Retirement Planning Software, Inc

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Strategies for Liquidating Assets at Retirement

Financial companies and their representatives increasingly deal with retired clients who need to spend down some of their assets to make ends meet. Once it is determined that it is appropriate to do so,* the next question is: which specific asset(s) should be liquidated?

We'll look at four different strategies for answering this question, and explain why one of them appears to be more useful than the others.

Strategy #1: The Rule of Thumb

Probably the most popular strategy is the simplest one: liquidate non-qualified assets first, then qualified plan assets. In the simplest possible case, where a retiree's main assets are a 401(k), IRA or other tax-sheltered account, coupled with a similar basket of mutual funds that are not tax-advantaged, this rule of thumb works fine.

There are two main problems with it, though:

1. It is not specific enough: if the non-qualified portfolio includes a variety of assets (stocks, corporate bonds, municipal bonds, mutual funds, bank accounts, rental property, collectibles, residential real estate, etc.), the rule of thumb does not tell you which ones to liquidate first.

2. The advice is not always right. If a retiree's main concern is preserving assets for heirs, the step-up in basis on many non-qualified assets could more than offset the tax-deferral on qualified assets. There might be early withdrawal charges or penalty fees on certain investments. Specific non-qualified investments might have substantial capital gains taxes due on them, or the market conditions may be adverse. Beneficiary designations on qualified accounts are by necessity very simple, so non-qualified assets that pass through a will may be needed to achieve the right balance to meet estate planning goals. Non-qualified assets tied up in residential property, farms, family businesses, collectibles, or sometimes other investments may have sentimental or other hard to quantify benefits.

Of course this is, after all, just a rule of thumb. Due to its weaknesses, though, many advisers today are looking for a more detailed kind of analysis they can use to advise their retired clients.

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* See our earlier paper, titled "A Needs-Based Approach to Post-Retirement Withdrawals from Savings", available at http://www.stillriverretire.com/Downloads/Needs-based_Withdrawals.pdf.

Strategy #2: Asset Allocation

If the object is to end up with the right mix of assets, then the problem could be viewed as an asset allocation problem. All you need to do, therefore, is run an asset allocation program, applying the resulting percentages to the current asset total minus whatever cash needs to be withdrawn. When the re-allocation is complete, you have your cash and your ideal remaining asset allocation.

As before, though, there are two serious problems:

1. Asset allocation programs are becoming more powerful all the time, but they are mainly limited to allocating assets among different mutual fund options. With some effort they can be extended to individual securities and other financial instruments. But when a family farm, business, or residence is the largest asset (i.e., in most families), and when life insurance, annuities, collectibles and other personal possessions factor heavily, even the most advanced asset allocation tools would be pretty useless.

2. Asset allocation algorithms are not good at taking tax issues into account, especially if they are complex tax issues. For retirees, there are estate planning as well as income tax considerations, and income taxes themselves have both ordinary and capital gains aspects. Doing even an approximate job of evaluating these issues is asking too much from an asset allocation program.

Strategy #3: The Buyer's Approach

A very different approach takes an old investment adage to heart: any asset that you would not choose to buy at this time should probably be unloaded. This wisdom could suggest that a retiree look at his or her portfolio of assets and ask: if all I had was a big pile of cash, which of these assets would I want to acquire today? This question indirectly brings another factor into the equation: market conditions.

When people acquire assets, they usually do so with the idea that those assets will be worth more some day. The granddaddy of investment adages comes to mind here: Buy low, sell high. If the market is low, wouldn't you rather buy into it than sell into it? So if you are forced to sell some asset or other to raise cash, doesn't it make sense to sell the one whose value is nearer to a peak than to a valley?

The two main problems here are:

1. We're really talking about market timing, and as all investment professionals know, this is exceptionally difficult to pull off. It may be possible, by looking at historical trends and doing regression analysis, to identify times when markets have drifted significantly away from their trend lines and are either over-bought or over-sold. If you have a 20-year investment horizon, you may even be able to say with modest confidence that these are relatively good times to sell or buy. But there is no basis for looking at an over-sold market and predicting whether, over any short or moderate period of time, it will become less over-sold or more over-sold; the same for over-bought markets. The consequence is that most market timers lose money. So this does not appear to be a good basis for gauging the relative value of currently held assets.

2. There are important differences between buyers and sellers. Buyers do not have to worry about income taxes on the transaction, but sellers do. This can greatly affect the decision. Estate planning and sentimental issues also rarely affect buying decisions, but often do affect selling decisions.

Strategy #4: Weighted Asset Analysis

The most obvious strategy, though not the easiest, is probably the best: evaluate each asset individually, and get rid of the one that is most expendable.

How do we define "most expendable?" The answer, unfortunately, is not so simple. There are multiple criteria, some quantifiable and some not, and some criteria matter to some people (or apply to some assets) but not to others. This is real life, and an algorithm for identifying the most expendable asset(s) should take all this into account.

Still River's attempt to do this is intended to be a two-stage process. The first stage is automated, and uses quantitative methods to evaluate the quantitative criteria. It produces a listing of assets from most to least expendable. But the second stage must take place in the head of the retiree, preferably with the counsel of a professional advisor: is there some personal or some unusual financial reason why the assets that appear quantitatively to be most expendable really are not?

There is not much to say about this second stage, but we can provide a little more detail about the first, quantitative stage.

We have identified five quantitative criteria by which we evaluate assets:

- Expected after-tax financial performance during the retiree's lifetime
- Expected after-tax financial performance for heirs
- Investment risk
- Liquidity
- Balance of asset ownership between partners

These five items are listed in the order in which, in our completely unsubstantiated opinion, they would matter to the average person. However, we have designed our software to allow people to change this order by weighting each criterion separately. In practice, this makes a huge difference. If a family decides that avoidance of investment risk is their biggest concern, the final results (not all that surprisingly) are often nearly reversed. Allowing each retiree to weight the criteria, therefore, is a vital element in the analysis.

The first two criteria, relating to expected after-tax financial performance, also require special comment because there are many factors behind them. Expected performance takes into account not just the total expected future return on an asset, but also how much of that return is in cash, whether and how the cash income is taxed, how much of the capital gain portion (if any) is likely to be realized and taxable each year, whether the sale of the asset during the owner's lifetime will generate a taxable event and how great that tax will be, and whether the asset would pass to one's heirs on a favorable basis. In addition, certain types of assets raise additional special considerations: e.g., qualified plans that are subject to required distributions that are no longer tax sheltered, or life insurance policies that gain greatly in value at death. Our own technique is to project the future after-tax value of each asset taking all these things into account, assuming the asset is sold (a) just before death by the retiree, or (b) just after death by the heirs, and computing an average rate of return against the current value of the asset (assuming death at normal life expectancy).

This technique also has its flaws:

1. In order to evaluate assets as thoroughly as we would like, we would need to gather a great deal of information about each – probably more than we could reasonably ask for. We have decided, therefore, to ask for a little more than usual, but only for the most important items; beyond that, we make general assumptions.

2. Even though we explicitly allow for personal or special financial considerations to override the quantitative analysis, this method will still sometimes encourage someone to sell assets into an adverse market, or to sell an asset that was intended (because of its risk/return characteristics) to balance other elements of the portfolio.

An Invitation

As always, the next step continues to be just the next step, not the final step. No one has yet conceived of the ultimate and perfect method for evaluating the order in which assets should be liquidated in retirement. But we hope we are advancing the cause through this analysis, and by building a prototype tool that people can use to experiment with the concepts.

We invite you to try out our prototype. You can download a free demo of our Retirement Income – Sources calculator from our website: www.StillRiverRetire.com; select Downloads from the menu at the top of our home page and then the RetirementWorks® download. The PDF file that documents the "Retirement Income Sources" calculator is also available for download from the Downloads page. We are very interested in any comments you might have about the adequacy or inadequacy of this approach, and how you think it might be improved

Still River Retirement Planning Software, Inc. provides both web-based and desktop software offering specialized calculations related to retirement plans and retirement planning.

Contact us at 69 Lancaster County Rd., Harvard, MA 01451
tel: (978) 456-7971 fax: (978) 456-7972 email: csy@StillRiverRetire.com

