Trusted Advisor

September, 2003

By Gary E. Miller, C.F.P.

Contact Gary Miller at 949-249-2057
E-mail: Gary@trustedfinancial.net

Vol. 2, No. 7

Making Smart Retirement Distribution Choices

Depending upon your employer, your decisions around retirement income may range from challenging to confusing. After seventeen years of specializing in this arena, I still check my facts before advising a client with regard to such life changing decisions.

Those who are not self employed often have two retirement plans provided by their employer. A traditional *pension* plan usually features a monthly benefit check. A *profit sharing* plan such as a 401K, ESOP or SEP usually disgorges your funds in a single sum.

Pension Plans Distributions

Pension Plans usually offer three main income options:

1. *Income for your lifetime only*
2. *Income for your lifetime and that of your spouse*
3. *Income for a fixed, certain period of time*

There are variations within these major choices, so it is important to discuss the particulars of your plan with a representative of your company's benefits department *and*, for perspective, with a neutral outside source, preferably a Certified Financial Planner™ Practitioner. Here is a brief description of the three main pension pay out methods:

1. *Single Life Income:* Appropriate for someone with no spouse or dependents who wishes to maximize income. Your check is calculated based on your company's pension formula (i.e. Years of service + Age = X% of final year's salary) paid for the rest of your life. There is no residual income, and upon your death the checks stop coming.

2. *Joint and Survivor for Life:* Married retirees usually select this approach . Although the size of the benefit is reduced, the survivor is assured an income after the death of the retiree. Most pensions allow you to specify how much of a "Survivor Benefit" you wish to create. A 100% benefit means your spouse sees no reduction in the monthly pension income after your death. A 50% survivor benefit indicates the monthly check is halved. The catch, however, is that a higher spousal benefit means lower pay outs initially, while you are both living.

If you have significant savings (such as a 401k or 403B plan) it may be best to enjoy the higher joint benefit for the years you have together. Each couple is different, and can benefit from a "retirement adequacy analysis" prior to making this decision. By Federal law, if no retirement election is made this is the benefit that is automatically provided.

3. *Period Certain:* You tell the benefits department that you want them to send you a check every month for your joint lifetime and that in the event neither you nor your spouse live for the next ten years or fifteen years, or twenty years, payments will continue to your beneficiaries for the guaranteed term. This option makes sense if you retire at an older age, or if there are health challenges. Your monthly benefit will likely be a little smaller than under the pure joint and survivor election described above, but this may be worth insuring an income to your heirs, especially if they have health or financial needs that must be addressed.

Certified Financial Planner™

Gary Miller is in his 30th year of providing financial guidance to individuals and pension plans. He is a Registered Investment Advisor and a Certified Financial Planner ™ Practitioner. Gary holds a Certificate in Personal Financial Planning from the University of California, Irvine and has served as a Board member of the Financial Planning Association, Orange County Chapter.

There are many sub-variations on these three main themes. In addition, If you contributed after tax funds to build your pension, you may have the choice of receiving the accumulated contributions as a single large distribution check, or of leaving these funds in your pension, creating a larger monthly benefit. Some retirees elect to take out this amount to pay off their mortgage.

Profit Sharing Plan Distributions

Profit sharing plans may be taken as a monthly benefit similar to a pension plan, but more usually you must receive the accumulated assets as a "single sum distribution". In most cases, a direct rollover of these funds from your profit sharing plan to your IRA is recommended.[1] This avoids current taxation and keeps future earnings tax sheltered. An advantage of a single sum distribution is that it allows you to control your own funds and the way they are invested. The certainty of a monthly check, like pension, is sacrificed. Properly managed however, these funds can be made to grow more rapidly than buying power lost to inflation, and often become a crucial source of supplemental income in the later retirement years. Much of **Trusted Financial Advisors'** portfolio management involves managing IRA rollover accounts.

The Most Important Math Test of Your Life: Your Retirement Estimates

Making smart retirement distribution choices is determined by your overall financial circumstances. When analyzing our clients' needs we look at such concerns as the size of your Social Security check, additional sources of recurring income such as rental property and the availability of supplemental income such as an insurance policy cash value. Many folks may be able to tap the equity in their homes at some point. This is often part of a natural transition, if mobility challenges make it difficult to get around in a large multi-story home. Even when staying in place, a reverse mortgage may provide needed income.

Income is only half the picture. Expenses need to be realistically estimated. The most important thing is to avoid surprises. People who retired in 1973 paid about $2.00 for a ticket to the movies. The cost has quadrupled – can these retirees, many in their late '80's and early '90's say the same of their income or net worth?

After retirement, will you want to reduce your living style by 25%? Many computer based retirement calculators seem to assume so. My clients don't fit this assumption. Remember, if you retire at, say, age 60, you may well purchase three more automobiles, have the house painted a few times, and the roof replaced, before you transition to the next world! Consider what things cost thirty years ago, and you have some notion of what they will have risen to by the time you are ninety years of age!

The Fixed Income Challenge

"Recurring income" has a nice ring to it. It's the sound of hard cash dropping steadily into the bucket month after month. For this reason our balanced client portfolios always include a fixed income component. This balance allowed us to weather the miserable stock market of early 2000 to early 2003 with relative equanimity. Bonds and bond funds generally trended higher in addition to paying out regular income throughout this period.

But bonds can go down in value too. Keeping the image of a see-saw in mind, recall that when interest rates rise, the value of previously issued bonds falls (although good quality bonds continue to pay regular interest income).

Earlier this year, I anticipated that interest rates would see a bottom and turn higher but, with most other observers, I did not expect the about face to be quite so abrupt. Rates turned in mid June when a bevy of financial measures confirmed that the recession ended months ago and the Iraq action appeared to have reached a positive resolution. The change in ten year bond rates from about 3.5% to 4.5% has resulted in about a 10% loss of bond value.

Fortunately, we shortened maturities as did our leading bond mutual fund vehicle, Pimco Total Return fund, so the damage has been minimal to date. Still, interest rates are near historical lows as the following chart indicates.

Note: This graph tracks 10 Year Treasury Bond yields, not prices. Bond prices change in the opposite direction to yield.

As an advisor, I am faced with the twin challenges of producing attractive cash flow from the fixed income portion of client portfolios while avoiding a train wreck should interest rates jump once again. I had already begun to anticipate falling bond prices months ago (rising interest rates) by devoting fixed income capital to high dividend paying stocks, like Kinder Morgan L.P., Alliance Capital, L.P. and Real Estate Investment Trusts (REIT's) paying 5.5%-6.5% dividends. These are not bonds, but they were chosen to fulfill the role bonds play in a portfolio when reliable, recurring income is desired. While less secure than the guaranteed income offered by a bond, all of these high dividend paying stocks have the potential of *raising* their dividend as earnings grow in the future.

Caremark buys Advanced PCS... What does it mean for shareholders?

Most clients hold Caremark RX (CMX), a leading pharmacy benefit management company. After a careful analysis of this industry in late Spring 2002, Caremark became a core holding , which we continue to recommend. Interestingly, my initial analysis of the industry led me to Advance PCS (ADVP), larger than Caremark RX and also an excellent company. But quality of earnings issues and the belief that management at Caremark was more experienced and focused on generating free cash flow won my heart. As I was preparing this edition of *Trusted Advisor*, the purchase of ADVP by CMX was announced. A friendly merger with attractive synergies, this appears to be driven by need to negotiate from a position of size and strength with both the big drug companies and the Federal Government, when (if) a proposed Medicare drug benefit becomes law. Although Caremark RX stock dropped about 8% on the news, Advance PCS rose some 25%. The combined enterprise value to CMX shareholders therefore rose, and this should be reflected in CMX's share price once the deal is done, which is expected in the first quarter of 2004.

Initial indications from sources such as Standard & Poors are that the deal will improve the already respectable financial strength of Caremark. There is likely to be a protracted review by the federal trade commision as the issue of drug pricing has become highly politicized. Based on the current arbitrage spread for this deal however, Wall Street appears to expect a favorable completion. With the information I have at hand, I will support the merger by voting our shares in favor of the proposal.

(Footnotes)

[1] Another term, "lump sum distribution" refers to the taxable distribution of funds directly to the plan participant. Depending upon age and circumstance, there may be some advantageous tax treatment available, but rarely in my experience is a lump sum distribution better than a direct rollover to an IRA.

Trusted Financial Advisors bases it's articles on information from sources believed reliable. Accuracy cannot be guaranteed, however. Nothing in our articles or newsletter is to be construed as investment advice. Investment advice is rendered under written agreement only. ***You are cautioned not to act or invest on the basis of opinions rendered in our newsletter or at our web site. Trusted Financial Advisors will not be held responsible or liable for any actions taken by those who are not currently clients of the firm.***