PORTFOLIO STRATEGIES WORKSHOP

Establishing a Spending Account to Manage Income During Retirement

By Maria Crawford Scott

Peter and Cynthia Emerson are in their early 60s and are starting to plan for their retirement. They have already settled on an asset allocation that they are going to maintain during retirement. They have determined that they can withdraw roughly $18,000 each year from their savings to supplement their annual pension and Social Security payments.

Their savings, though, are spread over several different accounts and asset classes. Right now, they are trying to figure out how they should obtain their annual income from their savings—should they withdraw an equal amount from each account? From those that are doing well? From those that are doing poorly?

The Spending Account

One efficient approach to this problem is to establish a spending account using a money market fund or a similarly liquid investment. The account is intended to hold roughly one year's spending amount, although it will vary over time as the money is spent down and new money is added to it on a periodic basis.

Distributions from taxable savings should be reinvested in this account. Taxes must be paid on these distributions, so rather than reinvesting them, they can be used as part of your annual spending amount.

For many individuals, taxable distributions will not add up to the annual spending amount. In that instance, the other source of "income" for the spending account is from sales of taxable holdings. This should be done in conjunction with your periodic portfolio rebalancing.

Portfolio rebalancing consists of selling shares from the best-performing portion of your investments, or adding money to the lagging portion, so that your portfolio is brought back to your original target asset allocation and not overweighted or underweighted in a particular asset category. At the same time, you must weigh the need to rebalance against tax considerations—straying a few percentage points from your target asset allocation is preferable to selling shares and incurring taxes.

What if your portfolio isn't out of balance? In this instance, shares should be sold from each asset class such that the target asset allocation is reasonably maintained.

To maintain a target asset allocation, portfolio rebalancing does not need to be frequent—annual rebalancing is sufficient for many individuals. However, to maintain a spending account, the rebalancing frequency depends on how large a cash reserve you prefer, and how much variation you are willing to tolerate.

What's the minimum amount retired individuals keep in cash? A common rule of thumb is that individuals should have cash reserves for emergencies equal to six months' worth of living expenses. This generalization, though, was devised with working individuals in mind. The financial emergency that threatens workers is the loss of income from a layoff or disabling accident or illness. A retiree receiving income from Social Security, pension plans, and personal investments has little to fear from an interruption in income. Of course, portfolio values will fluctuate based on the volatility of the markets, but the proper protection against this risk is a diversified asset allocation plan.

The size of cash reserves for retirees really depends on comfort and convenience. Some retirees may regard a few months' spending amounts sufficient for emergencies; others may be more comfortable with six or 12 months.

The size of the cash reserve also depends on the frequency with which you rebalance. Less frequent rebalancing may be more convenient—and less time-consuming at tax time. But it will cause the spending account to fluctuate more in size and result in a larger portion of

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Table 1.
Annual Spending Accounts and Portfolio Rebalancing

Savings Portfolio Holding	Type of Acct.	Value as of Begin Year ($)	Return (%)	Distributions (to Spending) ($)	Value as of End Year ($)	Target Value ($)	Action Taken	Value after Transactions ($)
S&P 500 Index Fund	Taxable	120,000	31.1	3,000	154,320	137,508	Sell $5,220	149,100
Aggressive Growth Fund	IRA	30,000	29.1	0	38,730	34,377	None	38,730
International Fund	Taxable	30,000	1.2	—	30,360	34,377	None	30,360
Intermediate-Term Bond Fund	Taxable	90,000	15.2	8,100	95,580	103,131	None	95,580
Money Market Fund	Taxable	30,000	5.6	1,680	30,000	34,377	None	30,000
	Total:	**$300,000**		**Total:**	**$348,990**		**Total:**	**$343,770**
	Total less sales to spending account ($5,220):				**$343,770**			

Spending Account	
Starting Amount	$9,000
Distributions from funds	$12,780
Net sales from savings	$5,220
Total:	**$27,000**

Asset Allocation Asset Class	Target (%)	Before Rebalancing* (%)	After Rebalancing (%)
Large-Cap Stocks	40	45	43
Small-Cap Stocks	10	11	11
International Stocks	10	9	9
Bonds	30	28	28
Cash	10	9	9

**Using end-of-year total less assets needed for spending account ($343,770)*

assets in lower-returning investments at certain times.

The Emersons' Spending Account

How would the Emersons establish a spending account?

The Emersons' savings portfolio and asset allocation is shown in Table 1. They have accumulated $300,000 in savings, including $30,000 in an individual retirement account (IRA). Their target asset allocation has 60% of their portfolio committed to stocks, 30% in a bond fund, and 10% in cash.

Distributions from the Emersons' taxable funds are added to their spending account. Distributions from their tax-deferred fund are reinvested in that fund to obtain the benefits of tax deferral; the Emersons do not plan to withdraw assets from their IRA until minimum distributions are required to begin.

The Emersons establish their spending account with a six-month spending amount—$9,000, the minimum they will maintain at all times. They also plan to rebalance only once a year.

At the end of the year, distributions from all of their taxable funds total $12,780. That means they will need to withdraw $5,220 from their savings portfolio to reach their total $18,000 spending amount for the following year. Which funds should they sell?

The strong market has caused their portfolio to teeter off balance, in particular with their large-cap fund, which now accounts for 45% of their total savings portfolio before rebalancing. The other holdings are less off balance, within a percentage or two of their target allocation. For that reason, the Emersons decide that the only rebalancing that needs to be done is from their large-cap holding, and the sale can be used to meet their annual spending need. That still leaves the large-cap holding somewhat overweighted, but the Emersons decide that they would prefer to live with the slight overweighting, rather than to incur taxes on funds that will be reinvested.

Setting Up

Withdrawing funds for their spending account was a relatively easy decision for the Emersons this year. In future years, rebalancing decisions may be more difficult. Here are some thoughts to keep in mind when setting up a spending account:

- First, establish a minimum amount you wish to keep in the account for emergency purposes.
- Next, add all taxable distributions from your savings portfolio. If these distributions do not add up to your annual spending amount, you will need to withdraw assets from your savings portfolio.
- To determine which assets to sell to meet your spending amount, compare your current savings portfolio allocation with your target allocation, and sell the shares of those funds that are overweighted.
- If your portfolio is in balance, sell shares so that you will maintain your target allocation.
- Keep in mind that your target asset allocation is only a generalized target. Substitute convenience and tax considerations until you start straying by five percentage points or more.