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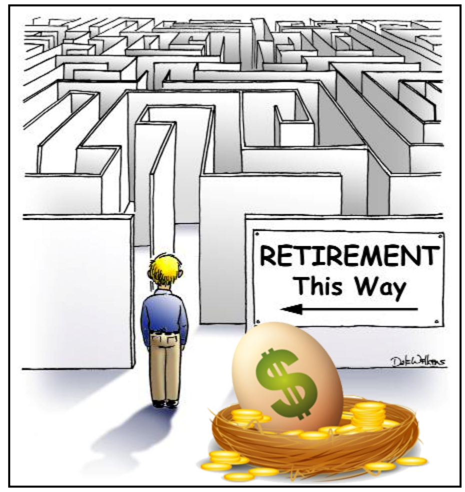
Nest Egg Economics

Navigating the Retirement Maze



"Everything should be as simple as possible, but not simpler."

– Albert Einstein, theoretical physicist (1879-1955)

As a financial planner, I can empathize with doctors who, when attending social functions, find themselves called upon as experts on whatever malady their conversation partner is suffering from. Similarly, I have become "The Retirement Expert," as my fellow Baby Boomers, approaching their so-called Golden Years, start to become concerned about a host of impending retirement-related issues. The number one question that I get asked: "Where should I be investing my retirement assets?"

My classic response, not all that different than that of the "doc-on-the-spot," is: It depends. Like most complex issues, an answer without first identifying the factors affecting such a decision – let's call it a "diagnosis of financial condition" – is usually both irresponsible and often wrong. While I certainly can't come up with a simple answer to this question, there are some principles that generally apply across the spectrum of soon-to-be retirees. So here are the basics.

It's about timing

The sooner that assets need to be tapped, the less risk one can afford to take. A 25-year old who won't be needing retirement assets for a long time can take greater market risks, and thus should be invested almost entirely in equities. Markets may fluctuate considerably over the next 40 years, but the long-term direction of the market is up. What should a 32-year old do if the market drops 40 percent? Absolutely nothing. The average gains over the next 30 years will likely more than compensate for short-term losses.

The time to get more conservative is when you will need to draw down assets in the near term. If a market correction occurs right before you have to start spending assets – such as when you retire and your investments start replacing your paycheck – selling assets at a loss means that you won't own them when the market comes back. This is why I generally favor a "bucket strategy" for clients beginning retirement – a year's worth of expenses in cash equivalents, five years in low-volatility bonds – because the assets that they sell will not be the ones that just took a huge hit, and the more volatile assets will have time to recover.

The importance of balance

While I generally encourage clients to put as much as possible each year into tax-deferred accounts, I also tell them to set targets so that they enter retirement with assets spread among three categories: tax-deferred, taxable, and tax-free (Roth IRAs). If nearly all of your assets are in tax-deferred accounts, it can lead to potential problems during retirement. Need to spend $80K on home improvements? Then you'll have to withdraw over $100K from your IRA to include the taxes due, and this withdrawal could move you into a higher tax bracket plus increase your Medicare premiums two years from now. Having available assets in taxable accounts increases your spending flexibility, and lets you better manage your marginal tax rate.

Be tax savvy

Where you place specific assets matters. As the saying goes: "It's not what you earn. It's what you keep." So most of your income producing assets (bonds, bond funds, REITs) are generally better held in tax-deferred accounts. Assets held for long-term capital gains and qualified dividends – both taxed at a reduced rate – belong in after-tax accounts. Muni bonds, because of their tax-advantaged status, should be held in after-tax accounts.

Roth IRAs are excellent tax-free investment vehicles and increase your spending flexibility during retirement. However, whether it makes tax sense to contribute to or convert to a Roth IRA in a given year depends upon current and projected future tax brackets, among other factors. Look for opportunities to do this in years where contributing or converting to a Roth IRA makes tax sense.

And a few final rules…

- Keep your fees low – Obvious, but important.
- Diversify – Broader global exposure will most likely give you better long term performance than just using an S&P 500 index fund. The same is true for bonds, diversified both globally and across bond types. You can usually achieve this kind of diversification with as few as six funds.
- Rebalance asset classes annually – Sell some of your winners to buy more of last year's losers. It's essentially a form of "dollar cost averaging," and it works over the long term.
- Stick to your plan – Don't get scared out of the market because of a down year, nor should you chase performance. According to a recent survey by DALBAR, bad market timing by individual investors resulted in average annual returns of 3.7% over a 30-year time period, while the S&P 500 returned 11.3% annually. Expressed as total return, the average investor tripled their assets during that time period, while the buy-and-hold investor made nearly 24 times their investment.

There isn't any real magic to sensible retirement investing. The challenge is sticking to your long-term plan when your emotions tell you to do otherwise. Consistency is how you win the game.

George Gagliardi is a fee-only financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.

Coromandel Wealth Management
15 Muzzey Street
Lexington, MA 02421

Phone: 781.728.9001
info@CoromandelWM.com
www.CoromandelWM.com