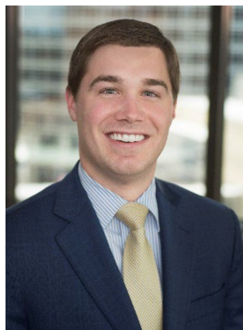
Legacy Trust

Investment Perspectives

Portfolio Structuring Considerations

September 2021



Brian Balke, CFP®, CIMA®
Wealth Advisor/Portfolio Manager

Key Takeaways

- Portfolio construction in retirement is tied to your overall financial picture and your expected income needs
- The different tax treatment of your various savings buckets can provide investment opportunities to maximize your after-tax returns
- Asset allocation decisions have a significant impact on the overall success of the investment plan

Many investors begin to look to their savings and investments for regular income when they transition from a working career to retirement. Personal financial planning considerations including expected income needs play a significant role in setting an investment plan for your overall portfolio and for how it should be implemented across your various pools of funds.

When we think about the transition from a working career to retirement, one of the first things that comes to mind is, how do I turn my investment portfolio and other retirement savings into a paycheck? My colleague, Brian Moore, recently posted an article on our website regarding Social Security and how impactful that benefit is in retirement. Outside of guaranteed income sources, such as Social Security or a pension, most retirees must rely on their savings to fund their lifestyle in retirement. This bucket of dollars is typically made up of all or a combination of the following: checking/savings accounts, taxable investment accounts and retirement accounts (Traditional 401k/403b/IRA and/or Roth 401k/403b/IRA). Before we start thinking about how to structure the portfolio, let's quickly define each of the above buckets.

Checking/Savings – consists of highly liquid, after-tax dollars that are readily available. This is usually where an "emergency fund" might sit. The benefit is that these dollars are available at any time and provide peace of mind, the downside is these dollars really don't appreciate in value, especially in today's low interest-rate environment.

Taxable Investment Accounts – this type of account can take a number of different forms (such as Investment Management Account (IMA), Joint Tenancy with Rights of Survivorship (JTWROS) or Living Trust. The common denominator in all of these vehicles is that the funds are made up of after-tax dollars with no income-tax strings attached. Income and capital gains are taxed on these investments, but distributions are not taxed as income like the below described retirement accounts.

Traditional Retirement Account – These can have a variety of names (IRA, 401k, 403b, SEP, SIMPLE) but all have the same general guidelines. A Traditional IRA allows the investor to grow dollars tax-free until age 72. Upon reaching age 72, the account owner must take out a required amount each year, a Required Minimum Distribution. This amount and all other distributions are subject to ordinary income tax unless dollars are sent directly to a charitable organization via a Qualified Charitable Distribution (QCD). Upon the death of the account owner, any amounts not inherited by a living spouse must be withdrawn within a 10-year period, forcing the realization of the full tax liability.

Roth Retirement Account – this type of retirement savings entity is newer than its Traditional counterpart. The Roth-style retirement account can be found in some 401k/403b plans but also can be funded directly through a Roth IRA. A Roth IRA allows the investor to put after-tax dollars into the account and then grow them tax-free, forever. Even when the dollars are ultimately passed down to heirs, the tax-free nature remains. If you have access within a retirement plan or meet the income requirements to fund a Roth IRA directly, these are great entities to think about putting some dollars into.

Now that we have defined the major savings vehicles, let's look at how a retiree might structure their portfolio in preparation for retirement.

Assumptions:

Family
- John (72) and Linda (72) Smith
- Three children (Jack (46), Ben (44) and Olivia (42)

Income Sources
- Social Security:
  - John - $36,000 annually
  - Linda - $24,000 annually
- Pension:
  - John - $18,000 annually
- Annual Required Minimum Distribution:
  - John - $47,000
  - Linda - $17,500

Annual Expenses
- $175,000

Emergency Fund
- $100,000 (bank account).

Investment Portfolio
- Living Trust Investment Account: $650,000
- John Traditional IRA: $1,200,000
- Linda Traditional IRA: $450,000
- John Roth IRA: $80,000
- Linda Roth IRA: $120,000

Income vs. Expenses
- Total Income: $142,500
- Total Expenses: $175,000
- Shortfall: $32,500

Source: FactSet Research Systems

As we think about the portfolio, we know that dollars are going to be coming out of the Traditional IRAs each year to meet the Required Minimum Distributions (RMDs). Outside of the RMDs, some liquidity will also need to come from elsewhere to fund the income shortfall. The logical place for those to come from is the taxable bucket, which allows more control over the tax ramifications and keeps funds invested in the tax-free Roth IRAs. Based on the Smiths' total portfolio and distribution needs, they are taking about 4% ($97,000/$2,500,000) out each year. This is a very manageable number (for more information, see Danielle Parmenter's blog post on our website discussing capital adequacy for more context) and provides some flexibility on what amount of investment risk they will need to take on to achieve their goals.

When we contemplate the Smiths' risk profile they have a long-time horizon; figure 20+ years for at least one of them. The annual liquidity needed is also very manageable at around 4%. Based on the current interest rate environment, my suggestion would be to structure a 70% equity / 30% fixed income portfolio for the Smiths. However, we would look to take advantage of the different account characteristics and distribution needs when building out the portfolio.

Below is a high-level graphic of how we might suggest structuring the Smiths' total portfolio.

John and Linda Smith Total Portfolio

Asset Class	Market Value	% of Total
Equity	$ 1,750,000	70%
Fixed Income	$ 625,000	25%
Cash	$ 125,000	5%
Total Portfolio	$ 2,500,000	100%

John and Linda Smith - Living Trust

Asset Class	Market Value	% of Total
Equity	$ 500,000	77%
Fixed Income	$ 110,000	17%
Cash	$ 40,000	6%
Total Portfolio	$ 650,000	100%

John and Linda Smith - Traditional IRAs

Asset Class	Market Value	% of Total
Equity	$ 1,052,000	64%
Fixed Income	$ 515,000	31%
Cash	$ 83,000	5%
Total Portfolio	$ 1,650,000	100%

John and Linda Smith - Roth IRAs

Asset Class	Market Value	% of Total
Equity	$ 198,000	99%
Fixed Income	$ -	0%
Cash	$ 2,000	1%
Total Portfolio	$ 200,000	100%

A closer look at the Taxable Portfolio: The taxable account provides immediate access to funds and the ability to control tax consequences. The use of individual stocks allows for selective realization of capital gains and where appropriate, municipal bonds avoid the taxation of interest payments. We would keep ample fixed income and cash on hand to cover the roughly $32,500 annual need over and above the annual distributions from the IRAs.

A closer look at the Traditional IRAs: The Traditional IRAs provide numerous options for investments since any trades or income realized within the accounts are not immediately taxed. However, we are required to take certain dollars out each year as RMDs. As stated earlier, these distributions are taxed at the owner's ordinary rate unless funds are sent directly to charity. The investment flexibility allows us to use tax-inefficient assets such as, dividend yielding mutual funds, opportunistic fixed income and taxable bonds. We would look to have a higher allocation to fixed income and cash here since the accounts are relied upon for distributions and this is not the optimal spot within the portfolio for growth due to the taxation of the withdrawals.

A closer look at the Roth IRAs: While the smallest entity in market value of the bunch, you could argue the Roth IRAs could be the most impactful down the road. These accounts are really the engine for growth within the portfolio given their tax-free nature. The goal here would be to invest for growth and not draw from this bucket unless absolutely necessary.

By breaking down the portfolio this way, optimizing each bucket and maintaining sufficient stable assets, we can feel confident that the Smith family is in good shape today and for many years to come. You will notice we really didn't make mention of the underlying investments themselves but focused on the allocation and how to bucket different assets based on growth expectations and tax consequences. A properly structured portfolio can go a long way in terms of overall performance and tax management. If you are thinking about retirement or concerned that your portfolio may not be properly coordinated based on your unique goals and needs, please reach out to a Wealth Advisor at Legacy Trust and we would be happy to have a conversation.