Employees nearing retirement face a critical and often daunting assignment: how to manage a smooth segue out of a full-time career and into a financially secure retirement. One key to mapping out a successful transition is figuring out how to replace a reliable paycheck with multiple retirement income sources, including paychecklike sources such as Social Security as well as withdrawals from investment accounts.

Employees today face retirement income challenges unlike anything seen by prior generations. Gone are the days when an investor retired after 35 years at the same job to live off a generous lifetime pension and the safety and security of lifetime income from Social Security. For several decades, employers have been shifting from defined benefit (DB) plans, better known as traditional, employer-paid pension plans, to defined contribution (DC) plans, including 401(k), 403(b) and 457 tax-deferred savings plans. This epochal makeover of the retirement plan environment has pushed considerably more responsibility for both retirement funding and distribution planning onto the employee.

Given the ongoing DB-to-DC transition, it’s more critical than ever for employees to be able to pensionize their retirement investment accounts—their DC plan accounts and individual retirement accounts (IRAs)—as part of an effort to generate dependable, lifetime retirement income. Many investors have come to view their total assets in these accounts as one lump sum and focus primarily on continued preservation and protection of the nest egg from fluctuating markets. Such a mind-set can be counterproductive to lasting retirement security.

Before starting work on designing a strategy for retirement withdrawals from investment accounts, near-retirees need to be able to see and understand their total retirement picture. They need to figure out how to fit various pieces of their retirement puzzle together to create the desired result:

**AT A GLANCE**

- Employees nearing retirement face the challenge of turning multiple retirement income sources into dependable, lifetime income.
- Through retirement planning education, employers and plan sponsors can minimize employee stress over retirement finances. In turn, this can lead to healthier employees and improved productivity.
- Employees should define retirement goals, estimate how much income will be needed, identify retirement income sources, implement the plan, and then monitor and update the plan as necessary.
- Options for distributions generally include tapping savings; minimizing withdrawals by relying on Social Security and a defined benefit plan, if available; limiting withdrawals to investment income; purchasing one or more annuities; and systematic withdrawals from investment accounts.
an income that will enable them to be financially secure for the rest of their lives.

Research suggests that employees could use some guidance on retirement income planning. The DB-to-DC shift, the Great Recession, a general distrust of financial firms, and the proliferation of complex and costly investment products have led to a lack of confidence among near-retirees, and many are not taking the necessary steps to prepare for retirement. Only 38% have estimated how much monthly income they would need in that life stage. A similarly insufficient 34% have estimated what their expenses will be in retirement. The numbers indicate that few people are adept at the financial planning skills necessary for converting their savings into the retirement income they’ll need.

While increasing numbers of employees bear most of the responsibility for planning, saving and investing for their retirement, plan sponsors and financial institutions can assist by providing older workers with information and tools for building a viable strategy not just for DC plan and IRA withdrawals but also for payouts from all retirement income sources. By offering retirement planning education to workers, plan sponsors can minimize employee stress over finances—and lower stress levels can lead to healthier employees and greater productivity. Also, for the plan sponsor, retirement planning education can drive a higher return on investment (ROI) on benefit plan spending.

Employees Can Follow These Five Steps Toward Smarter Retirement Income Planning

Employees, especially those within ten years of retirement, can benefit significantly from following a five-step approach to retirement income planning. We’ll present the framework for that approach here.

1. Define Goals
   Retirement planning should always be founded on a clear understanding of the employee’s goals for retirement. Those goals will likely include retiring by or at a given age, but more comprehensive planning requires a deep dive into quality-of-life issues. For example, where will the retiree live? How will retirees spend their time? Will they do volunteer work? Maybe work at a part-time job?

   In a goals-based planning scenario, retirement goals should be prioritized, with each goal categorized as essential, preferable or discretionary. Each category can be assigned a probability of success expressed as a percentage; this can drive the funding of goals within the category. Here are examples of each goal category:
   - **Essential goals** (95% probability of success). An essential goal in retirement entails being able to afford basic expenses such as food, shelter, clothing and health care.
   - **Preferable goals** (75% probability of success). An example of a preferable goal is an overseas vacation each year during the first ten years of retirement.
   - **Discretionary goals** (50% probability of success). A discretionary goal might be something like a vacation home.

2. Estimate How Much Income Will Be Needed
   Given the employee’s goals, what is the bill for retirement likely to come to? In estimating retirement expenses, care must be taken to account not just for regular monthly spending but also for:
   - Life expectancy
   - Potential costs of health care and custodial care
   - Other spending not likely to occur every month, like holiday spending on gifts and travel
   - Tax projections.

3. Identify Retirement Income Sources, and Formulate a Plan for Generating Required Income
   For any employee, zeroing in on an appropriate retirement income plan requires identifying various sources of retirement income and testing various strategies for generating the required amount of lifetime income. All potential income sources should be accounted for, including (but not necessarily limited to) the following:
   - Social Security
   - Pensions from employers or the government
   - Distributions from investment accounts
   - Annuities
   - Rental or other business income
   - A reverse mortgage
   - Part-time work.
4. Implement the Plan

Once the finishing touches have been made to a retirement income plan, the plan is ready to be set in motion.

5. Monitor the Plan, and Update It as Necessary

The plan sponsor or financial institution should ensure that employees will have ongoing, professional guidance on carrying out their retirement income plans. Even if an employee has been provided the best possible plan, backed by a thorough analysis of goals, income and expenses, major life changes will necessitate periodic reviews of the plan, and revisions will need to be made to reflect new circumstances and objectives.

Options for Receiving Distributions From Investment Accounts

Retirees’ approaches to using savings as a source of retirement income generally include the following:

- Tapping savings to pay for current living expenses without much planning (This approach poses the highest risk of outliving savings.)
- Minimizing withdrawals in favor of relying mostly on Social Security and perhaps DB plan benefits
- Limiting withdrawals to income generated by investments
- Using savings to purchase one or more annuities to deliver guaranteed lifetime income (The guarantee assumes that the annuity provider remains able to meet its financial obligations.)
- Systematic withdrawals from investment accounts, including Internal Revenue Service (IRS) required minimum distributions.

A Closer Look at Systematic Withdrawals

The most commonly used retirement income methodology is the use of an accumulation-focused investment portfolio with systematic withdrawals of both principal and income. Systematic withdrawals typically follow one of the following approaches:

- **Straight-line.** A viable annual withdrawal amount is determined based on an assumption about the average annual return that the employee will earn on investments.

The key downside to this approach is that it doesn’t account for any fluctuation of investment values.

- **Trinity study.** This involves calculating a viable, inflation-adjusted, annual withdrawal rate that will provide the retiree with enough income to live on for life. The calculation does account for fluctuation of investment values, but survival of the portfolio is based only on past market returns. The primary drawback of this approach is that past performance is not necessarily an indicator of future performance. The phrase *Trinity study* refers to the article “Retirement Spending: Choosing a Sustainable Withdrawal Rate” written by three professors at Trinity University and published in 1998 in the *Journal of the American Association of Individual Investors*.

- **Monte Carlo simulation.** This approach forecasts the probability of achieving a particular level of lifetime income, given many possible combinations of portfolio size, asset allocation, portfolio returns, annual withdrawals, inflation and time horizon. The objective is to determine an inflation-adjusted, annual savings withdrawal rate that will provide the retiree with enough income to live on for life. The main flaw of this approach lies in the fact that once the rate of spending is set, it is not adjusted for changes in the financial markets or the employee’s financial situation.

- **Spending in the context of a retirement plan.** A Monte Carlo simulation is used to determine an inflation-adjusted, annual withdrawal rate that will provide the retiree with enough income to live on for life. The difference here is that this more advanced approach accounts for fluctuations in the financial markets as well as in the retiree’s actual spending based on changes in financial condition or life cycle. This option is preferred due to its flexibility but requires ongoing analysis and planning to be successful.

Evaluating Potential Retirement Income Strategies

In step three of the five-step approach outlined above (identify retirement income sources, and formulate a plan for generating required income), multiple retirement income sources and strategies are identified. Each strategy then gets analyzed in terms of the following key factors:
• The projected amount of income to be generated
• The ability to shield against common risks, including:
  —Market risk
  —Inflation risk
  —Longevity risk (the risk of outliving retirement assets)
  —Death of the spouse
  —Changes in tax laws or other laws or regulations affecting retirement plans or Social Security.
• Minimizing investment expenses
• Tax planning
• Flexibility and ease of management
• Legacy planning.

No single strategy is likely to achieve a perfect score in such an analysis. The goal is to find a balance among strategies that allows an employee to minimize risk and meet financial goals while still getting sleep most nights.

Employees Can Benefit From Unbiased Financial Guidance

Deciding on an appropriate retirement income strategy—one that incorporates a plan for distributions from investment accounts—is an essential aspect of employees’ retirement planning. Using an objective financial advisor to assist employees in this effort can increase the odds that the employees will be able to make informed decisions that will have lifetime rewards.

Endnote