the later years when your portfolio's balance is lower, you'll have a higher ending balance than if the opposite occurred.
- **Expected inflation.** While inflation has been relatively tame recently (2.7% over the past 10 years), it was 4.1% in 2007. Over the past 30 years, inflation has averaged 4.2% (Source: Bureau of Labor Statistics, 2008). Inflation of 4% can have a dramatic impact on your money's purchasing power over a long retirement. For instance, at 4% inflation, \$1 is worth 68¢ after 10 years, 46¢ after 20 years, and 31¢ after 30 years.

So what is a reasonable percentage to withdraw on an annual basis? To be conservative, it is typically recommended that you only withdraw modest amounts from your retirement savings, especially in the early years of your retirement. A common rule of thumb is to withdraw no more than 4% in your first year of retirement, adjusting that amount annually for inflation.

With an asset allocation of 60% stocks and 40% bonds, one study found that over a 30-year period, withdrawing 4% initially and increasing withdrawals by 3% annually would result in an 87% probability of ending that period with assets remaining. A 5% withdrawal rate would reduce the probability to 63%, with the probability going down to 38% with 6% withdrawals and 19% with 7% withdrawals (Source: *AAll Journal*, August 2008).

Consider these tips when deciding how much to withdraw:

- **Use a modest withdrawal percentage to ensure you don't deplete your assets.** While you should go through the process of determining how much to withdraw based on your unique circumstances, be prepared for modest withdrawal percentages. With a \$1,000,000 portfolio, a 4% withdrawal equals \$40,000.
- **Stocks need to remain a significant component of your portfolio after retirement.** While the recent stock declines have been difficult to deal with, especially for recent retirees, stocks should still remain a significant component of your retirement portfolio.
- **Review your calculations every year.** This is especially important during your early retirement years. If you're depleting your assets too rapidly, you can make changes to your portfolio, reduce your expenses, or consider going back to work. As you age, your options tend to become more limited.
- **Work as long as you can.** Supporting yourself for a retirement that could span 25 or 30 years requires huge sums of money. Consider working at least a couple of years longer than originally planned. During those years, you continue to build your retirement assets, and you delay making withdrawals from those assets. Once you retire, consider working at least part-time to reduce your withdrawals from your retirement assets. Even modest earnings can help tremendously. For instance, if you earn \$20,000 annually, that is the equivalent of a 4% withdrawal from a \$500,000 portfolio.



Inflation, Disinflation, and Deflation

It's been a long time since the words "deflation" and "the U.S. economy" have been used in the same sentence. But with the sharp decline in the prices of stocks, real estate, and commodities over the last year, we're hearing those words in the same sentence increasingly often.

For many baby boomers, "deflation" and "the U.S. economy" conjures up images of the Great Depression, through which their parents and grandparents lived. Marked by one of the strongest bouts of deflation, unemployment, and economic misery in this country's experience, that decade haunts because so many of us have been led to believe it couldn't happen again, and because so many Americans alive today have never experienced anything but virtually uninterrupted prosperity.

Yet, while deflation is certainly not good for the U.S. economy, it may not bring with it the kind of misery that the doomsayers suggest. A review of these fundamental concepts of changes in prices may help you see and adapt to current developments a little better.

Moderate Inflation: Sign of a Healthy Economy

Simply defined, economic inflation means rising prices for goods and services. It's measured in a number of ways, but the most well known is the Consumer Price Index, or CPI. Compiled by the U.S. Department of Labor's Bureau of Labor Statistics, it measures the change in prices for an average market basket of consumer goods and services purchased by nearly 90% of the U.S. population.

Between 1926 and 2008, the U.S. experienced a healthy and moderate average rate of inflation of 3% a year. Moderate and stable inflation is good, for two reasons. First, moderate inflation is a sign of economic growth - increasing amounts of wealth - which facilitates an expansion of production and higher standards of living. Second, stable rates of inflation enable businesses and consumers to make reliable plans for spending and investment.

One way to see inflation as a positive factor is from the perspective of a homeowner. Many people who buy a new home stretch their budgets to obtain the nicest home they can. But as they earn more money, each year their debt payments eat up a smaller and smaller percentage of their income (if their mortgage features a fixed rate of interest). This gives them more money to spend on other things, which stimulates more economic growth.

The Problem with High Inflation Rates

Much above the "Goldilocks" rate of 2.5% to 3.5% a year, inflation can cause an economy to go off track. For one thing, higher inflation rates are often accompanied by *instability* in the rate of inflation, which disrupts investment and spending both by businesses and consumers. High rates of inflation put a strain on businesses to raise prices to balance their rising expenditures on labor and materials - without causing sales to decline.

As inflation rates increase, bond investors bid interest rates higher, which ultimately causes some borrowers to be turned down for loans. The danger is that, squeezed by higher costs of goods and debt, consumers and businesses cut back on spending - and that can lead to lower production, layoffs, and recession.

Disinflation: Slowing Inflation

Disinflation is, quite simply, the reduction in the rate of inflation. When high inflation undermines economic growth, disinflation moves the needle of price changes lower, eventually to a level where economic growth resumes. In that sense, disinflation is the remedy for inflation that is too high.

Many people confuse disinflation, which is a trend toward lower rates of inflation, with another condition: deflation.

Deflation: Falling Prices That Hurt Everybody

Deflation isn't a cure for inflation. It's the opposite of inflation - falling prices. While everybody likes to see prices come down for some things, it's only good for the economy when it's the result of higher productivity - as manufacturers of computers and color TVs, for example, became more productive, prices for those goods fell.

But deflation is said to occur when the prices of almost everything decline. The cause: people spending less. When businesses make less money, they're often forced to cut wages or lay off workers, which leads to a downward spiral of less spending, more layoffs, higher unemployment, and economic stagnation - or worse.

Returning to the example of the homeowner, it's easy to see the nastiness of deflation. Imagine a homeowner in an environment of deflation. The homeowner still has his job, but his income is reduced. This makes his debt payments relatively more expensive and reduces the amount of money he has to spend on other things. If the deflationary spiral continues over an extended period of time, the homeowner might be unable to continue making his mortgage payments and lose his home.

Deflation reflects a decline in the sum total of money chasing goods. Once an economy is caught in a deflationary spiral, it's very difficult to overcome. Central banks try to stimulate borrowing and spending by reducing interest rates, but when rates reach 0%, there's no more room left for monetary policy to stimulate growth.

Deflation Doesn't Necessarily Mean Depression

If these conditions sound familiar, they should. To date, we haven't descended into deflation - yet - but the U.S. Consumer Price Index recorded its lowest rate in 54 years in 2008. At 0.1%, inflation was tamer than at any time since 1955 (Source: National Bureau of Economic Research, 2009). The U.S. economy last experienced deflation in the 1930s, when six out of 10 years were characterized by deflation.

As we learned during Japan's deflationary "lost decade" of the 1990s, deflation isn't always accompanied by an economic depression. During that period, Japan's economy grew in every year except two, but its average growth rate was a meager 1.5% a year, compared to 9% a year from 1956 to 1973, and 4% a year in the 1980s.

Whether the U.S. is teetering on the brink of deflation, or has merely come to the end of a period of disinflation, matters less than what conditions are doing to the emotions of investors. Stressful times often lead investors to make the wrong decisions. Knowledge and perspective are keys to making wise decisions.



Reevaluate Your Life Insurance at Retirement

As retirement age approaches, it's usually a good time to reassess your life insurance policies to see if your needs have changed. With your children on their own and no earned income to replace, you may no longer need a large life insurance policy. Especially if your insurance premiums are high, you may be tempted to cancel the policy, take the cash surrender value, and enjoy retirement. Before doing that, however, make sure there aren't other uses for your life insurance policy, such as:

- **To leave a legacy to heirs** - Even if the money isn't needed for your children's support after your death, many people like the thought of leaving a large inheritance to their children or grandchildren. With an insurance policy in place, you can feel free to spend your retirement assets, knowing the insurance policy proceeds will be paid to your beneficiaries after your death. If you have a large estate, the policy proceeds can be used to help pay estate taxes.
- **To pay your grandchildren's college expenses** - With the rapidly increasing costs of college making it more and more difficult for parents to cover this cost, you might want to use an insurance policy as a college fund for your grandchildren. If you're still alive when they start college, you might be able to borrow some of the cash surrender value to pay these costs.
- **To support adult children** - There are a variety of reasons why you might want to provide financial help to an adult child. Perhaps your child is a doctor, but has significant debt from college. Or your child might work at a job that doesn't pay a significant amount of money.
- **To provide a large charitable contribution** - A life insurance policy can serve a couple of purposes when making a large charitable contribution. You can name the charity as the beneficiary of the policy. Or you can leave other assets to the charity that would have been included in your estate and possibly subject to estate taxes. The proceeds of the life insurance policy, if properly structured, can then be paid to your heirs estate- and income-tax free.
- **To help deal with long-term-care costs** - Many individuals don't purchase long-term-care insurance believing their spouse will take care of them. However, when one spouse dies, there may not be anyone to take care of the surviving spouse. The proceeds of a life insurance policy can be used to provide long-term care for the surviving spouse.
- **To optimize pension benefits** - When retiring, irrevocable decisions about pension-plan benefit payments must typically be made. An individual life income option will pay higher benefits than a joint and survivor benefit, but then your spouse will not have pension benefits if you predecease him/her. You could use the proceeds from a life insurance policy as a source of income for your spouse after your death.

While it is generally believed that life insurance needs decrease after retirement, there are a variety of reasons why you might want to retain your life insurance policy.



Buying When Prices Are Low

For some investors, a long or steep decline in the price of a stock is a signal to beware. For others, it's a temptation to pick up a bargain at a steep discount and make a handsome profit when the stock rebounds. In practice, it takes a lot of savvy to accomplish. Here are a few tips that help you know when and when not to buy.

Pay attention to the market trend

Most stocks follow the market trend. When you're investing in a stock that's become exceedingly unpopular, it stands to reason that you've got a better shot of making money when the trend is up than when it's flat or down.

Know the reasons for the stock's decline

You may think you know a company because it has a big name and has been around for a long time, but that alone is hardly insurance against its near-term demise. Before you snap up any shares, you need to do your homework and find out why the stock has declined. Is it just bad press over a minor mistake, or is the company's whole business model no longer valid?

Look at the fundamentals

If you're putting your hard-earned money into a troubled enterprise, you owe it to yourself to examine some of the key ratios that indicate the company's underlying strength. These include revenue and profit trends, return on equity, debt-to-equity ratios, and dividend payout ratio.

Check out the stock's PEG ratio

One of the most well-known barometers of the value of a stock is its price to earnings, or P/E ratio. This compares the price of the stock to the company's per-share earnings. An even better indicator of the value is a stock's PEG, or price to earnings growth, rate. The PEG incorporates analysts' estimate of the company's future prospects to its current stock price. A PEG ratio below one means the stock may be underpriced compared to how well it will perform going forward.

Look at the stock's technical indicators

Technical analysts examine a stock's chart of price movements and changes in volume of trading over time to try to estimate which way the stock price will move in the future. While not infallible, some key technical indicators can help you gauge whether the time is right to buy a given stock.

If all of these considerations sound complicated, that's probably a good thing if it makes you hesitate. If you're not dissuaded by the relative complexity, consider three more tips:

- Don't invest too much.
- Set an intended investment amount and stick to it.
- Seek the help of an investment professional.



The Fundamental Investing Principle

The whole point of an investment program is to accumulate sufficient funds to meet your financial goals. So what is the most fundamental investment principle - selecting the proper investments, accumulating the correct combination of assets, timing the market to avoid corrections? Actually, the principle may not even sound like an investment principle at all. To help ensure you meet your financial goals, you must save significant sums of money on a consistent basis. That one habit will do more to help you reach your financial goals than anything else. The sooner you start this habit, the less you need to save. Consider the following example.

Fresh out of college and 25 years old, you decide you'll need \$1,000,000 when you retire at age 65. You can save on a tax-deferred basis through your employer's 401(k) plan and expect to earn 8% compounded annually. If you start at age 25, you'll need to invest \$3,860 a year for 40 years to reach your goal. However, you decide to wait 10 years. At age 35, you now need to invest \$8,827 per year for 30 years. Still seems like too much? Consider that at age 45, you need to invest \$21,852 annually. The really bad news is that someone waiting until age 55 will need to invest \$69,029 annually to reach that goal. By postponing investing, you lose time, and with it, the ability for compounding returns on your contributions to perform much of the work of attaining your goals.*

Let time work for you instead of against you.

* This example is for illustrative purposes only and is not intended to project the performance of a specific investment. It does not consider the payment of income taxes. Keep in mind that a plan of regular investing does not assure a profit or protect against loss in declining markets.

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