Pension Section News

Sept. 2016
Issue 90

INTERVIEW WITH
Charles S. Yanikoski

TELL US A LITTLE ABOUT YOURSELF.

I first became interested in retirement in 1980, when my dad asked me at age 62 whether he could afford to retire then. I did what I could without benefit of software, and advised him to hang in there until he was 65. This worked out well for him, but the real lesson for me was that even most people who are smart and mathematically inclined (my dad was a mechanical engineer with numerous patents to his credit) are clueless about retirement finances. For that matter, so was the financial industry (and by the way, it pretty much still is). Eventually I reoriented my entire career toward contributing to solutions in this field.

WHAT ATTRACTED YOU TO THE ESSAY CONTEST?

As I began to ease into my own semi-retirement last year, I realized that I had a couple of potentially practical ideas that I had never done anything with in my own retirement software business. The essay contest presented a fine opportunity to put those ideas into the public arena, where perhaps someone else could use them—or maybe they would inspire even better ideas from someone else.

WHAT STEPS, IF ANY, WOULD HELP MAKE THE IDEAS IN YOUR ESSAY A REALITY?

My essay describes a manual approach to a difficult subject. Software could be developed that would do the same thing in a way that was simultaneously more sophisticated in its decision-making process and less difficult for the individual consumer to use. I am beyond the point in my own career where I want to develop this kind of product on spec, but I would be happy to consult with anyone who wanted to pursue it—or equally happy to see them run with it on their own.

WHAT GROUPS WOULD NEED TO BE INVOLVED?

There are four kinds of groups that have a big stake in sound retirement planning by consumers: financial companies that want to sell financial products, financial advisers who want to sell financial services, employers and employment-related groups (such as pension funds, professional organizations and unions) that are interested in the welfare of their employees or members, and organizations of consumers that consider the financial welfare of their members to be part of their mission. Any or all of these could justifiably pursue such a project.

WHAT ELSE WOULD YOU LIKE TO TELL US?

I wish to state clearly, for the record, that I consider the ideas in my essays to be in the public domain once they are published by the Society of Actuaries, and I disclaim any ownership or other entitlement if some other person or entity chooses to use them either in their current form or in some other form. ■

Decumulation Strategy for Retirees: Which Assets to Liquidate

By Charles S. Yanikoski

When it's time to decumulate, most people have multiple assets from which they can draw. So which asset(s) should go first? Unfortunately, this simple question has no easy answer, either in general, or, typically, in specific cases. Furthermore,

- Making poor choices can have harmful affects which, for middle-income families, may be unaffordable.
- Most consumers know nothing about this subject—it's rarely addressed even in the professional literature, let alone in the consumer literature.
- Most professionals do know something about it but do not have a well-considered and well-organized methodology for choosing which assets to liquidate.
- In addition to the financial effects, choices based on guesswork that proves to be wrong are particularly subject to regret and recrimination.

The more assets one has, the more difficult it is to choose which to liquidate. Furthermore, the decision can be hard even if there are only a few assets because there are many factors that can enter into the decision, some of which are difficult to quantify and some of which cannot be quantified at all.

Among these factors are financial questions dealing with risk, liquidity, income generation, future growth potential, taxation, timing, liquidation costs (including penalties) and portfolio diversification. Nonfinancial considerations include whether the asset is used for personal purposes (e.g., a vacation home, a boat, a work of art) or whether there is a sentimental attachment to it.

THE IDEAL SOLUTION

There is more than one way to approach decisions of this kind. Decisions involving multiple, complex choices are typically best handled by good software. The ideal software would

- Be fully informed about all the assets, including nonfinancial concerns.
- Be fully informed about all other current and probable (or even possible) features of the individual or household financial situation, including morbidity and mortality, so that both "normal" and exceptional scenarios could be projected. This is necessary so that future cash flows and marginal tax rates can be estimated.
- Know about the individual's desires and fears about money, not limited just to "risk tolerance."
- Have the capacity to evaluate all the assets against all of the issues previously listed, and to weigh them against one another, producing a financially and emotionally satisfying recommendation, with an English-language explanation of why the recommendation is being made.
- Include an asset allocation analysis to assure appropriate diversification.

Since such software does not exist, however, and is probably not even on the horizon, a more immediately practical approach is worth exploring.

A PRACTICAL ASSET DISPOSAL WORKSHEET

Less ambitiously, an automated spreadsheet could be created to help evaluate each asset based on various factors. Within the context of an essay, however, it is more immediately useful to devise a manual worksheet.

To begin, we identify seven main factors that affect the decision, though most have multiple subfactors. The worksheet (Figure 1) illustrates how the worksheet looks. Instructions explaining use of the worksheet are below, then a sample completed worksheet (Figure 2).

Worksheet Instructions

1. Assign values from 0 to 5 for each of the seven issues listed in the columns, placing the values in the row marked "Column importance." These values should be 0 or 1 in a column that does not apply to you or matters very little. They should be 4 or 5 in columns where the issue is financially significant or personally meaningful to you. Here are factors to consider in determining these values.

   a. **Taxes.** Enter a **higher** number if you currently

      are in a high federal tax bracket.

      live in a state with high state taxes on ordinary income, investment income and/or capital gains.

   b. **Timing.** This has been prefilled as 5—timing is always important!

   c. **Lost income.** Normally, enter a 3 or 4 here, but it can be lower if none of your assets produce much income, and you live almost entirely from the **sale** of assets and from Social Security, pensions, annuities, gifts from family and/or other sources of income not connected with assets you own.

Figure 1 Worksheet Layout

(List Assets in This Column)	Taxes		Timing		Lost Income		Side Effects		Obligations		Efficiency		Sentiment and Risk		TOTAL SCORE
Column importance		X	5	X		X		X	5	X		X		X	X

d. **Side effects.** Enter a **higher** number if you are considering the sale of assets that you currently use, or that other people use (such as a vacation home, a car or boat, livestock or farm equipment). Or enter 0 if none of this applies.

e. **Obligations.** Also prefilled as 5—if any of your assets are collateral for loans or liens or are pledged for some other purpose, then this is important; if none of them are restricted in these ways, or if the restrictions could be dealt with easily, then this column will have no impact anyway.

f. **Efficiency.** Enter a **higher** number if you

- need cash right away.
- are concerned about the amount of effort it might take to liquidate any of your assets (for example, real estate).

g. **Sentiment and risk.** Enter a **higher** number if

- you are risk-averse.
- your asset portfolio is not well diversified and balanced.
- you or anyone else has an emotional or nonfinancial attachment to any of your assets.

2. **List individual assets you would consider liquidating, and assign values from 0 to 5 for each of them in the narrower of the two columns in each of the eight vertical sections, excluding any columns that have 0's in the row marked "Column importance."** These values should be 0 or 1 in a column where that particular issue has little or no negative effect if that particular asset is disposed of. Enter a 4 or 5 if, instead, you expect a significant negative impact. Here are factors to consider in determining these values asset by asset.

a. **Taxes.**

- Enter a **higher** number if sale of this asset generates
  - ordinary income and you are in a high federal or state bracket, even more so if you expect to be in a lower bracket in the future or if this asset might be left to heirs who would be in a lower tax bracket.
  - capital gains and you are in a very low federal or state bracket (such that It would cost you more taxes than additional ordinary income would).
  - a significant capital gain and the asset could have a good chance of being left to an heir (for whom the

asset would get a step-up in tax basis, eliminating the capital gain).

- a short-term capital gain instead of a long-term gain, and this would be disadvantageous to you.
- a tax loss likely to be more valuable some other year.

• Enter a lower number if sale of this asset generates

- little or no tax liability.

a tax loss that can be used to offset other gains, all the more so if there is a chance of this asset going to an heir who would receive a step down in basis.

b. **Timing.**

• Enter a **higher** number if

- the market (stock, bond, real estate, etc.) for this asset is below normal, so that selling now locks in losses (or precludes likely future gains).
- sale of this asset generates a penalty for early withdrawal, a tax penalty, a surrender charge, or other penalty that will shrink or disappear if you dispose of the asset later.
- by contract or for some other reason this asset is due to increase in value or produce a large dividend or other income in the relatively near future.

• Enter a **lower** number if

- the market for this asset is currently above normal.
- you feel that even though the asset is currently selling below normal, that's because of a serious problem that probably isn't going away.
- by contract or for some other reason this asset is due to decrease value or produce a large expense or other loss in the near future.

c. **Lost income.**

• Enter a **higher** number if

- this asset produces little or no income.
- you expect, or worry, that the income it produces will decline.

• Enter a **lower** number if

- this asset generates unusually high cash income.

Figure 2 Sample Completed Worksheet

(List Assets in This Column)	Taxes		Timing		Lost Income		Side Effects		Obligations		Efficiency		Sentiment and Risk		TOTAL SCORE
Column importance	5	X	5	X	3	X	1	X	5	X	2	X	3	X	X
401(k)	4	**20**	3	**15**	4	**12**	5	**5**	5	**25**	5	**10**	5	**15**	**102**
Employer stock	2	**10**	2	**10**	1	**3**	5	**5**	5	**25**	5	**10**	5	**15**	**78**
Apple stock	3	**15**	5	**25**	3	**9**	3	**3**	5	**25**	5	**10**	3	**9**	**96**
Savings bonds	1	**5**	0	**0**	2	**6**	4	**4**	5	**25**	4	**8**	2	**6**	**54**
Bank CDs	0	**0**	0	**0**	1	**3**	5	**5**	5	**25**	4	**8**	5	**15**	**56**
Empty house lot	3	**15**	2	**10**	0	**0**	3	**3**	2	**10**	2	**4**	1	**4**	**46**

Note: In this sample case, withdrawals from the 401(k) and the Apple stock are about of equal attractiveness. This individual would probably do best to withdraw from one or the other, or from a combination (especially since 401(k) withdrawals and common stock sales have very different tax consequences).

- you have a strong expectation this asset will generate future cash income or capital gains.
- you consider the income this asset produces to be highly reliable.
- income from this asset is tax-free or tax-sheltered.

d. **Side effects.**

- Enter **5**, or
- Enter a **lower** number if
  - this asset, in addition to its financial value, is currently in use by you or someone important to you in a way that would be inconvenient, difficult or even impossible to replace—the more difficult, the lower the number.
  - this asset is highly liquid, so it would be helpful to save for an emergency, and/or it cannot be disposed of at fair value.

e. **Obligations.**

- Enter a **higher** number if
  - this asset is completely unrestricted.
  - this asset will be liquidated or partially liquidated without your choice (e.g., a bond is maturing, or required distributions must be taken from an IRA).
- Enter **0** (or some other low number) if
  - this asset is collateral for a loan you do not intend to pay off, has a lien that you cannot easily clear off, is co-owned by someone else, requires the approval of an uncooperative ex-spouse to liquidate, or is pledged or restricted in some other fashion.

f. **Efficiency.**

- Enter a **higher** number if
  - this asset requires a lot of effort to maintain.
  - it complicates your financial records or tax accounting.
  - it is not very liquid or marketable and might not be sellable at the time you need to do it.
- Enter a **lower** number if
  - this asset is trouble-free.
  - it would be time-consuming or expensive for you to dispose of it.

g. **Sentiment and risk.**

- Enter a **higher** number if
  - this asset is risky (because it's value fluctuates, income from it fluctuates, it's future is uncertain, or you're just not comfortable with it).
  - you have too high a percentage of your net worth in this asset, so that there's risk from insufficient diversification in your portfolio.
  - you inherited the asset or were talked into acquiring it and you aren't sure whether or why you should still have it.
- Enter a **lower** number if
  - this asset helps balance your portfolio, because it's of a different type, from other assets.
  - you have a not strictly financial attachment to the asset (e.g., it was given to you by someone you love, it's connected with your past, it supports a cause you believe in, etc.).
  - another family member or heir is attached to it and/or hopes to inherit it.

3. **Tally the scores.** In each of the eight vertical issue sections, multiply the individual score for each asset times the overall weighting factor (from "Column importance") and put the answer to the wider column to the right of each asset score. Then add these scores horizontally to produce a total for each asset. Assets with high scores are normally the most ripe to be disposed of.

REALITY TEST AND DECISION

Although the obvious final step is to dispose of as much of the assets with the highest score(s) as needed, this is too simplistic, for several reasons.

- There might be reasons to either keep or sell an asset that are more important than this method reflects.
- Several assets might have high scores that are only slightly different. The methodology is not so precise or perfect in design that these differences are necessarily meaningful.
- Some assets (e.g., real estate, businesses, vehicles, collectibles) may have to be sold as an entirety, or not at all. It might not make sense to dispose of such assets if the cash needed is not that large.
- Even if the needed cash can be obtained from the sale of a single asset, there may be little reason to actually do so. It might make more sense to take a smaller amount from several places.

- Investments should continue to be diversified. It's important to consider what the asset allocation will be after assets are sold.
- Splitting up the sale of assets can help to optimize income taxes on a year-by-year basis. If some sales generate taxes while others do not (or actually generate losses), then one can mix and match these sales to avoid taxes if one is already in a high bracket, or to generate tax liabilities deliberately if one is currently in a lower tax bracket than normal, or to do some of both. If tax-generating sales would push the taxpayer into a higher tax bracket, for instance, such assets could be sold only up that limit and then non-tax-generating sales used to avoid entering the higher bracket.

Finally, the user of this worksheet should step back and ask: Am I satisfied disposing of the assets I have chosen? Am I satisfied with what my portfolio will look like after these sales? If not, there may be some tweaking left to do.

Of course, all decision-making methods and tools enable, at best, to make **prudent** decisions, not **optimal** ones. The method outlined here, though useful, is still simpler than what a well-designed automated system could produce, but for the typical middle class household, it is probably sufficient, and certainly an improvement over less rigorous decision-making processes.

Charles S. Yanikoski is the president of RetirementWORKS Inc. He can be reached at *csy@StillRiverRetire.com.*