A Year-End Portfolio To-Do List for Retirees

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Presentation Overview

Year-End Portfolio To-Do's

- Check withdrawal rate sustainability
- Assess portfolio positioning, troubleshoot problem spots
- Tee up liquid reserves for 2018-2019
- Take required minimum distributions
- Identify opportunities to reduce investment-related tax bill
- Make charitable contributions

Other Financial To-Do's for Retirees

- Re-shop Medicare coverage (Dec. 7 deadline)
- Organize paperwork for 2017 tax return
- Make additional contributions, if eligible

To-Do 1: Check Withdrawal-Rate Sustainability

2 Quick Calculations to Arrive at Your Withdrawal Rate

Calculation 1: Total Spending Minus Income from Non-Portfolio Sources = Withdrawal Amount

Calculation 2: Withdrawal Amount Divided by Jan. 1, 2017, Portfolio Balance = Withdrawal Rate

A Simple Withdrawal Rate Example

- 67-year-old Jean spent $66,000 in 2017
- She received $26,500 from Social Security and another $16,500 from consulting
- Her total portfolio withdrawal (after taxes) was $23,000 ($66,000 minus $43,000 nonportfolio income)
- Her portfolio value as of Jan. 1, 2017 = $760,000
- Her 2017 withdrawal rate: 3.02% (her $23,000 divided by $760,000 balance)

Is Her Withdrawal Rate Sustainable?

- Most financial planners believe a 4% starting withdrawal, with annual adjustments for inflation, is a sustainable withdrawal system for a person with a balanced portfolio
- A sustainable withdrawal rate is one that is likely to ensure a stable standard of living for a retiree until age 90 or 95
- Withdrawals include income and dividend distributions as well as withdrawals of principal

Your Withdrawal Rate System Shouldn't Be Static

- Factor in market conditions
  - Take less in weak markets
  - Take more in strong ones
- Build in flexibility in case of unanticipated expenses
- Pay attention to your time horizon
  - Take less if time horizon is very long
  - Take more if it's shorter (RMD tables)
- Pay attention to your asset allocation
  - More stocks support a higher withdrawal rate (unless stocks are very expensive)
  - More bonds/cash necessitate a lower withdrawal rate

To-Do 2: Check Up on Portfolio Positioning, Troubleshoot Problem Spots

Why Do This at Year End?

- In weak market years, you may be able to take advantage of tax-loss selling
- If taking withdrawals and/or are subject to required minimum distributions, you can sell from portfolio's overweight/problem areas

To-Do 2: Check Up on Portfolio Positioning, Troubleshoot Problem Spots

Assess Portfolio Asset Allocation, Intra-Asset-Class Allocations

- Morningstar's X-Ray tool a good starting point
- Portfolio Manager enables you to X-Ray, as does Instant X-Ray (on Tools tab of Morningstar.com)

Portfolio Tools

Portfolio Manager
Enter a portfolio and see why Barron's ranks our Portfolio Manager the best on the Web. Track and analyze your portfolio, using unique Morningstar features such as Portfolio X-Ray®, Interpreter, and Stock Intersection.

Portfolio Monitor
Get a clear view on your investments with personalized portfolio reports, including your performance, top contributors and detractors, and a breakdown of your current asset, sector, region, and investment style allocations.

Asset Allocator
Determine which combination of asset classes (cash, stocks, bonds) will give you the best chance of meeting your investment goals without taking on undue risk.

Portfolio Allocator
Create a portfolio of stocks or funds that has the asset mix (and other key portfolio attributes) that you desire. Alternatively, rebalance the holdings in an existing portfolio.

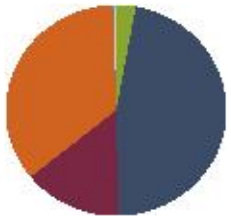
Instant X-Ray®
Understand your portfolio's basic characteristics at a glance, including its asset allocation, exposure to different investment styles, and other important factors.

To-Do 2: Check Up on Portfolio Positioning, Troubleshoot Problem Spots

Tracking | My View | My Performance–beta | X-Ray® | Set This View as Default View

X-Ray Overview | X-Ray Details | X-Ray Interpreter | Stock Intersection | Print

Asset Allocation | Holdings Detail ▸▸



	Long%	Short%	Net%
Cash	3	0	3
U.S. Stocks	47	0	47
Foreign Stocks	14	0	14
Bonds	35	0	35
Other	0	0	0
Not Classified	0	0	0
Total	**100**	**0**	**100**

Stock Style Diversification | Holdings Detail ▸▸

Valuation

Size	Value	Core	Growth
Large	26	24	21
Med	6	6	7
Small	3	3	4

Not Classified 0.00%

Interest Rate Sensitivity

Credit Quality	Ltd	Mod	Ext
High	21	49	0
Med	17	0	7
Low	0	4	0

Not Classified 0.00%

Stock Sector | Holdings Detail ▸▸

	Portfolio (% of Stocks)	S&P 500 (%)
Cyclical	**35.40**	**29.94**
Basic Materials	4.81	3.31
Consumer Cyclical	11.33	10.15
Financial Services	16.69	14.40
Real Estate	2.57	2.08

Stock Type | Holdings Detail ▸▸

	Portfolio (% of Domestic Stocks)	S&P 500 (%)
High Yield	**5.47**	6.41
Distressed	**0.83**	0.42
Hard Asset	**11.54**	12.33
Cyclical	**44.87**	41.99
Slow Growth	**10.87**	11.99

Start by Focusing on Asset Allocation

- Portfolios are getting more aggressive, even if investors aren't boosting their stock positions
- 60% stock/40% bond portfolio in March 2009 would be 83% stock/17% bond today
- New retirees need to be particularly attuned to avoiding "sequence of return risk"—encountering bum market early in retirement, necessitating withdrawals from a declining portfolio
- Lowering withdrawal rates can help, as can having sufficient liquid reserves.

How to Assess If Asset Allocation Is on Track?

- Some good starting points for assessing asset allocation
  - Morningstar Lifetime Allocation Indexes
  - Target-date funds can be a starting point if you don't have targets)
- The bucket approach provides another framework for setting an in-retirement asset allocation
  - 1 to 2 years' worth of living expenses in cash
  - ~8 years' worth of living expenses in high-quality bonds
  - Money above and beyond those amounts in stocks
- Sample allocation for someone spending $40,000/year from $1 million portfolio
  - Cash: $80,000 (2 years)
  - Bonds: $320,000 (8 years)
  - Stocks, etc.: $600,000 (everything else)

What to Do If You're Heavy on Stocks

- Take withdrawals from overweight and problematic equity positions
- Make sure cash positions are "topped up" and can carry you through the next few years
- Rebalance into bonds, but limit interest-rate sensitivity and keep credit quality high
- Invest with flexible core fixed-income funds
- If retirement is close at hand and you're notably underweight bonds, de-risk immediately
  - Move bond money to cash
  - Dollar-cost average during a period of months
- If selling stocks, mind the tax consequences!
  - Focus selling in tax-sheltered accounts
  - Use RMDs to help correct imbalances (prune stocks)

Some of Morningstar Analysts' Favorite Core Bond Funds

Gold- and Silver-Rated Short-Term Bond Funds (time horizon of 3-5 years)

- Fidelity Short-Term Bond FSHBX
- Vanguard Short-Term Inflation-Protected Securities VTIPX or VTIP

Gold and Silver-Rated Intermediate-Term Bond Funds (time horizon of 5-8 years)

- Baird Aggregate Bond BAGIX
- Dodge & Cox Income DODIX
- Fidelity Total Bond FTBFX
- iShares Core Total USD Bond Market IUSB
- Harbor Bond HABDX
- Metropolitan West Total Return Bond MWTRX
- PIMCO Total Return PTTRX
- Vanguard Inflation-Protected Securities
- Vanguard Short-Term Bond Index VBISX
- Vanguard Total Bond Market Index VBMFX

What to Do If You're Light on Stocks?

- Stay mindful of current valuations: Average price/fair value for Morningstar's covered stocks = 1.04
- Employ a dollar-cost averaging strategy, deploying fixed amounts at regular intervals
- Alternatively, wait for downturn to bump up equity position (deploy ¼ of assets when S&P 500 drops 5%, another ¼ when S&P drops another 5%, etc.)
- Make sure you have a good value-oriented manager in your portfolio
- Look to Morningstar's highly rated stocks for ideas
- Hold a bit of extra cash to meet opportunities as they arise
- Tilt toward quality and value, which have underperformed during current rally

Some of Morningstar Analysts' Favorite Quality-Conscious, Value-Leaning Funds (Gold- Or Silver-Rated)

- Dodge & Cox Stock DODGX
- American Funds American Mutual AMRMX
- American Funds Washington Mutual AWSHX
- AMG Yacktman YACKX
- Oakmark OAKMX, Oakmark Select OAKLX
- Vanguard Dividend Appreciation VDAIX or VIG
- Vanguard Equity-Income VEIPX
- Vanguard Value Index VIVAX
- Vanguard Value ETF VTV

Highest-Rated High-Quality Stocks (4- or 5-star, wide moat, low fair-value uncertainty rating); 10 as of 11/26/17

- Colgate-Palmolive CL
- Dominion Energy D
- Enterprise Products Partners EPD
- Imperial Brands IMBBY
- Merck MRK
- Procter & Gamble PG
- Reckitt-Benckiser RBGLY
- Roche Holding RHBBY
- Spectra Energy SEP
- Unilever PLC UL

To-Do 3: Tee Up Liquid Reserves for 2018-2019

Why You Need Liquidity in Retirement

- To meet living expenses in case income distributions are insufficient and/or it's not a good time to sell anything
- To engage in opportunistic bargain-hunting if stocks or bonds decline

How Much Liquidity Is Enough?

- 6 months' to 2 years' worth of living expenses

Where to Go to Free Up Cash

- Have income and dividend distributions deposited into cash bucket
- Sell appreciated equity holdings
- Steer required minimum distributions into cash bucket

To-Do 4: Take Required Minimum Distributions

RMD Basics

- Must begin to take RMDs by April 1 of the year following the year in which you turn 70 1/2
- Must then take them by Dec. 31 of each year thereafter
- 50% penalty (plus ordinary income taxes!) on missed RMDs (amount you should have taken but didn't)
- RMDs are calculated based on average life expectancies; increase as you age
- RMDs apply to traditional IRAs, 401(k)s, 403(b)s, 457 plans, SEP, and SIMPLE IRAs
- Roth IRAs aren't subject to RMDs; Roth 401(k)s are
- RMDs taxable as ordinary income
- Must calculate RMD for each PLAN separately
- But if you have multiple IRAs, can take RMD from a single account or holding

How to Use RMDs to Improve Your Portfolio

- Conduct portfolio review/identify areas to trim
- Prune RMDs from highly appreciated/problem spots
- In 2017, good candidates for trimming include:
  - Mid- and large-cap growth holdings
  - Technology holdings
  - Emerging markets stocks and bonds
- Can also use RMDs to refill cash bucket, make charitable gifts

What to Do With RMDs You Don't Need to Spend?

You Have to Take Your RMDs, But You Don't Have to Spend Them

- Keep an eye on your RMDs relative to your withdrawal rate
  - At age 70 1/2, RMD = 3.6%
  - At age 85, RMD = 6.75%
- If you don't need your RMDs to live on, consider the following:
  - Direct them to charity via qualified charitable distribution (QCD)
  - Invest in a Roth IRA (you or your spouse must have enough earned income to cover contribution amount)
  - Invest in a taxable account

To-Do 5: Identify Opportunities to Reduce Investment Tax Bill

- Watch out for mutual fund capital gains distributions (but don't worry about them if you own a fund in your retirement account or IRA)
- Scout around for tax-loss candidates (but don't expect to find many)
- Defer capital gains realization if possible (let market do rebalancing in taxable accounts)
- Consider tax-gain harvesting if in the 10% or 15% tax bracket
- If in temporarily low tax bracket, consider the following:
    - Tax-gain harvesting
    - Roth IRA conversions
    - Expedited IRA distributions

2017: Another Bad Year for Mutual Fund Capital Gains Distributions

Should we expect them?

- If recent history is any guide, yes
- Flows from active funds into ETFs have exacerbated capital gains distributions

From where?

- Actively managed equity funds, especially those that have experienced poor performance/redemptions
- Large-growth funds

How Does Tax-Gain Harvesting Work?

- Investors in the 10% and 15% tax brackets currently pay a 0% rate on long-term capital gains
    - $37,950 for individuals
    - $75,950 for married couples filing jointly
- Pre-emptively selling resets the cost basis to today's higher levels
- If taxpayer's rate goes higher in the future, then less taxes owed upon sale
- Check with an accountant before pursuing this strategy

To-Do 6: Make Charitable Contributions

Basic	• Write checks to charity
Advanced	• Give appreciated shares
Super-Charged	• Give appreciated stock to donor-advised fund

Another Tool in the Kit: Qualified Charitable Distributions (QCDs)

- If you're post age 70 1/2 and are subject to RMDs, can direct up to $100,000 of RMD to charity/charities of your choice
- Only IRAs can be used for QCD—not 401(k)s, SEP, or SIMPLE IRAs
- Strategy is usually more advantageous than taking RMD, writing a check to charity, and deducting the contribution
- Reduces adjusted gross income, enabling you to qualify for credits and deductions
- Ask financial provider to work with charity to conduct transaction

Also Consider: Reshop Medicare Coverage

Medicare Open Enrollment Runs Until Dec. 7

- This is your chance to select a different Medicare Part D (prescription drug) plan
- Can also re-shop Medicare Advantage plans
- 73% of current Part D enrollees will see a premium increase in 2018 if they do nothing
  - Of those, about 1/3 will see premium increases of more than $10/month
- Review Annual Notice of Change, detailing any changes in your plan for the year ahead
- Plug in your own data (Medicare number, any drugs that you take) on Plan Finder on Medicare.gov website
- Focus on total projected costs as well as premiums
- Stay alert to premium surcharges for higher-income people (2016 MAGI above $85,000 for singles or $170,000 for joint filers)
- Enroll in plans by calling Medicare (1-800-Medicare) rather than going through provider website

Also Consider: Organize Paperwork for 2017 Tax Return

- Collect receipts and paperwork for deductible items
  - Healthcare receipts (deductibility threshold increases to 10% for all)
  - Charitable contributions
- Establish a central location for 2017 investment-related tax info (get ready for 1099 avalanche)
- If paying quarterly estimated taxes, final deadline for 2017 tax year is Jan. 16, 2018
- While you're at it, tackle other valuable organizational jobs
  - Establish "Master Directory": http://www.morningstar.com/finance/MasterDirectory.aspx
  - Employ a centralized password minder (LastPass, Dashlane, etc.)
  - Double check beneficiary designations

Also Consider: Make Additional Retirement Contributions

Yes, "Retirees" Can Still Make Retirement Contributions

- Cannot contribute to a traditional IRA if older than 70 1/2
- Can contribute to a Roth IRA past 70 1/2 if you or your spouse has earned income to cover contribution amount
  - Contribution limit for 2017-2018 is $6,500
- Can also make health savings account contributions at any age if not covered by Medicare and are covered by high-deductible health plan
  - Contribution limit for 2017 is $4,400 (singles)/$7,750 (couples) if covered person is over age 55
- Can also contribute to 401(k), 457, 403(b) or SEP-IRA if still employed, regardless of age