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How To Keep Your Retirement Plan's GPS On Track

PAUL KATZEFF | 3/31/2017

Each year brings its own set of tests to your retirement plan, whether from stock market volatility, politics, the strength of the economy. But this year seems to carry an extra dose of uncertainty.

How can you adjust your retirement portfolio to thrive at a time when the eight-year-old bull market is stubbornly refusing to admit its age, President Trump's policies are being challenged and interest rates are pointing higher?

Foremost, don't panic, experts say. They recommend taking several steps to put and keep your retirement on track while absorbing any blows from unfavorable events.

Step one is to sketch out a plan, if you don't already have one, says Eric Aanes, president of Titus Wealth Management, north of San Francisco.

A plan should identify your assets, liabilities, incomes and expenses as well as your goals and time frame for each goal. Think of each goal in financial terms: It is a future expense. Do you want a warm-climate home? Do you plan to join a golf club? Will you travel a lot? Host the kids, grandkids and friends? The idea is to make sure you will be able to pay for everything, year by year.

"Listing each income source helps you avoid overlooking any," said Skip Johnson, partner in Great Waters Financial, in Minnesota. "The same for expenses. And listing each one helps you remember or look up the dollar amount."

If you find shortfalls where expenses are bigger than your income, you can start to plan for solutions. Those range from saving more to delaying retirement, working during retirement and putting your money into different types of assets — an annuity instead of cash, for example.

Once you have your basic plan in place, you're ready to make any adjustments warranted by events as they unfold. Ways to meet that challenge are the focus of this special report.

Implement Your Plan
One key: Regardless of your age, start by focusing on factors you can control, not on macro factors you can't control, says Kimberly Foss, president of Empyrion Wealth Management, in Sacramento, Calif.

"You can't control whether the Federal Reserve raises rates," Foss said. "You can't control how the market responds to rate hikes, or how much the country spends on infrastructure. But you can control three crucial things about your own portfolio."

First, your costs. "You can control what you pay an advisor to a degree," Foss said. "And you can control expense ratios of funds and ETFs by choosing funds and ETFs with lower ones."

Second, you can control your asset allocation. The longer your time horizon and the less bothered you are by market volatility, the greater your allocation to stocks can be.

Third, you can control your diversification, especially in the part of your portfolio that is devoted to diversification — your mutual funds and ETFs.

Fixed Income

Since we're in a period of rising interest rates, Foss has guided clients to lower weightings in stocks and bonds that historically get hurt by rising rates.

She has advised clients to lower weightings in utilities, whose relatively high dividends make them proxies for bonds, to less than 5%. "Each client has different needs, so I'm describing moves in general," she said.

In bonds, financial advisor Aanes is steering clients clear of long-term debt. "The longer the duration, the more it gets hurt by rising rates," he said. He's avoiding bonds with a duration of five years or more. "We like durations of two to three years," he said.

So if you're enticed by the cup and handle formation of Utilities Select Sector SPDR (XLU), just be ready with an action plan if higher rates start weighing on any outsized positions in utility stocks and ETFs that you might have in your portfolio.

And Aanes is rotating investor clients into high-quality bonds and funds, and away from high yield. "In the event of a pullback in equities, high-quality corporates will hold up in price much better than high yield," he said.

For bond mutual funds, the portfolio tab of each fund's Morningstar.com page shows details about the portfolio's duration, credit quality and sector weightings. Investors with access can find ratings and other details for individual bonds at Fidelity.com and other websites.

For investors who want to hedge market uncertainty not just with income but with guaranteed income, consider fixed annuities, says Great Waters' Johnson.

Annuities can provide a preset dollar amount of income that you cannot outlive. If you delay the start of payouts, that can reduce your taxable income and your Social Security taxes. But payout rates may not be better than comparably sized certificates of deposit (CDs), and fees are typically hefty. "Understand the fine print," said Stan Haithcock, an annuity consultant, speaker and independent agent, who markets his services as Stan The Annuity Man.

Tax Reform

What about the prospect of lower tax rates for individuals and corporations, as well as a change in the long-term capital gains rate? "Think long-term," Foss said. "In 20 years, these changes will probably look very minor."

But don't ignore moves that can save you big bucks while not interfering with your basic investment strategy. "One of my clients has almost $1 million in unrealized capital gains," Foss said. "If the long-term capital gain rate comes down, he could save a lot."

Currently, taxpayers in the 39.6% ordinary income bracket — such as couples making $470,701 or more a year — pay 20% plus a 3.8% tax on certain investment income to help pay for ObamaCare. That could fall to 20% or even 16.5% under some proposals.

Still, Foss' client was very overweight in U.S. large caps. "It's more important for him to diversify into other categories, so I had him migrate out of one-third of those gains," Foss said, meaning that she directed the client to take profits on 33% of U.S. large caps so he could rotate into other categories. The client incurred the current high cap-gains levy for the sake of what Foss feels is a better strategic asset allocation. "He'll benefit more in the long run," Foss said.

Shopping For Stocks

Johnson also is trimming clients' weightings in U.S. stocks. "Prices are above historical valuation averages," he said. "For someone who would usually have a 60-40 stock-bond allocation, U.S. stocks should be a 35% weighting now," he said. "We see some better opportunities in some emerging Asian markets and some developed European markets. Those areas have underperformed, but they have stability in earnings and in their governments, and several markets have accommodative monetary policies."

If you don't want to shop for individual stocks in those markets, consider ETFs, Johnson says. For more pointers about stock investing in retirement, read Ken Shreve's nearby report.

And what about the prospect of big infrastructure and defense spending? Broadly, big caps like Boeing (BA) stand to benefit. But many industrials, materials and defense stocks have grown expensive. "You still must do the homework to find individual leaders in those segments," Foss said. "Companies in those segments will still have room to run if the economy keeps expanding and corporate earnings keep climbing. If not, I wouldn't be surprised to see a pullback."

Other Planning Steps
Health care costs in retirement loom large. A couple settling for Medicare coverage, who retire this year, will spend an average of $260,000 for medical care through retirement, according to Fidelity Investments. How is that possible? Rising drug costs are one culprit. Another is that Medicare Parts A and B do not pay for such things as dental care, hearing-aid fitting exams, routine foot care and eye examinations. Medicare also does not cover nursing home care.

And long-term care insurance (LTCI) will cost that couple an additional $130,000.

Worse, many insurers are limiting LTCI coverage to five years, Foss says. And, still, premiums are soaring. "If you buy long-term care insurance before your fifties, over your lifetime you may pay way too much," Foss said. "And after age 65 insurers may not be willing to sell you a policy." Your window of opportunity is roughly your early fifties until your mid-sixties.

Making the most of an HSA account tied to your health care coverage during your working years can be a big help.

Another timing related question is, When should you start to collect Social Security? If you start taking Social Security at age 62, rather than waiting until what the Social Security Administration calls your full retirement age (FRA), you can expect up to a 25% reduction in monthly benefits.

And for each year that you delay the start of benefits between FRA and age 70, your eventual benefits increase by about 8%. Full retirement age is 67 for anyone born in 1960 or later.

If your health and your family health history suggest that you'll live a long life, start your benefits as late as possible if you can afford that, Aanes says. But if delaying benefits means that you'll deplete too much of your retirement nest egg — because, say, you'd be forced to withdraw a lot more than 4% annually — then start your benefits early, he adds.

In a nearby report, Russ Britt explains more about timing the start of Social Security.

Finally, which type of retirement savings accounts should you save in? A traditional or a Roth? With a traditional IRA, you contribute a portion of pretax income, which grows tax-free and then is subject to income tax when withdrawals are made in retirement.

With an IRA, the choice is entirely yours. Even if your income is too high to qualify for direct Roth contributions, you can kick in money to a regular IRA, get the deduction on your contribution, and then convert it to a Roth. You would owe income tax on the amount of the conversion.

But if you're participating in a 401(k) plan and your income is too high — the 2017 phaseout range for couples filing jointly is $99,000 to $119,000 — then your contribution to your regular IRA is not deductible, says Ed Slott, founder of IRAhelp.com. When you do the Roth conversion, the tax-free portion will be the amount of after-tax funds in all of your IRAs as a percentage of all your IRA funds. If you have no other IRAs, then any conversion of nondeductible money is tax-free.

With a 401(k) account, you can use a Roth only if your plan offers one.

Basically, the younger you are and the more likely that your tax bracket stays the same or rises in retirement, the more you stand to benefit from using a Roth rather than a traditional IRA or 401(k). If you will be working for at least another seven years, you should use a Roth, Aanes says.

And if you do convert a traditional IRA to a Roth, remember that you'll owe income tax on the money converted. Consider doing it in something like five yearly portions so you spread the tax impact out, Foss advises.

Johnson provides a bottom line for coping with today's uncertainty and risk. "Don't worry about the politics," he said. "Just focus on your retirement plan. Decide what sort of retirement you want, and work backwards from a budget. Step by step, just make sure you've got the assets to pay for retirement lifestyle goals."

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