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Before You Open That Nest Egg …

Ten questions to ask before taking the first dollar out of your retirement savings

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A steady paycheck is one of life's comforts. Once or twice a month, the money lands reassuringly in your lap. Until, that is, you retire. And then it stops. Suddenly, unless a traditional pension is close at hand, you are the one who has to make sure that the money lands in your lap. And you -- and those who depend on you -- will suffer if you don't.

That means, among other steps, calculating your income needs and whether your nest egg is big enough to support them; it means deciding which assets to tap and when. And it means designing a plan that keeps the paychecks coming -- for a retirement that could last 30 years or more.

After decades of saving for later life, millions of Americans are getting ready to crack open their nest eggs. But are they ready? We asked financial advisers across the country to identify the most important questions investors should ask themselves before withdrawing dollar one from their savings. If you can answer these questions, or simply consider these issues, your chances for a secure retirement should be better than most.

PODCAST:

Estimating expenses in later life can be one of the hardest parts of planning for retirement. **WSJ's Glenn Ruffenach interviews Brian Puckett, who runs a financial-services firm in Oklahoma City.** They discuss suggestions on how to project your living expenses decades into the future.

http://mp3.marketwatch.com/wsj/audio/20051208/pod-wsjruffenach/pod-wsjruffenach.mp3

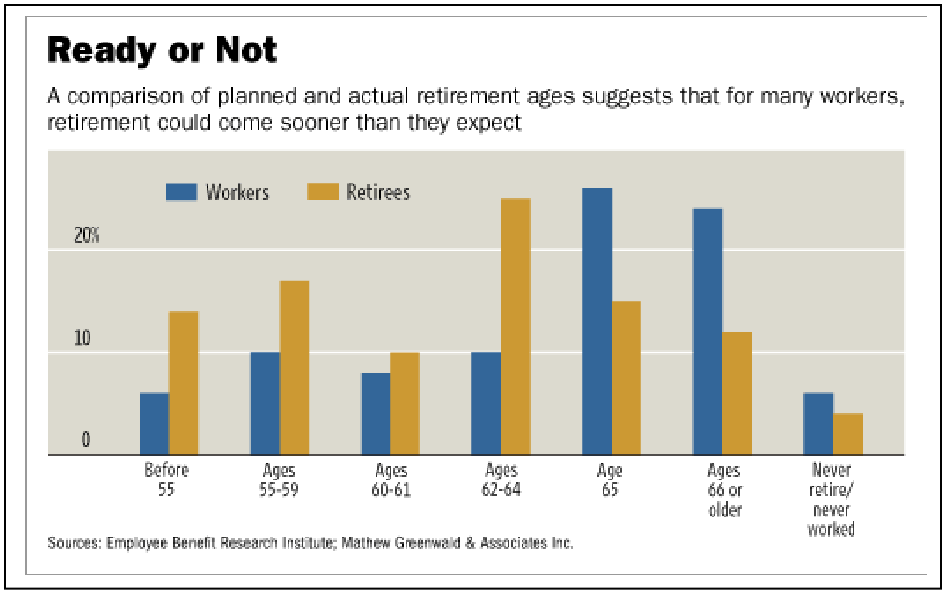
#1 -- Am I starting at the right time?

Ideally, the decision to begin tapping a nest egg is one that's been carefully planned over the course of several years. Often, though, the spark is something simple: a birthday.

Many Americans begin dipping into their retirement savings at age 62, or thereabouts. That's the age, of course, when people can first file for Social Security benefits; thus, it's about the age at which many workers retire. (The average retirement age in the U.S. is 61.6 for men and 61 for women, according to Murray Gendell, a research professor at Georgetown University.)

As appealing as early retirement might sound, it could put considerable strain on your savings. For example: Do you still have a mortgage? Most financial planners recommend paying off as much debt as possible before tapping a nest egg, so debt payments don't eat up your savings. What about health insurance? Medicare, unlike Social Security, isn't available until age 65 for most people. What kind of medical coverage -- if any -- do you have for the gap between ages 62 and 65, and how much will that cost?

The point: "Even a wait of two or three years [before tapping a nest egg] could make a real difference in retirement," says Christine Fahlund, senior financial planner at T. Rowe Price Group Inc., the Baltimore-based investment-management firm. "Every extra year, hopefully, your money has an opportunity for growth."



You also should investigate whether your employer offers, or is willing to consider, a "phased retirement," in which you reduce the number of hours you work but still draw a paycheck. Again, such an arrangement could give your retirement savings additional breathing room. A study in 2003 by Robert M. Hutchens, a professor of labor economics at Cornell University, found that 73% of employers were open to phased retirement, primarily on an informal basis.

#2 – Can I do this myself, or should I get help?

Yes, you can -- and yes, you should.

Almost every financial expert we interviewed said investors are capable of tapping their nest eggs on their own. Indeed, all efforts to create a paycheck in retirement -- whether you do it by yourself or have someone do it for you -- are much the same: siphoning money each month from a "bucket" (a cash reserve, a mutual fund, certificates of deposit) and refilling that vessel, on occasion, with investment gains from other "buckets."

For example, "a retiree with everything in one mutual-fund family," says Ron Kelemen, a certified financial planner in Salem, Ore., "would set up an automatic withdrawal program from a middle-of-the-road fund or a low-risk fund and periodically replenish it from a more aggressive fund."

That said, there are some good reasons why here, if at no other point in your financial life, it's worth spending time with an adviser.

Start with the various pieces of your nest egg. The sheer variety of assets held by many investors these days -- 401(k)s, individual retirement accounts, insurance policies, real estate, taxable savings accounts -- can make it difficult to know when and why to tap particular investments. (More about withdrawal strategies and taxes in a moment.) At the same time, Uncle Sam is doing his best to keep retirement planning as complicated as possible. Consider the following instructions from the Internal Revenue Service regarding mandatory withdrawals from IRAs:

"You must receive at least a minimum amount for each year starting with the year you reach age 70½ (your 70½ year). If you do not (or did not) receive that minimum amount in your 70½ year, then you must receive distributions for your 70½ year by April 1 of the next year."

Got that?

Financial guidance, of course, can be expensive. An adviser might bill by the hour, set a flat fee (say, $3,000 for a financial plan) or collect a percentage of the assets being managed (a 1% management fee on a $1 million nest egg would cost you $10,000 each year). To keep things simple, and relatively affordable, first try sitting down with a financial adviser who charges by the hour. (Among other sources, the Garrett Planning Network, at garrettplanningnetwork.com, can point you to such individuals.)

Ideally, several visits (at a cost of $100 to $200 an hour) will help you determine whether you want to manage and tap your nest egg on your own, or whether you want a financial adviser, or perhaps a mutual-fund company, to handle the job. Firms like Vanguard Group Inc., Fidelity Investments and T. Rowe Price are more than happy to manage your retirement savings and help generate a monthly check. If you end up working with a financial planner, his or her annual fee certainly should be no more than 1% of the assets under management.

"Can you [tap retirement savings] yourself? Sure," says Clark Randall, a certified financial planner with Lincoln Financial Advisors in Dallas. "But ask yourself three questions: Do I have the interest in doing this myself? Do I have the expertise? And do I have the time? If the answer to any of those is no, you might want some help."

#3 – What are my plans for my nest egg?

Look down the road. Would you like to see your nest egg maintain its size -- or get bigger -- as you age? Would you like to leave some of your money for your children or charity? Or do you plan to spend it all?

Clearly, investors who have no plans to leave an inheritance might be able to pull more money each year from their savings (and perhaps enjoy a more comfortable retirement) than a couple, for instance, who wish to pay for their grandchildren's education. Consider this example:

Two retired couples, each with a life expectancy of 20 more years, have $1 million in savings. The first couple would like to withdraw some money from their nest egg to supplement a pension, but they also want to leave, if possible, $1 million to their children. (In other words, the principal would be left intact.) The second couple, in contrast, thinks their kids already are in good financial shape; they plan to use every penny of the $1 million for their own retirement.

So, how much can each couple withdraw from their respective accounts the first year (assuming both accounts earn 8%, both couples pay 33% in taxes, and the amount withdrawn each year increases by the rate of inflation)? The first couple: about $12,000. The second couple: about $59,000.

#4 – Have I estimated my expenses in retirement?

Almost every financial adviser we spoke with said one of the first assignments they give clients approaching retirement is estimating annual expenses. Simply put, if you don't know what your bills might be each month or each year -- for both essential and discretionary items -- you won't know how much money you can withdraw safely from your nest egg. (Assuming, of course, that you would like your savings to last as long as you do.)

And yet, people are hesitant to take this critical step.

"It gets very emotional," says Norman Boone, a certified financial planner and president of Mosaic Financial Partners Inc. in San Francisco. "People say, 'I've always had the right to spend whatever I wanted.' But [in retirement], you have a finite amount of resources. People resist and resent that."

The key here is to be as specific as possible. Brian Puckett, a lawyer and accountant who manages his own financial-services firm in Oklahoma City, presses his clients to go beyond the basics (like utilities, insurance, food and transportation) and estimate what their dreams might cost and when the bills might kick in. "I'll ask them, 'When is that trip to Spain going to happen?' " he says. "And then we'll pencil that in and budget for that."

HOW MUCH TO LIVE ON

None of this is easy; many people aren't sure what their expenses might be next weekend, never mind 20 years from now. At the very least, though, "we try to get people to start" this process, Mr. Puckett says. "What's the monthly amount [of money] you're going to need? What's coming in? And where's the shortfall? That's crucial."

Any number of mutual-fund companies, Web sites and books offer worksheets to help estimate expenses in retirement. One example: Financial Calculators Inc. On the home page of the Web site -- Fincalc.com -- click on "ConsumerCalcs" and scroll down to "Retirement." Then click on: "How will retirement impact my living expenses?"

#5 – Do I understand my options … and the possible pitfalls … when leaving work and taking my nest egg with me?

Most nest eggs first take shape and reside within your employer's retirement program, whether it's a profit-sharing plan, a 401(k), or some other type of savings vehicle. Before you can start tapping that nest egg, you need to understand your options for getting it out of your employer's hands and into your own.

And it's not always as simple as: "Well, I'll just roll my money into an IRA."

Let's say your 401(k) contains company stock that's appreciated in value. Rolling that stock into an individual retirement account could mean that the proceeds eventually are taxed at ordinary rates; placing the stock in a separate account could allow you to take advantage of lower capital-gains taxes. Or, let's say you plan to retire before age 59½. If you roll over a 401(k) into an IRA and then tap those funds, Uncle Sam will collect ordinary taxes on the withdrawal -- and slap you with a 10% penalty. That's the fine the IRS levies on people taking early withdrawals from tax-deferred accounts.

(Yes, there is a way around that problem -- by means of a 72(t) payment, so named for the relevant section in the Internal Revenue Code. For more information online, visit 72t.net.)

If, in the end, you decide to move your savings into an IRA, such transfers come with their own land mines. A rollover, for instance, must be completed within 60 days of when the money comes out of your 401(k); if you take longer, the whole amount could be taxed. And the "receiving" IRA must be eligible to accept the assets. Example: A 401(k) can be rolled into a traditional IRA, but not into a Roth IRA. (If a Roth is the desired end, you must first move your 401(k) into a traditional IRA, and then convert the assets to a Roth IRA, paying tax on some or all of the amount involved.)

Returning, for a moment, to the idea of tapping a nest egg on your own or getting help: The fact that your retirement fund at work likely represents the biggest part of your savings argues for sitting down with a financial planner before making any moves. The stakes are simply too high.

"It seems that a week doesn't go by without hearing some rollover horror story where someone has lost his or her IRA," says Ed Slott, a Rockville Centre, N.Y., tax adviser who specializes in IRAs.

#6 – What is a realistic rate of withdrawal from my savings?

The key word is "realistic." Many Americans approaching retirement still think they can pull more money out of their savings each year than is prudent.

The number heard most frequently among retirement planners is 4%. That figure is based primarily on research by William Bengen, a certified financial planner in El Cajon, Calif. In other words, if your retirement savings total $1 million, you could withdraw $40,000 the first year. Assuming that a good chunk of your nest egg -- about 40% to 60% -- remains invested in equities (to help your savings keep pace with inflation), a 4% rate of withdrawal, according to Mr. Bengen, means your nest egg has a good chance of lasting as long as you do.

Remember, that's a starting point. Some planners say 3% is a safer figure these days, given that market returns in coming years are expected to hover in the single-digit range. Others say a withdrawal rate of 5% could be acceptable in the early years of retirement, when people are likely to be more active -- as long as they're prepared to trim withdrawals in later life. Age, health and family history will be part of the equation, as well; if you're in poor health, and if your parents and grandparents all died before their peers, that might argue for a higher initial rate of withdrawal on your part.

But again, 4% is the figure around which most realistic withdrawal strategies revolve. The problem, says Ms. Fahlund at T. Rowe Price, is that would-be retirees still set their sights too high.

"People prefer [withdrawal rates of] 6% to 7%," Ms. Fahlund says. That's an improvement, she notes, from the late 1990s, when retirees -- still enjoying the fruits of the bull market -- talked about withdrawal rates as high as 12%. But even rates of 6% to 7%, she says, could drain your savings prematurely.

"It's the biggest mistake [retirees] make," Ms. Fahlund says. "They withdraw too much initially."

#7 – Do I have a withdrawal strategy?

Put another way: Do you know which assets or accounts to tap first?

There are as many ways to open a nest egg as there are investors and planners. If you prefer fixed-income investments, says Mr. Kelemen in Oregon, you can set up a series of "laddered bonds," with different maturities, that will produce income each month. If you like stocks, he says, you can set up a portfolio that generates dividends.

For his part, Mr. Kelemen spreads no-load mutual funds across 10 asset classes, including a money-market fund. His clients receive a monthly check from the money-market fund. After he and a client decide how they wish to divide the client's holdings among those 10 classes, Mr. Kelemen rebalances the portfolio every three months to keep in step with the original allocation.

"At any one time, one or more asset classes are doing fairly well, most are OK, and a few may be lagging," he explains. "When that happens, we sell some of the overweighted classes -- the stuff that's done well -- and buy into the underweighted classes, the not-so-well, after we have replenished the money-market fund."

The strategy highlights one of the two most important parts of any withdrawal strategy: gauging market conditions in deciding which assets to sell and buy. The other piece of the puzzle is tax efficiency.

You're probably familiar with the conventional wisdom: Draw down your taxable accounts first; then turn to tax-deferred accounts, like IRAs; and save your Roth IRA (if you have one) for last. In this way, tax-deferred assets get more time to grow. But the sequence isn't always that simple.

J. Graydon Coghlan, president of Coghlan Financial Group in San Diego, gives the example of a man with $1.5 million in an IRA who is turning 70½, the age at which withdrawals from an individual retirement account become mandatory. His required distribution this year would be almost $55,000, leaving him in the 25% tax bracket (assuming a standard deduction).

If however, the man had withdrawn funds annually from his IRA starting 10 years earlier -- and reached age 70½ with $900,000 in his account -- his required distribution would be about $33,000, leaving him in the 15% tax bracket. The early withdrawals, meanwhile, could have been invested in tax-free municipal bonds or given as gifts to children or charity.

The point: A withdrawal strategy that focuses only on the short term -- on this month's check or this year's distribution -- is an accident waiting to happen. "You have to start projecting out -- five years in advance or more," Mr. Coghlan says. "Otherwise, you could be stuck with a huge tax bite."

#8 – Have I factored life expectancy and inflation into my plans?

Plan on living to age 90. At the very least. Almost every financial adviser we spoke with said they use a life expectancy in the 90s when calculating how long a nest egg should last. There are two reasons why you should do the same.

First, the word "average" can be misleading. Yes, you can use your average life expectancy to determine when you might die and how long your nest egg needs to last -- but remember that about half of all people will live beyond their average life expectancy. Put another way, the odds are 1 in 2 that your nest egg will need to last longer than you think.

(To get you started, men and women in the U.S. who reach age 65 can expect to live, on average, 16.4 more years and 19.4 more years, respectively.)

Second, most people fail to think about joint life expectancy. If you're married, the chances are good that one spouse will live to age 85 or beyond, and will need a nest egg that survives that long, as well. To be more specific: There's a 66% chance, according to research from the University of California at Berkeley and others, that one member of a 65-year-old couple will reach age 85, and a 39% chance that one member will live to 90.

Life expectancy and inflation go hand-in-hand. The longer you live, the more corrosive the effects of inflation on your purchasing power. At an annual inflation rate of 3%, a nest egg of $1 million will have a value of $737,000 after only 10 years.

The point: Before you begin tapping a nest egg, you should have a well-diversified portfolio with a mix of equities, bonds and alternative investments (like real estate and inflation-protected securities). Ideally, such a portfolio, coupled with a prudent withdrawal strategy, will keep pace with inflation and last as long as you do.

#9 – Should I buy an annuity?

Retirees often speak about running out of money as one of their biggest concerns, says Mr. Randall in Dallas. But that anxiety, he says, is somewhat misplaced.

"What they're really worried about is running out of income -- a regular paycheck," Mr. Randall says. That's where an annuity can help.

A nest egg, depending on how assets are allocated and the rate of withdrawal, could provide income for many years. But there's no guarantee; even the best strategies for tapping one's savings can founder. An annuity, however, assuming that it's purchased from a reliable insurance company, will provide guaranteed income for life. That security is what makes an annuity appealing -- and why retirees should consider making such products a part of their portfolio.

Yes, investors have long been wary of annuities, primarily because individuals had little or no control over their money once they handed it to the insurance company. But an increasing number of annuities today offer features that address such concerns. Take New York Life Insurance Co. and its "LifeStages Lifetime Income Annuity." Among other options, an investor can accelerate payments from the annuity, have payments increase automatically and add a death benefit.

The latest twist involves "longevity protection." Let's say you've done your life-expectancy homework, and you think there's a good chance you'll make it to your late 80s, and perhaps your 90s. For about $165,000, a 65-year-old man could buy an annuity from New York Life (with what the company calls a "Changing Needs Option") that provides an annual income of $10,000 until age 85, at which point the annual payments would jump to $50,000 until he dies. (That compares with a premium of about $126,000 for a fixed annual payment of $10,000 for life.)

That guaranteed increase means "you can spend more money" early in retirement, says Ted Mathas, executive vice president of New York Life, "and know [the higher payment] will kick in" if you live a long life. "That's the key -- insuring against the back-end risk."

Annuities, to be sure, have their drawbacks. The fees can be steep, and the products themselves can be maddeningly complex. Still, if you want the predictability of a pension as part of your income in retirement, you can, in effect, buy one with an annuity.

#10 – Do I have a backup plan?

It's the kind of number that can make a retiree weep. Earlier this year, Fidelity Investments, the Boston-based financial-services company, estimated that a 65-year-old couple retiring today, with no employer-sponsored retiree health coverage, would need about $190,000 to pay their medical expenses during the next 15 to 20 years. That includes $58,900 for Medicare premiums, $62,700 for prescription drugs and $68,400 for other health-care needs, like preventive care, eye exams, glasses, hearing exams and hearing aids.

So...do you have $190,000?

The point here isn't so much the size of your checkbook as it is your ability to adapt. What steps are you prepared to take if big bills (like health care), a bear market, rising inflation or some combination of calamities throw your plans to tap your nest egg out of whack?

Each alternative, of course, will prompt additional questions. Perhaps you return to work -- but will your health allow that? Perhaps you put off, or abandon, your dream to buy that recreational vehicle -- but how will that affect the quality of your retirement? Perhaps you slash your annual withdrawals from savings -- but do you have the self-discipline to do so?

Whatever the options and answers, the key, says Mr. Puckett in Oklahoma City, is to draft a strategy that's unique to your circumstances.

"A lot of people, when it comes to managing their money [in retirement], will default to what Mom and Dad did...[or] what the guy at work did," Mr. Puckett says. But "that has no relevance to your situation. Your retirement could be three times as long as your parents'. The only plan that's right for you is the one that's crafted for you."

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