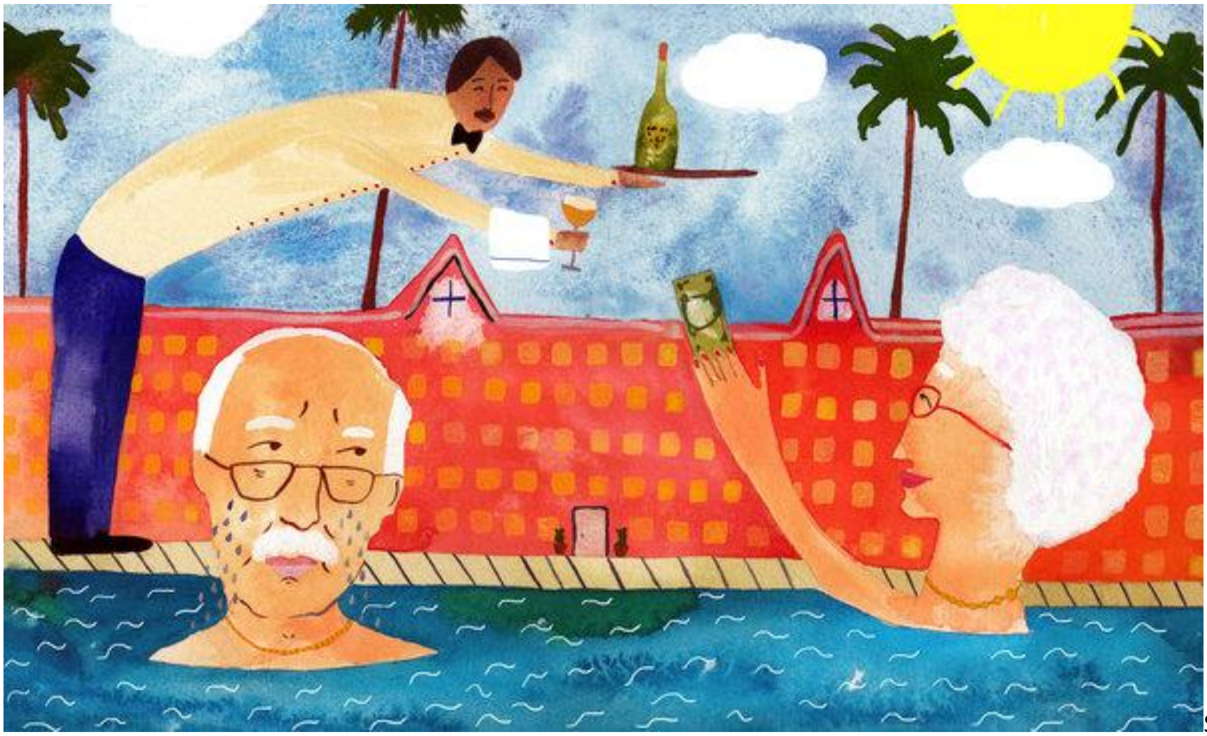
Parceling Out a Nest Egg, Without Emptying It

The New York Times


Sarah Williamson

By PAUL SULLIVAN

Published: October 16, 2012

MANY people nearing the end of their working lives may have resigned themselves to cutting back in retirement. But for the affluent and the wealthy getting on in years, this is a time to figure out how much to spend so that they neither run out of money before they die or leave too much to their children when they're gone. For the affluent, say, those who have accumulated a nest egg of $500,000 to $5 million, maybe even $10 million, the calculation is stark: how much should they budget to spend each year when they could live another 20, 30, perhaps 40 years?

For the outright wealthy, those with more than $10 million but less than $40 million, the question has a twist this year: how much of the $5.12 million exemption on gift taxes expiring Dec. 31 can they exploit now while maintaining their lifestyle for the rest of their days?

They are nice calculations to have to make, but that does not make them any less stressful for the people making them.

"With the $2, $3, $4 million folks, when they come in and want to know if they can live on that, it's a very serious conversation because there isn't a lot of room for error," said Joan Crain, senior director and wealth strategist for BNY Mellon Wealth Management. “Just in terms of coming up with a budget takes a lot of coaching. Many of them have never done that.”

What clients often forget are fixed costs — homes, cars, insurance — that must come down but take time to reduce, she said. Beyond that is her clients’ skittish approach to risk; putting all of their money in cash may make them feel safe, she said, but it probably will not support the lifestyle they want for decades.

A generational disconnect is at work here: most people plan to retire at 65, the retirement age established for Social Security in 1935, when the average life expectancy was 61. Today the average is over 80 for men and women with a college degree.

So the $5.12 million gift exemption — created in a compromise between President Obama and Congress in 2010 — presents the well-off with a decision laden with short- and long-term consequences. How much should they give heirs now — and thus avoid giving the government in estate taxes later — while maintaining their lifestyle over a probably longer but still unpredictable remaining life span?

Greg B. Davies, head of behavioral finance at Barclays, said the way people thought about investing once they stopped working was also outdated.

“The retirement industry has been telling us to dramatically reduce our risk at retirement because we don’t have income any more,” Mr. Davies said. “That’s true. But you also don’t need all the assets at once. People who dial down their risk to zero, it can be extremely harmful.”

His counsel to nervous retirees: Keep several years of expenses in cash and invest the rest of your money for the long term.

Mr. Davies challenged another bit of conventional wisdom: thinking that you will spend less in retirement — at least in the early years — than your preretirement salary.

“If you’re healthy, to think that spending 75 percent of your income, now that you have all this free time, it’s slightly ridiculous,” he said. Most people, he said, will need slightly more at retirement, not less. But then how should people do the math to avoid dying broke? The answer depends as much on timing as spending.

Mark A. Cortazzo, senior partner at Macro Consulting Group, tells clients who ask this question about three fictional brothers. Each one retired with $1 million on Jan. 1 but three years apart — in 1997, 2000 and 2003. They all invested that $1 million in the Vanguard 500 Index Investor Fund.

Between when they retired and Aug. 31, 2012, each brother withdrew $5,000 a month. The brother who had been retired the longest had $1.14 million on Aug. 31. The one who retired most recently had $1.15 million left.

But the one in the middle, who began taking his monthly withdrawals in 2000, had only $160,568. The reason? The stock market went down for the first three years he was retired, and then plummeted again in 2008. He had to sell more shares to get $5,000 each month.

"Most clients say, 'I don't mind dying broke if I'm bouncing my last check to the undertaker," Mr. Cortazzo said. "But I don't want to run out at 80 if I'm going to live to 95."

While it is unlikely that all of a retiree's money would be invested in one mutual fund, the illustration's simplicity makes a point that when you retire matters if you plan or need to withdraw the same amount each month regardless of what your investments are doing.

Mr. Cortazzo's solution is a variable annuity — under which an insurer agrees to make periodic payments to you pegged to the current value of your annuity — though he was aware of the bad reputation such annuities have among many advisers.

"Are variable annuities the end-all-be-all?" he asked. "No, they're expensive. They're restrictive on the investment options. But the income guarantee right now is in a sweet spot."

For many annuities, the annual guarantee is 5 percent of the annuity value at its highest point, down from 7 or 8 percent a few years ago. Further out on the wealth spectrum, people with tens of millions of dollars would seem to be immune from worrying about running out of money. Not necessarily, if they want to use the expiring gift tax exemption.

J. P. Morgan Private Bank's Advice Lab calculates that a 55-year-old couple with $40 million and 30 years to live could pretty much rest assured; they could give the full $10.24 million this year and have a high probability of maintaining a spending rate of $750,000 a year.

The calculation assumed they lived in New York for tax purposes and that their spending grew at 3.25 percent a year to keep up with inflation. Their assets, 10 percent of which were held in tax-deferred retirement accounts, grew at 7.7 percent a year.

For others of lesser means, it would be tricky to make a gift and still be assured of not running out of money. Consider a couple with $10 million and the same assumptions on age, life expectancy, returns and adjustments to spending. The spouses spending $250,000 a year could give away $2 million this year and have a very good chance of maintaining their standard of living, or they could give away $4 million and have a 50-50 chance of doing that.

But with the same $10 million and annual expenses of $400,000, the couple would have only a 55 to 60 percent chance of being able to maintain current spending, even without making any gifts to heirs. If the couple gave even $500,000 away this year, they would face a 50-50 chance of having to curb their standard of living.

"When you increase these assumptions out over time, and you assume volatility in the market, what we find is there is amazing sensitivity to the amount you withdraw from your portfolio," said Janine

Racanelli, managing director and head of the Advice Lab.

Various financial structures allow the wealthy to give away money without really giving it away. One is a so-called Crummey trust, often used for life insurance. It can be set up to allow someone who is worried about outliving his money to name a spouse as a type of beneficiary who can make a distribution to him later.

“If it turns out he lives longer, spends too much or has bad investments, he can say, ‘Gee, I’m running low,’ and his wife, as a discretionary beneficiary, can pay for lifestyle expenses,” said Carter Ruml, senior wealth planner at PNC Wealth in Louisville, Ky. “If she dies, she can appoint assets to the benefit of her husband and descendants.”

He added, “This is never the money you tap first because you’ve used your gift tax exemption to put money there,” he added. “But it really takes a lot of the concern away about giving too much. It’s an escape hatch.”

To many, even running these numbers on the back of an envelope is an exercise in futility. They are going to die with little or nothing regardless. But to others it is a balancing act.

Stephen Pollan, an author, life coach and lawyer, caused a stir in the late 1990s when he wrote a book advocating that people stop fretting over their estates. His book “Die Broke: A Radical Four-Part Financial Plan” (HarperBusiness) was published in 1997 when the prospect of running out of money seemed less likely.

The mantra he preached in the book — quit today, pay cash, don’t retire and die broke — could be summed up as take control of your career so you are not at the whim of an employer, don’t go into debt, stay active and transfer as many of your assets to your heirs as possible during your life. Today it may resonate even more with retirees or near retirees.

“Retirement is a nonevent,” said Mr. Pollan, 83 and still working. “It’s the height of stupidity and it’s lethal. One of the most important things in life is to have a purpose.”

He got the idea for dying broke, though, not from concerns about his and his wife’s financial situation but from a desire to buy his son, the food writer Michael Pollan, a pond for his house in Connecticut. His wife said if he kept spending money like that, they would die broke.

Mr. Pollan said he scoffed at the notion of people fretting about running out of money. “That’s looking around the corner, which you should never do,” he said. “We have small annuities, but we both still work. Working for us is the same as saying purpose. A life without purpose is empty.”

If you agree with him, keep working. If you don’t, it may be time to break out the calculator to do some serious math.