Rebalancing Your Portfolio When Making Periodic Withdrawals

By Maria Crawford Scott

Lois and Bill Swenson have enjoyed their first full year of retirement. Now, they have some serious juggling to perform—they need to withdraw their next year's spending amount from their portfolio, and they want to do so in a way that will keep their portfolio balanced according to their desired asset allocation, but that minimizes taxes.

What's the best way to proceed?

Where They Started

First, here's a review of their financial situation (see Table 1). At the beginning of the year, the Swensons had accumulated a total savings portfolio of $450,000. Part of those assets, a little under $300,000, were in tax-deferred IRA accounts, with the remaining $150,000 in taxable savings. The savings are needed to supplement the pension and Social Security annual payments that the Swensons will receive. They plan to withdraw roughly $20,000 a year, an amount that may increase with inflation if they find it necessary, although they do not plan to automatically increase it.

Before retiring, the Swensons had assessed their circumstances and decided on an asset allocation that consists of a 70% commitment to stocks (50% in large-cap stocks, 10% in small-cap stocks, and 10% in international stocks), 20% in intermediate-term bonds, and 10% in cash. The cash portion will be invested in a money market fund to provide liquidity for emergencies and to temper the volatility of the portfolio's value.

Why did they choose such a heavy commitment to stocks, even in retirement?

In fact, the commitment to stocks is not as heavy as it may seem at first glance. That's because the Swensons are receiving pension and Social Security payments; when the present value of these assured cash flows are added to the Swenson's investment portfolio, their fixed-income commitment is actually quite high—almost 50%. The Swensons do not plan on adding the value of their annuity payments each time they rebalance, but they do consider them when determining their overall asset allocation.

The Swensons also had some flexibility in determining how to divide their assets among taxable and tax-deferred accounts when they retired. To get the most benefit out of tax-deferral, they allocated their highest-returning investments—an aggressive growth fund, an international fund, and an S&P 500 index fund—to the tax-deferred portion.

The Swensons already had taxable assets in a large-cap equity-income fund and in individual small-capitalization companies prior to retirement. Other taxable savings include an intermediate-term bond fund, which will assure at least some steady income for their annual spending amount. Lastly, because the cash portion is to provide liquidity, it remains in their taxable account.

Fortunately, both Swensons are still some years away from age 70½, and they therefore do not need to withdraw from their IRAs immediately. For now, they will keep as much as possible within their tax-deferred accounts, and withdraw from their taxable investments. Therefore, capital gain and income distributions from tax-deferred funds are reinvested in those funds, while distributions from their taxable funds will be used as part of their annual spending, and are automatically "swept" into their money market fund.

Where They Stand

The first year of retirement was particularly good for the Swensons, with large gains in the stock market; their position at the end of Year 1 is indicated in Table 1. The Swensons also received distributions from their equity-income fund and their intermediate-term bond fund, which

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Table 1.
Rebalancing After Year 1

Savings Portfolio

Holding	Type of Acct	Value as of Begin Year 1 ($)	Return Year 1 (%)	Distri-butions (to MMF)	Value as of End Year 1 ($)	Action w/o Tax Consider.	Action Taken	Value after Transactions ($)
S&P 500 Index Fund	IRA	180,000	22.9	Reinvested	221,220	None	None	221,220
Equity-Income Fund	Taxable	45,000	19.7	2,409	51,456	sell $22,295	sell $14,000	37,456
Aggressive Growth Fund	IRA	22,500	19.1	0	26,798	None	None	26,798
Small Stock Holdings	Taxable	22,500	16.4	0	26,190	sell $2,912	sell $1,467	24,723
International Fund	IRA	45,000	14.8	Reinvested	51,660	sell $1,584	None	51,660
Intermediate-Term Bond Fund	Taxable	90,000	5.2	5,850	88,830	buy $11,323	None	88,830
Money Market Fund	Taxable	45,000	3.0	Reinvested	54,609	avail to spend: $4,533		70,076
	Total:	$450,000		**Total:**	$520,763	**Total:**		$520,763
				Total Ex Spend Amt:	$500,763	**Total Ex Spend Amt:**		$500,763

Asset Allocation

Asset Class	Starting Allocation (%)	Allocation as % of Total Excluding Spending Amount*	
		End Year 1 (%)	After Transactions (%)
Large-Cap Stocks	50	54.5	51.7
Small-Cap Stocks	10	10.6	10.3
International Stocks	10	10.3	10.3
Bonds	20	17.7	17.7
Cash	10	6.9	10.0

** Value divided by Total Ex Spend Amount. The $20,000 spending amount is also excluded from the money market fund to determine cash portion.*

were automatically distributed to their money market fund. Thus, the values at the end of the year reflect not only the performance of the funds, but also the distribution pattern chosen by the Swensons.

During the first year, the distributions that flowed into the money market fund total $8,259—less than the $20,000 that the Swensons need annually. That means they need to sell some of their taxable assets to make up the difference. On the other hand, the total value of their portfolio has increased; if they are to maintain a 10% commitment to cash, that means they have even less to spend from their distributions.

How do they withdraw assets while remaining both tax-efficient and balanced?

The bottom half of Table 1 indicates the Swenson's starting (desired) allocation, as well as the actual allocation at the end of Year 1. The latter allocation excludes the $20,000 spending amount that will ultimately be withdrawn and "spent" from the total portfolio and the money market fund.

Why exclude the spending amount?

The Swensons are using cash as a cushion to provide liquidity for emergencies; their allocation assumes a relatively steady allocation to cash. At some point, they will have spent their annual amount, and at that time they still want to have a liquidity cushion. Since spending money is withdrawn gradually, the asset allocation would be constantly changing if it were included within the calculation. The more practical approach is to take a snapshot of your portfolio at one point in time and exclude your annual spending amount.

At the end of Year 1, the amount accrued in the money market fund would allow them to spend $4,533 from the money market fund, while retaining the 10% commitment. That means they need to raise another $15,467 ($20,000 – $4,533), and at the same time rebalance their portfolio.

The table indicates that at the end of Year 1, the Swensons are overcommitted to large-cap stocks, and under-committed to bonds and cash. If the Swensons didn't have to worry about tax consequences, they could easily rebal-

Table 2.
Rebalancing After Year 2

Savings Portfolio

Holding	Type of Acct	Value as of Begin Year 2 ($)	Return Year 2 (%)	Distri-butions (to MMF)	Value as of End Year 2 ($)	Action w/o tax consider.	Action Taken	Value after Transactions ($)
S&P 500 Index Fund	IRA	221,220	–9.8	Reinvested	199,540	None	buy $4,409	203,949
Equity-Income Fund	Taxable	37,456	–11.2	1,470	31,791	sell $2,302	sell $6,711	25,080
Aggressive Growth Fund	IRA	26,798	–20.3	0	21,358	buy $4,286	buy $4,286	25,644
Small Stock holdings	Taxable	24,799	–18.7	0	20,162	None		20,162
International Fund	IRA	51,660	5.5	Reinvested	54,501	sell $8,695	sell $8,695	45,806
Intermediate-Term Bond Fund	Taxable	88,830	9.8	5,102	92,433	sell $822	sell $822	91,611
Money Market Fund	Taxable	50,000	3.4	Reinvested	58,272	avail to spend: $12,467		65,805
	Total:	$500,763		**Total:**	$478,057	**Total:**		$478,057
				Total Ex Spend Amt:	$458,057	**Total Ex Spend Amt:**		$458,057

Asset Allocation

Asset Class	Desired Allocation (%)	Starting Allocation (%)	Allocation as % of Total Excluding Spending Amount* End Year 2 (%)	After Transactions (%)
Large-Cap Stocks	50	51.7	50.5	50.0
Small-Cap Stocks	10	10.3	9.1	10.0
International Stocks	10	10.3	11.9	10.0
Bonds	20	17.7	20.2	20.0
Cash	10	10.0	8.4	10.0

** Value divided by Total Ex Spend Amount. The $20,000 spending amount is also excluded from the money market fund to determine cash portion.*

ance by selling $22,295 of their large-cap holdings, $1,584 from their international holdings, and $2,912 from their small stock holdings, and buying $11,323 for their intermediate-term bond fund.

However, the Swensons *do* have to worry about taxes. If they were to add to their intermediate-term bond holdings, they would either have to withdraw assets from their tax-deferred S&P 500 holding, or sell some of their large-cap equity-income fund holding, both of which would incur taxes simply to rebalance.

Instead, they set their primary focus on meeting their spending needs, and rebalancing by selective withdrawals. They decide to reduce their largest overcommitments by selling taxable assets, and so they sell $14,000 from their taxable large-cap holding, and $1,467 from their individual stock holdings, which meets their $15,467 spending need. They decide not to sell any international holdings, because they want the funds to remain tax-deferred, and although they could transfer the funds to their other IRAs, they are already overcommitted to those categories.

One option the Swensons consider is to transfer some IRA assets into a new IRA that is invested in an intermediate-term bond fund. They decide against this, however, because their undercommitment to bonds at this point is only by a few percentage points. Table 1 indicates their asset allocation at the end of Year 1, after they have made the rebalancing transactions.

Another Year

Jumping ahead a year shows the Swensons in another juggling act.

At the beginning of Year 2, they started with an allocation that is slightly off of their desired allocation (see Table 2). Year 2, however, proves to be horrible for stocks, and particularly for their small-cap investments. Despite the loss, the Swenson's equity-income fund makes a distribution, which along with distributions from the bond fund is swept into the money market fund. Not surprisingly, by the end of the year, their largest undercommitment is to small-cap stocks. Despite the stock market drop, they are still slightly overcommitted to large-cap stocks, but not to the extent that they were at the beginning of the year.

At the end of Year 2, the amount accrued in the money market fund would allow them to spend $12,467 ($58,272

– $45,805) while retaining the 10% commitment to cash. That means they need to raise another $7,533 ($20,000 – $12,467) for their annual spending, and at the same time rebalance their portfolio.

How do they rejuggle this time?

If taxes weren't a consideration, they would simply sell $2,302 in large-cap holdings, $8,695 in international holdings and $822 in intermediate-term bond fund holdings, and buy $4,286 in small-cap holdings.

But tax considerations remain. This year, though, they have more room to maneuver within their IRA accounts. While it would be disadvantageous to withdraw funds from any tax-deferred account, they need to sell $8,695 of their international fund holdings to rebalance. However, rather than withdrawing from the tax-deferred account, they can transfer some of these proceeds, $4,286, to their aggressive growth IRA to bring that into balance. The remaining $4,409 ($8,695 – $4,286) proceeds can be transferred to the S&P 500 IRA, while they simultaneously sell that same amount from the taxable large-cap equity-income fund—this maneuver allows the sale of one tax-deferred asset without removing funds from the tax-deferred environment, yet it keeps the large-cap commitment at the same level. This amount is added to the $2,302 that the Swensons need to withdraw from their large-cap equity-income fund to reduce the slight overcommitment to large caps; thus, a total of $6,711 ($2,302 + $4,409) would be sold from the equity-income fund. This amount, added to the $822 sold from the intermediate-term bond fund holdings, produces the $7,533 additional spending amount needed.

The bottom part of Table 2 shows that the allocation after all of these transactions is back to their desired level.

The Juggling Act

Retirement actually requires quite a bit of nimbleness and flexibility, at least as far as financial matters are concerned. For the Swensons, it was easier because they did not need to withdraw funds from tax-deferred accounts. If you are required to take distributions from your IRAs, it may be more difficult to simultaneously rebalance and keep tax consequences minimal.

Nonetheless, in the context of a withdrawal plan, rebalancing forces you to withdraw more from assets that are overperforming and withdraw less from those that are underperforming, a rough form of "sell at higher prices, buy (or sell less) at lower prices." On the other hand, tax considerations may interfere with this and you should sell taxable assets for spending purposes, and not simply to rebalance.

There are many approaches that can be used when rebalancing, and it will sometimes boil down to a matter of preference. However, here are some guidelines to follow when rebalancing your portfolio through periodic withdrawals:

- From a tax-efficiency standpoint, you are best off if you put your highest-returning investments in tax-deferred accounts, even if those returns are generated by capital gains rather than income or dividends.
- You are also best off deferring the withdrawal of assets from tax-deferred accounts as long as possible, unless you may encounter problems with the excess distributions and accumulations penalty. (For more on this penalty, see "Understanding the 15% Excess Distributions and Accumulations Penalties," by Clark Blackman II and Kevin McAuliffe in the June *1995 AAII Journal*.)
- Use taxable distributions from your taxable accounts as part of your annual spending amount; do not reinvest taxable distributions unless the total is greater than your annual spending needs.
- Keep your portfolio balanced by withdrawing from assets in which you are overcommitted and by shifting assets in tax-deferred accounts.
- Rebalancing does not need to be frequent—annually is sufficient. However, your actual portfolio allocations will be constantly changing due to varying performances, and as you withdraw funds to spend. When rebalancing, use an annual snapshot picture of your portfolio that excludes your spending amount.
- Don't worry about straying from your desired allocation by a few percentage points—the picture will change throughout the year, anyway. Take a wide-angle view rather than a narrow-focused close-up.