Creating a Retirement Paycheck Using an Income Floor

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First of all, just to make clear, I am not a financial advisor or anyone who has any background in financial planning. Before I retired, I was a cybersecurity analyst who, like many, had not thought much about how to create income in retirement. What follows is a recounting of some lessons learned as I tried to create a plan for generating retirement income. It should not be construed as advice since any advice should be specific to your situation.

Saving for Retirement Was the Easy Part

As I was approaching retirement, I started to get concerned about how to create income in a comfortable manner rather than just "take money out of savings when needed". It seemed like saving for retirement was the easy part so long as your company had a good retirement plan - which it did - and you started early enough - which we didn't. My wife didn't start contributing to a retirement plan until age 40 while I basically started at age 32. While we both retired at age 63 (she in 2010 and I in 2013), I compensated by working part time until age 68.

Figuring Out Retirement Income Is the Hard Part

Two years before I retired, I started to explore different options for generating income (bucket strategy, 4% rule, variable percentage withdrawal, annuities, and so on). However, it was hard to determine which one would work best for us - both financially as well as emotionally. When I talked to some advisors prior to retirement, their advice focused on managing my investments. However, to generate income, the advice was to "take money out of savings when needed" using something like the 4% rule - not the advice I was seeking. So, in order to develop my own strategy, I decided to establish some goals, which are as follows:

- Have reliable and predictable lifetime income for essential expenses
- Plan for discretionary income to maintain our lifestyle
- Protect against inflation
- Mitigate impacts of market volatility.

If sufficient assets permit:

- Plan for college expenses (grandchildren)
- Leave a legacy.

Reliable Lifetime Income

The first goal of having reliable lifetime income for essential expenses is at the core of what some have called an income floor, which I consider to be like a retirement paycheck. Reliable lifetime income is income that is guaranteed for life and is not significantly impacted by market conditions. Some examples are social security, defined benefit pensions, and some types of annuities.

My Version of a Bucket Strategy Using an Income Floor

I initially started with the classical three bucket strategy but modified it to address my stated goals.

- Bucket 1 became my income floor (reliable lifetime income), which does not need replenishment except for addressing inflation. This bucket, or more accurately an income stream, covers our essential expenses.
- Bucket 2 was used to cover discretionary spending for a rolling 5 years but has undergone some modifications 7 years into the plan.
- Bucket 3 could then be used to address future inflation, replenishing bucket 2, and legacy. Since my plan was not to need bucket 3 within 5 and maybe up to 10 years, I could take more risk with the potential for better returns given the longer investment time period.

BUCKET 1 - THE INCOME FLOOR

The first challenge to establishing an income floor was determining the amount needed for essential expenses. I documented all our expenses for two years prior to retirement, identifying what we would consider as essential. By definition, everything else was discretionary, planned one-time expenses, or not applicable. Since I was still working, I also had to factor work-related expenses that would not apply.

With essential expenses identified, I then explored how to create a lifetime income stream that could establish that income floor. Since neither my wife nor I had a pension, we could initially only count on Social Security. My wife had retired three years before me and started Social Security benefits at age 63. I estimated my benefits at my full retirement age (FRA) using the ssa.gov website. We then sought to self-fund a "pension" using single premium immediate annuities (SPIA). When combined with my projected social security income at FRA, this income stream would cover our essential expenses.

Social Security: I used "my" Social Security benefit (as the higher income earner) versus "our" Social Security benefit to ensure that the passage of one spouse does not have an adverse financial impact on the surviving spouse.

Annuities: To self-fund this pension, we used roughly 35% of our original retirement assets (at the point when I retired). We purchased the annuities as joint survivor with 15-year guaranteed payment to our beneficiaries, in case we unexpectedly passed early. I did look at annuities that paid fixed (2%) Cost of Living Adjustments (COLA). However, the income reduction during the early phase of retirement was too much to accept from our viewpoint.

COMMITTING TO AN ANNUITY WAS A CHALLENGE

I will admit that taking that much money out and committing to funding this "pension" was probably one of the hardest things we've done. In that we wanted to further protect such annuity payments in case of company failure, we also spread our SPIA purchases across a few higher quality companies to stay within our state's insurance guaranty program coverage limits. This program would replace the annuity in the unlikely case the company fails.

BUCKET 2 - DISCRETIONARY SPENDING/REQUIRED MINIMUM DISTRIBUTIONS

My initial goal was to find funding sources in this bucket that would not be significantly impacted by market volatility in the near term (~5 years). Presently, our Bucket 2 consists of a 5-year CD ladder which covers our estimated RMDs each year for the next five years. CDs, with their return rate of 3.0-3.5%, were the best choice at the time. Since one year's required minimum distributions (RMD) coincidentally funds two years of discretionary spending, we also have plans to invest any unspent RMD funds in tax-efficient accounts. Beyond the 5-year ladder, our current plan is to do in-kind distributions of RMDs from our tax deferred account (Individual Retirement Account or IRA) to a taxable account to satisfy our annual RMDs. An alternative is to use multi-year guaranteed annuities to extend the ladder if rates are good.

This Bucket 2 originally used 11% of our initial retirement assets and constitutes about 18% of our investable assets (Buckets 2 and 3 combined). When I start my RMD in 2022, I envision that this bucket will transition from a 100% tax-deferred bucket to a combination tax-deferred and taxable account, where tax planning takes on a more significant role. While we have been replenishing this bucket for the first seven years of retirement and have 10 years of discretionary funds “set aside”, it is likely that this bucket will disappear after 10 years with Bucket 3 covering discretionary expenses if needed.

BUCKET 3 - INVESTMENT

With 35% of the original retirement asset needed for the self-funded pension and 11% needed for 10 years of discretionary spending, this leaves roughly 54% of our original retirement assets to Bucket 3. This bucket also represents the remaining 82% of investable assets.

Bucket 3 is generally heavily weighted with equities using a diversified index-oriented portfolio spread between small, medium, and large cap along with Real Estate Investment Trust (REIT), international, and emerging market funds. We also have both investment grade and high yield bond funds. In this bucket, we normally maintain an 80/20 equity/bond ratio. While this 80/20 ratio may seem high for a retiree, keep in mind that Bucket 1 (fair market value of SPIAs) and Bucket 2 (CD ladder) constitutes 46% of our retirement assets. I consider such assets as “bonds” from a total asset allocation viewpoint. With Bucket 3 at an 80/20 equity/bond ratio, the overall allocation ratio is roughly 43/57, which many would consider conservative. Approximately 25% of Bucket 3 is also in a Roth account and continues to grow via planned conversions while the tax rate is low, where conversion amounts are constrained by marginal tax rate and Medicare Income Related Monthly Adjustment Amount (IRMAA) penalty considerations.

Assessing the Income Floor Against the Goals

If we look at our previously stated goals, we can see how this plan addresses them:

RELIABLE LIFETIME INCOME

The income floor (my version of Bucket 1) covers in excess of 100% of essential expenses regardless of market volatility and satisfies this goal. In a severe market downturn, the income floor provides a stable paycheck while a probability-based approach such as a 4% withdrawal plan may provoke some anxiety, especially if the downturn lasts more than a couple of years or if there is extreme volatility. While the Social Security income is inflation protected, in the long term, resources from Bucket 3 will be needed to supplement this income floor since the self-funded pension is not inflation protected.

DISCRETIONARY INCOME

If Bucket 2 is properly structured (with bonds, CD ladder or a deferred annuity, for example), it should be possible to draw funds for discretionary expenses from assets not impacted by market volatility. Presently, we have upwards of 10 years of such spending covered during our earlier phase of retirement that is minimally impacted by market volatility. One other aspect of identifying discretionary income as a bucket is to preserve one’s lifestyle as part of an overall plan and not rely on serendipitous market outcomes.

Beyond the next 10 years as our discretionary spending wanes, I envision using Bucket 3 for discretionary expenses if needed.

INFLATION

Inflation is potentially one of the harder challenges for any retirement income plan especially when income is not automatically inflation adjusted. Social Security has some inflation protection but with every succeeding year, that protection gets less due to the way cost-of-living adjustments are used to compute increase in benefits. Since our self-funded pension was not inflation protected, which over time will reduce in value, it must be supplemented either from discretionary funds or the investable IRA (Bucket 3).

Periodically, I do an assessment using a Retirement Planning Tool to determine if the income floor needs further supplementation due to changes in spending or inflation. Seven years later, it hasn't and there is a chance it might not need supplementation (see next paragraph). However, if we do need to supplement the income floor, we plan to initially use dividend income from blue chip companies or other "dividend aristocrats". Currently, we have a set of funds that have provided consistent dividends which are automatically reinvested. In six to 10 years, these dividends could become an additional cash flow to address inflation if needed. During the past 12 months (including the March 2020 downturn), our dividend return from Bucket 3 was 2.9% while market gains were negative. In 20 years, the projected annual withdrawal rate against Bucket 3, just to address inflation for the income floor, would grow to 1.9%. This projection is based on Monte Carlo simulations at 90% confidence level needed to address an annual inflation rate of 3% and an annualized 3% rate of return. As such, it seems this dividend strategy appears to be a viable option. If inflation gets worse or the withdrawal rates increase, a qualified longevity annuity contract (QLAC) or a deferred annuity are additional strategies being considered to address inflation.

It turns out that waiting to age 70 to collect my Social Security benefit was one of the best inflation hedges possible and in retrospect, should be the number one implementation goal for creating a retirement paycheck. Given the SPIA purchases were sized to complement my Social Security benefits at age 66 and not age 70, our income floor covers substantially more than our essential expenses. Since I did not include my wife's Social Security benefit in computing the needed "pension", her Social Security benefits were also in excess of our essential spending needs. If I add my 32% Social Security boost plus my wife's Social Security benefit, this total "excess" amount (as of 2020) already exceeds the 80.6% annual inflation supplement needed in 2040, effectively eliminating any need to address inflation for the SPIA income. The 80.6% is the cumulative inflation impact that will occur in 20 years with inflation at 3%. Given the excess income is also CPI-U (Consumer Priced Index for All Urban Consumers) inflation protected, the amount 20 years later should be substantially more. The combination of her "early" Social Security benefit, SPIA income, part-time work, spousal Social Security benefit, and planned IRA withdrawals (for "buying" more Social Security annuity) made it possible to wait to age 70 to maximize my Social Security benefits.

Mitigate Market Volatility

This goal is one of the main reasons I like the income floor. If the market suffered a significant drop and interest rates were to stay low for years, we would not have to cut back on essential expenses and still have 10 years of discretionary funds available. If we were in a probability-based withdrawal plan, I think I would feel the need to cut back on spending. This would most likely impact our "go-go" years if the downturn lasted a while. I also believe that there could be a lot of emotional strain even if the "math" works out that doing 4% withdrawals will be okay in the long run. I think there would be a strong possibility that we would underspend if such a sequence-of-return issue arose, a concept that I knew nothing about when we first established our goals.

Income Floor Strategy Summary

In my opinion, this income floor strategy follows a safety-first mindset and is a reasonable trade-off between safety and maximizing returns.

Prior to retirement (seeking advice for retirement income), I've had advisors tell me that annuities are for retirees with limited assets who need assurance those assets will last their lifetime. They felt that I would be better off in a probability-based withdrawal scheme even though some of their more pessimistic simulations indicated that we could run out of funds in less than 30 years.

However, in the end, I prefer to have that peace-of-mind of stable income rather than worry about probabilities and percentages, at least, for essential expenses. As part of my annual monitoring process, I run Monte Carlo simulations (with 90% confidence level) using annually updated expense data against our current retirement account balances - Buckets 2 and 3 combined. Our projected annual savings withdrawals continue to stay under 1.8% until age 85 (covering all inflation supplementation and discretionary spending) and goes to a maximum of 2.5% at age 95.

With this low withdrawal rate and growth-oriented investment posture, the legacy projection (at my age 95) grows with each succeeding year. As such, we are in reasonable shape to address our last two goals, college funding and legacy, when the time comes.

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