The Importance of Fixed Income in Retirement

Retirement income planning strategies have long used "the 4% rule" developed by William Bengen in the 1990s as the gauge against which all payout approaches are judged. Simply put, it stated that, in the first year of your retirement, you could withdraw 4% of your total savings. In the years that followed, you would withdraw 4% of your total savings, plus an additional amount to account for inflation. Generally, it was thought that if you followed the 4% rule for the entirety of your retirement, there was a high probability that you would be able to sustain a stable income from an investment portfolio over a 30-year retirement.

However, the 4% rule doesn't consider lifestyle changes that retirees may desire; variable taxes and fees that individuals still need to pay on their investment portfolio; expensive, unpredictable events like the need to pay for long-term care; or today's higher-than-average rate of inflation. It also assumes that the retirement portfolio in question is a blend of 50% stocks and 50% bonds, but many people (including TSP account holders with money invested in a target date fund) decrease the percentage of stocks held in their portfolio as they approach retirement age in an attempt to protect their investments from market downturns.

At the end of the day, a general rule of thumb is unlikely to offer the best advice for how a particular individual should manage retirement income.

That said, one of the best ways to prepare for a stable retirement in which you neither run out of income nor outlive your assets is to diversify the sources of your retirement income and add sources that incorporate contractual guarantees. This can help you minimize sequence of returns risk while simplifying your retirement and providing predictability in the amount of income you will receive each month.

> **Note:** Sequence of returns risk involves the required sale of assets to support fixed expenses in years of poor investment returns. A retirement portfolio will normally not be able to recover from such sales, ultimately impacting the portfolio's longevity. For

example, a sharp decline in the market in the early years of your retirement may decrease not only the number of years your portfolio will last, but also the amount of money that you are able to "safely" withdraw as your retirement progresses. A decline in the market in the middle or later years of your retirement may or may not have as great an impact on your remaining funds' ability to rebound. As the market is unpredictable, moving money within your retirement portfolio into more stable assets can help mitigate sequence of returns risk, but requires careful balancing of risk mitigation and keeping pace with (or exceeding) inflation.

Sources of Fixed Income

Fixed income is income that doesn't vary from month to month. Investors can source fixed income from individual bonds or bond funds, but most commonly, fixed income is received in the form of a monthly pension or Social Security payment. Annuities are another type of financial product that incorporates contractual guarantees and can be designed to offer varying amounts of fixed income in a tax-efficient manner.

Pensions

Pensions that provide fixed income in retirement used to be relatively common, but their popularity with employers has waned over time, while employees shifted to seeking greater portability and more options within their retirement accounts. Ordinarily, only those working in a few specific industries are still able to retire under a pension plan. Fortunately, military retirees fall within those groups. The amount of money that is paid to military retirees depends on when they joined the military, their years of service, and their pay grade at retirement. All servicemembers who joined the military after January 1, 2018, are enrolled in the Blended Retirement System; others may be paid under the legacy High-3 pension plan.

- Legacy High-3: If you serve for at least 20 years, you qualify for a lifetime monthly annuity payment that is calculated at 2.5% times your number of years of service times the average of your highest 36 months of basic pay. TSP contributions are not matched by the government under this system.
- Blended Retirement System: If you serve for at least 20 years, you qualify for a lifetime monthly annuity payment that is calculated at 2% times your number of years of service times the average of your highest 36 months of basic pay. In addition to this pension benefit, the government contributes 1% of a servicemember's pay to their TSP account and also matches TSP contributions, up to 5% per paycheck and the IRS limits each year.

Military retirement pay is protected from inflation by annual cost-of-living adjustments. Additionally, surviving spouses may continue to be paid a survivor's annuity for the remainder of their lives (up to 55% of the retiree's pay) if they participate in the Survivor Benefit Plan.

Social Security

Eligible workers qualify for Social Security benefits once they have worked for 40 quarters or 10 years of employment. However, a typical worker cannot begin to receive Social Security checks until they are between the ages of 62 and 70 years old (with Full Retirement Age, or FRA, depending on their year of birth). Benefits are calculated using 35 years of earnings, but also depend on when an individual elects to begin receiving income: early, at retirement age, or after retirement age.

Claiming Social Security benefits early, before you reach your FRA, will permanently reduce your benefits by 6.67% per year. Delaying retirement until after your FRA will increase your benefits by 8% per year. Therefore, if you are able to live off of other sources of retirement income and delay taking Social Security payments until age 70, you can substantially increase your monthly payments. The maximum benefit amount for early retirement at age 62 is currently $2,572 per month and $4,555 for retirement at age 70 – a difference of about $2,000 per month.

Note, too, that most actuaries also predict a 25% reduction in benefits for everyone starting their claim in or after 2037, so if you are under age 50 right now, this prediction probably applies to you. Social Security payments are also protected with regular cost-of-living adjustments.

> **Read more**: Retirement Focus on Social Security

VA Disability Payments

If a veteran qualifies for disability compensation from the Department of Veterans Affairs, these inflation-adjusted, tax-free benefits continue for the duration of the veteran's life. The amount of the benefit depends on the disability rating that the veteran has received and whether or not the veteran supports any dependents.

Annuities

An annuity allows you to deposit a sum of money with an insurance company and receive reliable, tax-advantaged income payments in the future. Premium deposits establish a tax basis that grows at a fixed rate over a set period of time or until payments are initiated. Interest rates are often higher than what might be offered by a savings account, Money Market account, or Certificate of Deposit.

Depending on the payout option chosen, an annuity can provide guaranteed income for a fixed period of time or for the duration of your entire life. This is different from an IRA, 401(k), or TSP account, where it is possible for withdrawals to cause a zero balance, eliminating future payments.

> **Note:** Annuity payments will *never* cause a zero balance if you choose a life income payout option. The resulting floor of income acts as a financial safety net, guaranteeing payments for life that can supplement your other retirement income – or replace it, if your other sources of income become exhausted.

Furthermore, non-qualified annuity premium contributions are made with after-tax dollars (not from a retirement account). When premium deposits are ultimately returned in income payments, a portion is tax-free, based on what is known as an "exclusion ratio." This means that the owner gained more interest due to tax deferral while accumulating (i.e., earning interest on interest), and receives a portion of each income payment in retirement tax-free after income payments begin.

Note that fixed annuity payments are not adjusted for cost-of-living.

In summary, fixed income sources are predictable and provide peace of mind that your retirement income will not be impacted by what happens in the market. That said, the value of fixed income assets can be affected by high rates of inflation, so having a variety of investments that contribute to your retirement income in addition to fixed income sources can help you maintain your desired standard of living throughout retirement and until the end of your life.

> If you're interested in learning more about how an annuity can provide fixed income and support your retirement goals, you can request more information or schedule an appointment with an annuity expert. We're here to help.