

Retirement questions

Retired? Nearing Retirement? Some answers to how you can respond to financial market turmoil.

If you're approaching—or already have crossed—the finish line to retirement, you should focus on meeting two goals. One, providing yourself with an income that will let you live comfortably, and, two, making certain that your retirement resources will last for your lifetime. Today, when your retirement savings are apt to have been diminished by the market downturn, meeting those goals is a greater challenge than ever.

Here are a few of the questions that you are likely to be asking yourself, and some answers:

What resources should I tap?

The main sources of funds to generate retirement income are the retiree's taxable investment portfolio and tax-qualified retirement plans [an IRA or 401(k) plan, for example]. These sources supplement Social Security benefits, or a pension, or both. The rate at which a retiree makes withdrawals and his or her portfolio return each has a role in determining how long a retiree's savings will last.

From a tax perspective, continuing to shelter retirement assets from tax for as long as possible should be the best approach, tapping taxable accounts first, followed by traditional IRAs and then Roth IRAs. (If all the requirements are met, Roth IRA withdrawals are tax free.) A study by Professor William Reichenstein of Baylor University supported that conclusion. In his model Professor Reichenstein kept the asset allocation and withdrawal rate constant. Withdrawals came in this order: (1) the minimum amounts required to be distributed from a traditional IRA or company retirement plan, generally beginning at age 70-1/2*; (2) bonds and then stocks from taxable accounts; (3) stocks and then bonds from Roth IRAs; and (4) stocks and then bonds from the balance of the tax-qualified plans. This strategy consistently extended the life of retirement resources from roughly two to five years longer than a strategy that tapped retirement accounts first.

Although this order offers a reasonable rule of thumb, it may not apply for every retiree every year. For example, in a year when a retiree has extensive tax-deductible expenses that reduce taxable income significantly, his or her tax rate may be low. It then may make sense to take advantage of it by tapping taxable accounts first. The game plan of taking the minimum required amount from an IRA may be revised, too, to include larger withdrawals in order to take advantage of the low rate.

How much should I tap?

Studies have suggested that, with a 4% withdrawal rate and 3% annual adjustments for inflation, retirees stand an excellent chance of having enough savings to last for 30 years. (Whether 4% gives the retiree enough dollars to live on is another question.)

Right now, at a time when many retirees' savings have taken a significant hit and their portfolios are underperforming, it's only natural to wonder to what extent these studies can be relied upon.

Suppose a retiree had \$1 million in savings during his or her first year of retirement. Using the 4% rule of thumb, he or she withdraws \$40,000 in year one and \$41,200 in year two. But what if year two were 2008, and the retiree experienced losses that reduced his or her savings to \$800,000? Using the same withdrawal strategy, the odds of draining his or her resources rise dramatically.

According to T. Rowe Price research, if the retiree's portfolio is invested 55% in stocks and 45% in bonds, and the market gains an average 4% to 6% a year over the next five years, that 20% drop in savings leaves the retiree with a 49% chance of depleting his or her savings prematurely. With a 30% loss, the number rises to 79%.

What can retirees do while awaiting better times? Choices can be limited, and may be unpleasant. If a retiree enjoys being busy, perhaps part-time employment. Another thing to consider, if you are on required minimum withdrawals* (RMD) and you take funds above the RMD, reduce the distribution to only the RMD.

What place should stocks have in my portfolio?

Traditionally, many investors consider retirement a time to pull back from the market as they retire and seek a reliable, stable source of income. Recent market volatility, too, may lead some to reduce the portion of their portfolios allocated to stocks and move to what they consider to be safer territory. But is that the right course of action?

"This time is different" is a common phrase right now. But, even so, taking a historical perspective suggests that abandoning the market completely can mean lost opportunities. The S&P 500** was down 38.5% for 2008.

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But investors saw similar drops on at least two previous occasions: from January 1973 to October 1974 (-48.2%) and from March 2000 to October 2002 (-49.2%).

Yet stock market rallies can come quickly and unexpectedly. After the 1973-1974 bear market, the S&P rose 37% in 1975 and after the 2000-2002 market, 28.7% in 2003. When an investor is out of the market, he or she loses the chance of taking advantage of what might prove to be a significant run up.

Then, too, market indices only tell part of the story. Although stock and mutual funds showed losses across the board in 2008, the damage wasn't uniform for all of them. Certain sectors fared better than others. Some sectors may be poised for a quicker recovery in 2009. But which ones? We recommend that you seek out our professionals, who have the knowledge and research capabilities to help give you the guidance that you need to make the informed decisions.

What fixed-income investments should I be considering?

Typically, a retiree who seeks a regular source of income at a relatively low risk turns to bonds. But today the right choices may not be as clear-cut as they once were.

Because of a rush to "safe" investments, yields on Treasury bonds and notes have fallen dramatically. Maturities of under three years were coming in at less than 1% in December 2008 and even 30-year bonds were under 3%. These low yields pose a problem when the market recovery begins. As yields rise, the market value of existing bonds will fall. Retirees who need to sell lower-yield Treasuries will face losses.

Although inflation has slowed (with talk of deflation in the air), rates are bound to rise at some point. Buying bonds at their current yields offer little protection. Treasury Inflation-Protected Securities (TIPS) may be the solution for some investors. At the end of 2008, TIPS yields ranged from 1.81% for five-year TIPS to 2.36% for those with a 20-year maturity. But unlike regular Treasuries, prices and payouts of TIPS are adjusted twice a year to compensate for any inflation. Tax alert: Payments of interest is taxable, as is any increase in the value of principal, even though an investor has not actually received a payout that would cover the tax on the latter amount.

Corporate bonds are offering more attractive yields. But in the current economy, with the chance of bankruptcy for even corporate giants, investors are exposed to greater risk.

By comparison, municipal bonds historically have been considered to offer minimum risk because state and local governments have much lower default rates than corporate bond issuers. Generally, because state and local governments pay income that is exempt from federal tax, yields on tax-exempt municipal bonds have been lower than those for Treasuries. Yet, because some investors have been shying away from them in recent months, munis have been yielding as much or even more than taxable Treasuries.

One reason is that munis may no longer give investors the sense of security that they once did. The high ratings by credit agencies have been called into question after the subprime mortgage crisis. Another factor is the growing fear that financially strapped cities and states may have trouble meeting scheduled interest payments on their bonds. There is also fear that cities, hospitals and transportation systems could default on their obligations. And add in the call risk factor, too: If munis become more popular (a strong possibility if taxes go up), a municipality may buy back its bonds in order to reissue new ones at lower rates. One solution may be to stay with state general obligation bonds rather than local issuers that might not be as creditworthy and to seek out municipalities that are standing on firm financial ground.

Where can I find unbiased, informed guidance?

In times such as these, you can turn to our investment advisors to analyze what the recent drastic changes in the financial markets could mean to your future investment course. These professionals understand the importance of prudent investing and your desire for unbiased advice. They are committed to helping you find the path that will allow you to reach your goals at a risk level that you find appropriate.

Contact us at any time to set up an appointment for a portfolio consultation. We look forward to hearing from you.

*2009 Required Minimum Distribution rules have changed. Please call us for additional information on this important topic.

**References to market indices are for illustration only. Investors cannot invest directly in any index.

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A Division of Salisbury Bank and Trust Company

19 Bissell Street
Post Office Box 1868

Lakeville, Connecticut
06039-1868

t: 860.435.9801
t: 800.222.9801

f: 860.435.5224
www.salisburybank.com