

Retirement Withdrawal Strategies

You have a brokerage account, a rollover IRA, and a ROTH, and retirement is right around the corner. How should you approach your investments to support you through the years to come? To some extent, your withdrawal approach will be dictated by the IRS rules on minimum distributions that apply to traditional IRAs and 401k-type plans. But you should still consider your options and make sure to take the most advantageous approach when you start to withdraw.

For those able, but not yet required to take distributions from tax-deferred accounts, it is typically most practical to withdraw from taxable accounts first, as the withdrawals would be taxed at capital gains rates instead of ordinary income rates. Generally speaking, the higher your marginal tax rate, the more sense it makes to first withdraw from a taxable account.

There are some exceptions to this rule:

- If the bulk of your income comes from tax-sheltered accounts, withdrawals should be made from these accounts until taxable income at least reaches the lowest tax bracket. This exception should apply to any year when taxable income is low.
- Other withdrawal sequences may be preferable if an IRA's beneficiaries will be in a higher tax bracket than its owner.
- Substantially appreciated assets held in taxable accounts might be better off left alone, as they benefit from a step-up in basis at your death - the basis becomes the fair market at that moment, instead of what you actually paid for the asset. The assets in your IRA, in contrast, are not subject to a step-up. Consequently, an asset in a taxable account can be far more valuable to your heirs than the same asset held in an inherited IRA.

These are just a few of the situations that may apply to you when considering your brokerage and IRA account. Deciding between withdrawing from a ROTH or a traditional IRA involves yet another round of analysis. Give me a call if you would like more information or would like to discuss your specific situation.

Riding Out The Market

Thinking about volatility and actually experiencing it are two different things. In this issue of *The Educated Investor*, we revisit one of the most important components of portfolio design that helps us withstand the market's ups and downs: **diversification**.

Those who are familiar with our general investment approach are comfortable with the basic tenets of diversification. Nevertheless, we thought it would be helpful to revisit the subject. Why does diversification remain as important today as ever, particularly in light of the current market? Did you know that there are types of diversification that we advise against?

Defining Diversity

What exactly is diversification in the context of investing? Your portfolio is **diversified** if it is built to be — and managed to remain — a blend of **dissimilar** (low-correlated) investments among equities, fixed income and hard assets, as well as among domestic and international risk factors within equities and fixed income.

The number of holdings alone doesn't count for much. It is more important that your portfolio is blended appropriately for your unique willingness, ability and need to accept market risk. It's possible to be diversified either way, but these remain critical components when planning for a successful investment experience. Diversifying or spreading your investments among multiple types of dissimilar investments is not directly about maximizing expected returns. It's about taking neither more nor less risk than you need to, depending on what is appropriate for your individual goals.

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Professor Harry Markowitz described the essential relationship between diversification and investment risk in his acceptance of a 1990 Nobel Prize in Economics (along with professors Merton H. Miller and William F. Sharpe):

An investor who knew future returns with certainty would invest in only one security, namely the one with the highest future return. If several securities had the same, highest, future return then the investor would be indifferent between any of these, or any combination of these. In no case would the investor actually prefer a diversified portfolio. But diversification is a common and reasonable investment practice. Why? To reduce uncertainty!

In the next article, we'll discuss in more detail the role that risk plays within diversification. It is entirely possible to have a portfolio that is diversified across a wide range of uncorrelated asset classes or risk profiles. However, if it is diversified in a way that is either overly or insufficiently risky for you, you've not yet achieved your true goal.

Just-Right Diversification

What is the appropriate level of risk within your diversified portfolio? Like Goldilocks' porridge, it's possible to have too much, not enough, or just the right amount.

You've probably heard us caution against taking on more risk than you can comfortably digest. This has particularly been the case during the long, pleasant growth that most of the riskier asset classes have been experiencing since around 2003. During such times, it's easy to forget how quickly and sometimes severely the markets can turn.

Investor risk tolerance may have experienced a bit of a fire drill during last quarter's gyrations. We were delighted to see that the vast majority of our clients recognized the risk for what it was. We've been cautioning all along against abandoning one's carefully designed, diversified portfolio when the markets turned risky. Our clients took that advice and stayed the course with admirable discipline. An educated investor is indeed a powerful one!

We may not have discussed the opposite effect as frequently: building a portfolio that is **too** conservative for your needs. This is a phenomenon that can particularly prey upon those who are in or near retirement, when the ability to take on financial risk typically decreases. With a shorter investment horizon, you may have less ability to

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Rather than simply increasing fixed income and decreasing equities, you can reduce exposure to the riskier equity asset classes, such as small-cap and value. Even then, you may choose to reduce rather than eliminate these holdings. The objectives of your portfolio might warrant a more conservative approach, but that doesn't mean it's necessary to wholly abandon allocations to individually riskier components. Again, even as each component may be individually more or less risky, a careful blending of low-correlated holdings can actually reduce overall volatility.

Another technique is to incorporate relatively short-term, rather than longer-term, fixed income holdings. For example, by investing in five-year government agency bonds rather than long-term Treasury bonds, it is possible to reduce expected risk within your fixed income holdings. This in turn can enable you to retain a higher percentage of equity allocation (and its higher expected returns). The result, if properly constructed, can be a conservative but effective portfolio, with a risk profile that is designed to be "just right" for you.

TAKE THE LGC&D PORTFOLIO ANALYSIS CHALLENGE

*Is your portfolio appropriately diversified
or have you gone over to the dark
side of diversification?*

*Contact us to set up a complimentary portfolio
analysis and we'll show you the light!*

simply wait out bear markets when they occur. If you are no longer working, you might not have the same ability to replace or recover from financial losses. You may in general grow less willing to take on risk and to suffer the emotional stress that bear markets can generate. For all of these reasons we might consider reducing the expected risk within your retirement portfolio. However, it is possible to become **too** conservative.

It is true that, as broad categories, equities are more volatile than bonds. For example, the standard deviation of the S&P 500 Index is more than twice that of long-term government bonds. Yet, it is also true that retaining a modest amount of this more volatile equity component within an otherwise all-bond portfolio can actually increase expected returns while reducing volatility. The reduced volatility is a result of the **low correlation** between equities and fixed income. Over the long-run, equities and fixed income tend to march out of step with one another and thus balance each other out. At the same time, the higher expected returns of equities versus bonds remains to enhance your portfolio's performance. There are a few ways to migrate to a more conservative portfolio, if that is your objective, in an efficient and effective manner.

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The Dark Side of Diversification

It's easy to walk a sandy beach, pick up random shells and call them a collection. The collection might be diverse, but clearly it lacks a guiding plan. Too often, investors pick up investments in a similar way. The results, even if diverse, can disappoint.

Quantity rather than quality — A portfolio can hold a very large number of stocks or mutual funds, but still not be properly diversified. For example, owning five or more different U.S. large-cap growth funds or stocks provides only minimal diversification benefit. In this case, all the assets would be invested in the same basket and exposed to the same types of risks. On the other hand, it is possible to hold a **single** DFA core equity fund that is diversified across a variety of risk factors. If that fund happened to match your personal risk profile, you would already have achieved appropriate diversification. (Note, such a precise risk profile match would be unusual, although possible.)

Too many cooks — Almost all of your portfolio's risk and return is determined by asset allocation and minimizing costs. At the risk of appearing self-serving, we caution our clients against translating the need to diversify investments into the need to diversify management of those investments. When multiple managers are overseeing portions and nobody is overseeing the big picture, it becomes a significantly greater challenge to build and maintain an appropriate, effective overall asset allocation. It can also be more expensive, more time-consuming for you (as you must take on the oversight role yourself), and more likely to result in errors if the proverbial left hand doesn't know what the right hand is doing.

