COUNTRY Trust Bank®

# Financial Planning Insights – Retirement Income Strategies

December 2024



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Retirement is like a long vacation in Las Vegas. The goal is to enjoy it the fullest, but not so fully that you run out of money. - Jonathan Clements

## Focus On the Way Down

Accumulating wealth for retirement seems simple enough in theory: spend less than you make and save the rest. The real challenge lies in effectively managing these savings to ensure a steady income throughout retirement, without exhausting the funds prematurely or leaving too big of a surplus behind. This creates an interesting puzzle.

This puzzle raises several important questions: When will I retire? How much will I need to spend? Will I have sources of income other than my savings? How long will I live? A well-thought-out strategy for generating retirement income is necessary to maintain financial stability all the way through retirement.

What does that strategy entail? There's no one-size-fits-all solution. A quick search might suggest hundreds of different retirement income strategies. Many of these are essentially the same, just packaged under different names. In his book "How Much Can I Spend in Retirement?," respected retirement researcher Wade Pfau distills these down to thirty-six distinct strategies. The key is to identify the strategy that best aligns with your individual needs.

## Start With an Overall Plan

Before choosing the best income strategy for your retirement, it's wise to start with a retirement plan. This plan can help answer crucial questions, such as how much money you'll need annually. Once you've determined your spending needs, consider the income sources that will help meet these needs. Two common sources are Social Security and pensions. By subtracting these income sources from your spending needs, you'll identify the income gap that must be filled with your savings and investments.

## Consider Additional Factors

Choosing a retirement income strategy to fill this gap can be influenced by various factors. Even if two individuals appear to be in similar situations, there may be subtle differences that could significantly impact their chosen income strategy.

For instance, understanding your **risk tolerance** and **risk capacity** is an important factor. In investing, risk typically refers to the volatility of an investment's value - how much and how often the value of the investment may rise or fall. Consider whether you are comfortable with investments that may experience significant short-term losses in pursuit of potentially higher long-term gains, or if you prefer a more conservative approach, prioritizing short-term stability even if it means potentially lower long-term returns. Your risk profile isn't just about personal preference; it also depends on your financial situation, time horizon, and overall retirement goals. A *Risk Profile Questionnaire* can help you assess both your emotional comfort with risk (risk tolerance) and your financial ability to withstand potential losses (risk capacity). This understanding will help guide you towards investment strategies that align with your personal circumstances and retirement objectives.

Another important factor in your income planning is the age at which you anticipate passing away. **Longevity risk**, or the risk of outliving the average lifespan, is a major concern. Many individuals aim to ensure they have sufficient funds to sustain their lifestyle even if they live beyond the average life expectancy. No one wants to find themselves in their twilight years unable to afford even the most basic necessities, like a carton of eggs or their favorite fruit. Conversely, preserving an excessive amount of money for an age you may not reach can limit your spending throughout retirement. It's worth considering what sacrifices you're willing to make early in life so there's money left if you live to 100 or beyond. Some people find that they could have retired earlier, or gone on more vacations, rather than save for an age they may never realistically reach. Therefore, finding the right balance between spending too little and spending too much requires proper attention.

It's also important to consider how much of your spending need is essential and how much of the need is discretionary. Taking money out of an investment account when that investment is down can compound your loss. If this happens early in retirement, this can cause you to run out of money faster. To mitigate this problem, limit withdrawing money from investments when their values drop. This is easier to accomplish when addressing discretionary expenses that can be delayed or cut back if needed.

## Retirement Income Strategies

As noted, there are many different retirement income planning strategies. Discussing every strategy would require a book. Instead, we will cover only some of the most common strategies.

## The 4% Rule

The 4% rule was introduced by Bill Bengen in 1994. The rule states that one may take 4% of their total savings in the first year of retirement. They can then increase that starting amount each year by inflation. Based on the historical data that Bengen analyzed in his research, a person following this rule would have a 100% chance of passing away without depleting their savings over any of the 30-year periods he tested.

The research that resulted in the 4% rule has several caveats:

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- An investment portfolio containing 50% **large-cap common stocks** and 50% intermediate-term U.S. **Treasury Bonds** was used.
- The 30-year periods in his analysis were from 1926 – 1976. This includes The Great Depression.
- The 4% rule assumed a retirement of 30 years.

You may have an investment portfolio that is different than a 50/50 allocation or contains investments other than large-cap stocks and intermediate bonds. Your retirement might be more or less than 30 years. It's possible to experience an extreme market event that is worse than the Great Depression. If these worst-case scenarios don't happen, you may pass away with much more money left over than you desired. A retiree's spending needs often change in different phases of retirement. They may want more money in the first years of their retirement, less in the middle, and more towards the end if personal medical care costs rise. This can make the 4% rule inefficient for some people.

## Dividend Income

A common strategy that is often considered is to only live off of **dividends**. This strategy involves relying on the income generated from dividend-paying stocks to cover your living expenses. Dividends are payments made by some companies to their shareholders on a periodic basis. To implement this strategy, you need to build a portfolio of dividend-paying stocks. Refer back to your income gap from earlier. If you need $30,000 per year and your portfolio yields 3%, you will need a portfolio value of $1 million. An attractive characteristic of this strategy is that most dividends, those known as *qualified dividends* are taxed at a lower rate than ordinary income in a non-qualified account. Note that this tax impact and portfolio value needed may change if your portfolio is in a qualified account such as an IRA. This strategy offers an income stream and potential portfolio growth, but also comes with the risk of dividend cuts and market volatility.

However, this strategy also has its drawbacks. Even if you diversify your investments across different sectors and focus on quality companies with a strong track record of paying and increasing dividends, you are still at risk of missing out on other high performing investments that do not pay a dividend but offer plenty of return in appreciated value or price. Dividend investors should be careful of pursuing higher-yielding stocks to maximize income. These companies may also come with a higher risk.

## Total Return

Total return investing is a strategy that focuses on maximizing the overall return of a portfolio by considering both **capital appreciation** and **income** generated from investments. This approach involves building a diversified portfolio that includes stocks, bonds, and other assets to achieve a balance between growth and income. Instead of relying solely on dividends or interest, total return investors aim to generate income through a combination of price appreciation and income. This strategy allows for flexibility in generating cash flow, as investors can sell assets that have appreciated in value to meet their income needs, while also reinvesting dividends and interest to compound their returns over time.

The key to total return investing is maintaining a well-diversified portfolio and regularly rebalancing it to ensure it aligns with your financial goals and risk tolerance. By focusing on the total return, investors can create a diversified and adaptable investment strategy that can weather different market conditions. This approach can be particularly beneficial for retirees, as it provides a steady income stream while also allowing for potential growth in the portfolio's value.

Both the Dividend Income and Total Return strategies may be the right fit for certain retirees. Remember though that both of these strategies have a significant amount of market risk. This may be unsuitable for some people.

## Guaranteed Income

Those uncomfortable with market risk may be interested in a strategy that guarantees all of their retirement income. This strategy typically involves maximizing Social Security benefits and pensions, with annuities as an additional option if needed. Social Security provides a reliable source of income that adjusts for inflation, and retirees can increase their monthly benefits by delaying their claims until age 70. Pensions, if available, offer another source of guaranteed income, providing financial stability throughout retirement. By incorporating these elements, retirees can ensure a steady income stream without exposure to market volatility.

Annuities can further enhance this strategy by converting a portion of savings into a predictable income stream. Annuities from insurance companies guarantee payments for life, or a specified period, thus protecting retirees from the risk of outliving their savings. This approach shifts the risk to the insurance company, ensuring that retirees have a reliable source of funds regardless of market conditions. Combining Social Security, pensions, and annuities creates a robust retirement income plan that offers predictability, security and peace of mind.

A strategy that relies solely on guaranteed income can come at a price. By transferring market risk to other organizations such as the Social Security Administration, the company providing your pension, or an insurance company offering an annuity, you may be losing out on potential growth of your assets that could have funded an enhanced lifestyle.

## Bucket Approach

The bucket approach is also known as a time segmented approach. This method divides retirement savings into three distinct "buckets," each with a different investment horizon and risk profile. The first bucket is for short-term needs and contains cash, or cash equivalents, such as money market funds, certificates of deposit (CDs), or short-term bonds. This ensures that retirees have immediate access to funds for living expenses and emergencies without worrying about market volatility.

The second bucket is for mid-term goals and is typically invested in more conservative assets like intermediate-term bonds or balanced funds. This bucket aims to provide growth while still maintaining a relatively low level of risk. The idea is that these funds will be used after the short-term bucket is depleted, usually within five to ten years. By having this intermediate bucket, retirees can protect themselves against the risk of having to sell long-term investments during a market downturn.

The third bucket is for long-term goals and is invested more aggressively in assets such as stocks or equity funds. This bucket is designed to grow over a longer period, typically ten years or more, to outpace inflation and provide for future needs. The aggressive investment strategy in this bucket aims to maximize growth potential, acknowledging that there will be more time to recover from market fluctuations. By segmenting assets in this way, the bucket approach helps retirees manage risk, ensure liquidity, and achieve growth, providing a balanced and sustainable retirement income plan. This strategy is still subject to market risk while some assets are also missing out on any opportunity for growth.

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## Four Box Strategy

The Four Box Strategy for retirement income is a method that helps retirees manage their finances by categorizing their expenses and matching them with appropriate income sources. Here's a breakdown of how it works:

Essential Expenses: These are your non-negotiable costs like housing, utilities, groceries, and healthcare. The goal is to cover these with guaranteed income sources such as Social Security, pensions, or annuities.

Discretionary Expenses: These include costs for hobbies, travel, dining out, and other non-essential activities. These can be funded through more variable income sources like investment dividends, interest, or even part-time work.

| **Essential Expenses** | **Guaranteed Income** |
|---|---|
| Food, Home Insurance, Property Taxes | Social Security, Pensions, Annuities |
| **Discretionary Expenses** | **Income From Assets** |
| Plane Tickets, Golf, Gifting | Stocks, Bonds, High Interest Savings Accounts |

## A Tale of Two Retirements: Jane and John

**Jane Smith**, aged 65, has accumulated $200,000 in retirement savings and has a low risk tolerance. She is interested in a guaranteed income strategy throughout her retirement and less exposure to market volatility. To achieve this, Jane works with a COUNTRY Trust Bank (CTB) Financial Advisor to build a retirement plan focused on guaranteed income. She delays her Social Security benefits until age 70 to receive the maximum possible monthly payment. Additionally, Jane has a small pension from her previous employer. She chooses a life payout option rather than a lump sum which provides her with steady monthly income for life.

To cover her remaining income gap, she purchases an annuity with a *portion* of her savings. This annuity guarantees her a fixed monthly payment for life, ensuring she won't outlive her savings. Jane is comfortable giving up the opportunity for growth on some of her assets for the security of the guaranteed income. Her strategy provides her with a predictable and stable income stream, covering her essential expenses without worrying about market fluctuations. She feels secure knowing her basic needs are met, regardless of market conditions.

**John Doe**, aged 65, has $200,000 in retirement savings and a high risk tolerance. His primary goal is to maximize growth potential and maintain flexibility in his investments. John is comfortable with market risk and prefers investing over annuities, seeking income through a diversified investment portfolio. He works with a CTB Financial Advisor to build a retirement plan and adopts a total return strategy, aiming for both income for his current retirement lifestyle and growth to support his future needs. John claims Social Security right away to provide an immediate source of income.

John relies on his CTB Financial Advisor and their team to invest in a portfolio that includes a mix of stocks, bonds, and other assets to achieve a balance between growth and income. He relies on his team to regularly review and rebalance his investments. This allows him to take advantage of market opportunities and mitigate potential losses while enjoying his retirement without the stress of constant portfolio management. His strategy allows him to achieve potentially higher returns, providing flexibility to adjust his withdrawals based on market performance.

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| 4% Rule | • **Summary**: Withdraw 4% of retirement savings in the first year of retirement and adjust that amount for inflation each subsequent year.<br>• **Pro**: Simple and straightforward guideline to manage withdrawals over a 30 year period.<br>• **Con**: Does not account for varying income or spending needs. This may result in running out of money or leaving behind an excessive amount. |
| Dividend Income | • **Summary**: Involves investing in stocks of companies that periodically pay dividends, providing a steady income stream and some potential for growth.<br>• **Pros**: Produces a relatively stable income stream through regular dividend payments.<br>• **Cons**: Dividend income can be less predictable if companies cut or suspend their dividends during economic downturns. High-yield dividend stocks may carry higher risk. |
| Total Return | • **Summary**: Focuses on the overall return of a portfolio by considering both capital appreciation and income generated from investments, such as dividends and interest.<br>• **Pros**: Provides flexibility in generating income by allowing investors to draw from both capital gains and income sources. This approach can lead to long-term wealth accumulation and better performance measurement by considering all sources of return.<br>• **Cons**: May require selling investments that have fallen in value to meet income needs, which can be challenging during market downturns. Additionally, it can be more complex to manage compared to strategies focused solely on income. |
| Guaranteed Income | • **Summary**: Secures a steady and reliable income stream through financial tools such as annuities, pensions, and Social Security.<br>• **Pros**: Offers financial stability and peace of mind by providing predictable income that is not affected by market fluctuations.<br>• **Cons**: Typically offers lower overall returns compared to other investment strategies. Additionally, some products, like annuities, may involve fees. |
| Bucket Approach | • **Summary:** Divides retirement savings into three buckets: cash for immediate needs, conservative investments for short-term needs, and aggressive investments for long-term needs.<br>• **Pros:** Provides a balanced strategy that offers liquidity for immediate needs while allowing for potential growth over time.<br>• **Cons:** Requires careful management and regular rebalancing, and the investments may still be subject to market risk. |
| Four Box Strategy | • **Summary:** Categorizes retirement expenses into essential and discretionary, matching them with guaranteed income sources for essential spending and variable income sources for discretionary spending.<br>• **Pros:** Can provide stable income for essential expenses while allowing flexibility and potential growth for assets that cover discretionary expenses.<br>• **Cons:** Requires careful planning and ongoing management to balance income and expenses. |

## Summary

Selecting the appropriate retirement income strategy is a highly individualized process. It is contingent upon various factors such as personal financial goals, risk tolerance, and life circumstances. This paper has examined several strategies, ranging from insurance-based to market-based strategies, to a blend of both. The wide range of methods highlights the absence of a universal solution or one-size fits all approach. Consequently, it is imperative to seek guidance from a qualified financial planner who can offer personalized advice and assist in tailoring a retirement income plan that aligns with your unique needs and aspirations. Engaging with a professional can lead to a more secure and comfortable retirement. Consider reaching out to your COUNTRY Trust Bank Financial Advisor to build your plan.

## Glossary:

**Annuities:** Financial products that provide a fixed stream of payments to an individual at a price. Typically used as an income stream for retirees.

**Capital Appreciation:** The increase in the value of an asset or investment over time.

**Dividend Yield:** A financial ratio that shows how much a company pays out in dividends each year relative to its stock price.

**Longevity Risk:** The risk of outliving one's savings.

**Bond:** a fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental). A bond can be thought of as an IOU between the lender and borrower that includes the details of the loan and its payments.

**Intermediate-Term Bonds:** Bonds that typically have maturities of 3 to 10 years.

**Stock:** A stock represents ownership in a company and constitutes a claim on part of the company's assets and earnings.

**Large-Cap Stocks:** Stocks of companies with a large market capitalization, usually over $10 billion.

**Qualified Dividends:** Dividends that are taxed at the lower long-term capital gains tax rate rather than the higher ordinary income tax rate.

**Market Risk:** Also known as systematic risk, refers to the potential for an investor to experience losses due to factors that affect the overall performance of the financial markets.

**Risk Tolerance:** The degree of variability in investment returns that an individual is willing to endure.

**Risk Capacity:** The ability to withstand potential financial losses without jeopardizing financial goals.

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