Briefly Noted

Determining the Perfect Withdrawal Rate

Two professors and a financial adviser have created a methodology they claim can identify the "perfect withdrawal amount." This is the amount a retiree can withdraw each year and pass away with either zero dollars or with a specified proportion of the portfolio to be bequeathed. The authors of the paper introducing this methodology say it is designed to ensure the retiree takes the maximum withdrawal each year without outliving his or her savings or having excess savings at the end of his or her life. Though a practical application is still under development, the methodology offers an alternative way of determining withdrawal rates.

The formula behind the methodology is withdrawals (w) equaling the rate of return over the retirement period (R_n) times the starting balance (K_s) minus the ending balance (K_e) multiplied by a sequencing effect (S_n). In mathematical terms, it is:

$$w = (R_n K_s - K_e)S_n$$

The ending balance can either be an amount to be bequeathed, or zero if no bequeathed amount is desired.

A starting withdrawal amount is calculated at the beginning of retirement. Then the withdrawal amount is recalculated each year thereafter. The authors say the annual recalculation is necessary to capture all new information. This makes the methodology adaptive to portfolio and market changes.

Annually recalculating the withdrawal amount will lead to varying withdrawal amounts. This is a logical outcome if the mathematical goal is to end the forecast period with a set amount of savings, such as $0 on the last day of life, exclusive of any amount to be bequeathed.

For those who prefer stability in the annual withdrawal amounts, the authors suggest basing the withdrawal rate on a band of confidence intervals and then only adjusting the withdrawal rate when it falls out of that range—for example, say a retiree chooses a withdrawal amount based on a 70% chance of portfolio success (a low probability of having to reduce the withdrawal rate in the future). The withdrawal amount stays unchanged as long as each subsequent recalculation shows that the withdrawal amount remains within a range of acceptable confidence intervals (e.g., between a 50% and 90% chance of portfolio success).

Source: "The Perfect Withdrawal Amount: A Methodology for Creating Retirement Account Distribution Strategies," E. Dante Suarez, Antonio Suarez and Daniel T. Walz, SSRN, November 11, 2014.

Tailor Retirement Withdrawals Based on Your Tax Situation

A common rule of thumb for retirees is to take required minimum distributions (RMDs) first, then withdraw from taxable accounts followed by traditional individual retirement accounts (IRAs) and 401(k) plans. Roth IRAs should be last in line for withdrawals. The rationale for this order is to minimize the tax impact of taking withdrawals, but following it may not always be optimal. Rather, retirees may be better off by using a more flexible approach, writes Morningstar's Christine Benz.

As a retiree's tax status changes from year to year, there can be advantages to favoring withdrawals from one type of account over another. Distributions from traditional IRAs and 401(k) plans are taxed at ordinary income rates and have the potential to push a retiree into a higher tax bracket. Distributions from Roth accounts, conversely, are neither taxed nor they do they alter a person's tax bracket. Investments held in taxable accounts can be eligible for the discounted long-term capital gains and qualified divided tax rates. Plus, realized losses on investments can be used to lower taxable income (up to $3,000 per year).

Given these varying tax treatments, retirees can alter their tax bill by making prudent choices about which account they will withdraw from.

Benz gave a few examples of when it might make sense to stick to the conventional rules of thumb or disregard them:

- **Roth IRA Conversions:** Converting a traditional IRA (or a 401(k) plan) to a Roth IRA makes the most sense right after retirement but before RMDs have to be taken, since the conversion will boost taxes and potentially put the retiree in a higher tax bracket.
- **Unusually High Deductions:** The ideal time for taking a withdrawal in excess of the RMD is during a year with unusually high expenses (e.g., medical bills). The tax rate will be lower and future RMDs could be reduced in size.
- **Unusually High RMDs:** If high portfolio returns result in larger RMDs, favor taking withdrawals from taxable or Roth accounts to avoid paying a higher tax rate.

Source: "Don't Be Dogmatic About Retirement-Portfolio Withdrawals," Christine Benz, Morningstar, February 19, 2015.

The "Other" Costs of Financial Fraud

Victims of financial fraud incur varying degrees of indirect and direct financial costs as a result of the criminal activity. These costs can include legal and banking fees as well as stress and anger, according to a survey conducted for the FINRA Investor Education Foundation.

Notably, no single demographic was the prime target for the fraud, although the survey purposely included an equal number of men and women. Men and survey respondents with higher incomes (defined as over $75,000 per year) lost the largest amount of money in the fraudulent incident.

Personal relationships most commonly led the victim to be introduced to the perpetrator, signaling the presence of affinity fraud. The results show 18% of victims said a friend or family member introduced them to the perpetrator, while 13% were introduced through a professional contact. The introduction occurred for about 11% of victims either through a social networking website (e.g., Facebook) or through a social setting, such as a place of worship. It's worth noting that unsolicited emails and telephone calls accounted for nearly a quarter of all introductions.

Once introduced, perpetrators seemed to limit the amount of interaction. Nearly 80% of victims said they communicated either just a few times or very little. Only 15% report having a great deal of interaction.

About half of all victims (47%) said they felt responsible for what happened. More than 60% said they were defrauded because they were too trusting and 51% say they should have trusted their instincts about an offer being too good to be true. Not surprisingly, 74% of survey respondents were angry about the incident, 70% were regretful, 69% felt victimized and 68% felt betrayed.

Indirect financial costs (late fees, bounced check fees, legal fees, etc.) were inversely correlated with age, with only about a third of victims over the age of 55 incurring them. Non-financial costs were evident across age groups, with stress and anxiety being most common.

The survey only measured the impact of the fraud, not how much money was lost in the scams themselves. Nonetheless, the results show the importance of asking questions and conducting a background check before engaging in a financial transaction or a new investment. The April 2011 *AAII Journal* lists a variety of questions to ask an investment adviser ("How to Check Out a Financial Advisor"). Also, be aware of the ongoing scams, such as "The 'Dirty Dozen' Tax Scams for 2015" highlighted in the March 2015 *AAII Journal.*

Source: "Non-Traditional Costs of Financial Fraud," Applied Research and Consulting and FINRA Investor Education Foundation, March 2015.

The Cost of Postponing IRA Contributions Until April

AAII members who postpone making contributions to their individual retirement accounts (IRAs) until April are not alone. Statistics compiled by Vanguard show more than 20% of IRA contributions for the 2007 through 2012 tax years occurred in April.

Put another way, Vanguard says its clients make "more than double the amount of IRA contributions in April of the following tax year than in January of the current one." April also far exceeds March, which ranks second in total monthly contributions made.

Though making IRA contributions in April is a common occurrence, it is not a smart one from the standpoint of long-term wealth. Rather, a "procrastination penalty" exists. Vanguard says this penalty can cause a 10% forfeiture in wealth.

The fund giant based the finding on a hypothetical portfolio. It assumed two investors contributed $5,500 to an IRA annually for 30 years. The "early bird" investor made the contributions on January 1 of each tax year. The "last minute" investor made the contributions on April 1 of the following year. Both investors realized an annualized return of 4% after inflation.

The early bird investor ended up with $158,967 in accumulated wealth. The last minute investor, conversely, ended up with $143,467, or $15,500 less than the early bid investor. The only difference was the timing of their contributions.

The findings are similar to a T. Rowe Price study published last year (see "Which IRA Should You Contribute to and When?" in the July 2014 *AAII Journal*). This study found that making lump-sum contributions at the beginning of each year results in greater wealth than end-of-year contributions over rolling three-, five- and 10-year periods.

A good compromise between making contributions at the start of each tax year and waiting until April 15 of the following year (the deadline for making an IRA contribution for the previous tax year) is to set up automatic contributions. These ensure dollars are invested over a period of time, add discipline to the savings process and spread out the budget impact of making a contribution.

Source: "Delaying IRA Contributions Until April Can Cost You," Stephen Weber, Vanguard, February 15, 2015.