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Retirement Distribution Pitfalls: Income-Producing Securities

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Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be relying strictly on income-producing securities to meet income needs. Sticking exclusively with income distributions can leave retirees beholden to the current interest-rate environment. We've seen that problem in sharp relief during the past several years, as income-oriented investors have been forced into riskier areas, such as emerging-markets bonds, to scare up the income they need.

Workaround: The bucket approach to retirement income is essentially a total-return approach that relies on regular rebalancing to provide income for living expenses. Using such a structure, a retiree would own bonds and dividend-paying stocks but would also own other stock types, including those that don't pay dividends. Such a strategy could potentially provide a better-diversified portfolio than the income-only approach for some retirees, and may also allow a retiree to enjoy a fairly stable standard of living.

All investments involve risk, including the loss of principal. There can be no assurance that any financial strategy will be successful. Diversification is an investment method used to help manage risk. It does not ensure a profit or protect against a loss. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

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Key Reasons Why a Taxable Account May Be Underrated, Part 1

Benefits of a taxable account

- Flexibility
- CompoundingTax Losses
- Low tax withdrawals
- Better control of tax liability
- Step-up cost basis

Tax-sheltered savings vehicles offer tax-deferred compounding, meaning investors won't pay any taxes on a year-to-year basis as long as they don't withdraw any assets. And depending on the vehicle, they may also receive a tax break on contributions and/or withdrawals, too. Those tax breaks can help enhance take-home return.

With all the attention paid to accumulating money in those tax-sheltered accounts, many investors see saving in a taxable account as a last resort—something to be considered only after they've fully funded their tax-sheltered accounts.

But investing via a taxable account can be a sensible maneuver, and not just if you're running out of tax-sheltered receptacles for your money. In fact, investors may want to consider simultaneously funding their taxable and tax-sheltered accounts, and the current tax and interest-rate environment make saving in a taxable account particularly sensible. Here are six key reasons why.

Reason 1: Flexibility.

Investing via a taxable account carries two key advantages, both of which make the taxable account more flexible.

First, liquidity: If you have near-term income needs or are simply building an emergency fund, a taxable account will allow you access to your money without any strings attached (though you may owe taxes if your investments have appreciated). True, a Roth IRA allows you to tap your contributions (not your investment earnings) at any time and for any reason, which is one reason it's a suitable vehicle for younger investors who are conflicted between saving for near-term financial goals and retirement. But for higher-income folks who need to use their tax-advantaged options for retirement savings, putting money for liquidity needs into a taxable account may be the way to go.

The other reason investing in a taxable account is so flexible is that you can invest in literally anything. You'll have to choose from a preset menu if you're investing in a company retirement plan, for example. And while you may have more leeway when investing in an IRA, there are still a few investment types that are off limits. A taxable account is the one account type that gives you carte blanche. (Of course, it also gives you more opportunity to make mistakes!)

Reason 2: Compounding and potentially minimizing taxes if you plan carefully.

When investing inside of a taxable account, it may not be all that difficult to simulate the tax-deferred compounding you get with many tax-sheltered vehicles. The key is to choose investments that kick off limited taxable income and capital gains distributions. For example, income from municipal bonds is exempt from federal and in some cases state income taxes. Choosing tax-efficient securities can make it possible to buy and hold a basket of securities for years inside a taxable account while owing very little in taxes on that portfolio during your holding period.

It's also worth noting that income is low on an absolute basis right now, so the tax hit associated with owning securities that produce income that is taxed at your ordinary income tax rate is also going to be pretty low, at least in dollar terms. (That will change if yields go up, though.)

Reason 3: You can use tax losses to reduce your tax bill.

In addition to the ability to have your assets grow without owing a lot in taxes, investing in a taxable account also gives you the ability to harvest losses, something that is not easy to do with investments held inside tax-sheltered accounts. You can sell securities that are trading below your purchase price and use your loss (the difference between your purchase price and your sale price) to offset capital gains or, if you still have excess losses, up to $3,000 in ordinary income.

Key Reasons Why a Taxable Account May Be Underrated, Part 2

- Flexibility
- CompoundingTax Losses
- Low tax withdrawals
- Better control of tax liability
- Step-up cost basis

In a year like 2008, when stocks were badly in the dumps, the ability to engage in tax-loss selling was a rare silver lining.

Reason 4: You may be able to enjoy no- or low-tax withdrawals.

In addition to being able to keep your tax costs down while you own the securities in a taxable account, currently low capital gains rates also help you limit your tax costs when you eventually sell them. As recently as the late 1990s, a 20% long-term capital gains rate applied to investors in the 28% income tax bracket and above. Now, only investors in the very highest income tax bracket (39.6%) pay a 20% long-term capital gains rate; investors in the 25% to 35% brackets pay 15% and investors in the 10% and 15% brackets currently owe no taxes on long-term capital gains.

Reason 5: You'll have more control over your tax bill in retirement.

The ability to pull your money out with limited tax liability (because capital gains rates are pretty benign right now) can prove particularly beneficial when you begin taking money out of your accounts during retirement. You'll owe ordinary income tax on distributions from traditional 401(k)s and IRAs during retirement, and the timing and size of those distributions will be out of your control once you have to begin taking required minimum distributions (RMDs). By diversifying your asset mix across taxable and Roth accounts, you'll help ensure that at least some of your distributions will come out with low or no tax ramifications.

Holding taxable assets in addition to tax-deferred and Roth also helps ensure that, if you determine that you want to convert some of your Traditional IRA or 401(k) assets to Roth, you'll be able to pay the conversion-related taxes without having to dip into your IRA/401(k) funds, thereby sidestepping further taxes.

Reason 6: Your heirs will receive a step-up in basis.

Another key advantage to investing inside of a taxable account is that your heirs will be able to take advantage of a step-up in cost basis, essentially wiping out any capital gains tax liability that you racked up over your own holding period. That means that when they inherit assets from you, the taxes they'll eventually owe when they sell will be calculated by looking not at your purchase price but what they were worth at the time of your death. Even if your heirs end up selling the inherited assets shortly thereafter, you've still reduced the drag of taxes on your overall estate.

401(k) and IRA plans are long-term retirement-savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Direct contributions to a Roth IRA are not tax-deductible but may be withdrawn free of tax at any time. Earnings may be withdrawn tax and penalty free after a 5 year holding period if the age of 59 1/2 (or other qualifying condition) is met. Otherwise, a 10% federal tax penalty may apply. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult with a financial or tax professional for advice specific to your situation.

A municipal bond investor is a creditor of the issuing municipality and the bond is subject to default risk. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes would apply to any capital gains distributions.

Investing does not ensure a profitable outcome and always involves risk of loss. There is no guarantee that diversification or asset allocation will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market.

April Employment Report: Mixed News

The April employment report wasn't so strong that it created worries about economic overheating and Federal Reserve tightening, and it wasn't as weak as to create concern that the economy was about to slide back into a recession.

Looking at private sector job growth, which excludes the much slower-growing government sector, the three-month average, year-over-year growth rate remains relatively high at 2.6%, which is down just a touch from recent highs and still above the 2.4% average growth rate of the past 12 months. Overall, it seems the jobs report was strong enough to keep a rate increase on the table for September, but weak enough that a June rate increase now appears unlikely.

Private Sector Employment and Wage Growth

	Employment Growth (%)	**Hourly Wage Growth** (%)
April 2014	2.1	2.1
May	2.2	2.1
June	2.2	2.0
July	2.3	2.1
August	2.3	2.1
September	2.4	2.1
October	2.4	2.1
November	2.4	2.1
December	2.5	2.0
January 2015	2.6	2.1
February	2.7	2.0
March	2.7	2.1
April	2.6	2.1
Average (12 months)	**2.4**	**2.1**

Source: Bureau of Labor Statistics. Growth rates are calculated on a year-over-year, 3-month average basis.

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