DIESEL

A System for Generating Cash Flow During Retirement

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Goals of Today's Presentation

- Distinguish between “cash flow” and income.
- Show historical data that challenges the concept that very low withdrawal amounts from fixed income-oriented portfolios should be a standard portfolio strategy for clients seeking retirement income.
- Provide evidence that a more broadly diversified portfolio can produce a sustainable withdrawal that is materially larger than the generally accepted level of 3-4%.

Goals of Today's Presentation

- Challenge current actuarial assumptions that posit life expectancies based on stale data.
- Challenge the idea that retirees will demand increasing withdrawals based on an inflation index.
- Detail the D.I.E.S.E.L. process which stands for Dividends, Interest and Equity SElect Liquidations, to facilitate monthly distributions to retired clients through a process that emphasizes stability and total return.

Bonds, Inflation and Longevity

Bonds are NOT the Answer!

- Primarily fixed-income-oriented portfolios should NOT be a standard portfolio strategy for clients seeking retirement income.
  - Bonds are certain, they are not safe.
  - The trade off for certainty is a much lower return.
  - If people retire earlier and live longer, then bonds won't work.
  - Bonds are a diversifier, not a solution.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Retirees Do Not Need Income!

- What investors need is “cash flow,” not income
- The difference is that income is associated with interest-bearing investments like bonds, and to a lesser extent dividend-paying stocks.
- Cash flow makes no distinction as to the origin of the money; it could come from a number of sources including interest, dividends, and the liquidation of securities.

The Problem With Inflation Assumptions

- Inflation assumptions are tricky and any assumption on inflation may prove to be unrealistic as this number cannot be predicted in advance.
- Obviously, any study that increases withdrawals by the 1972 – 1981 inflation rates and uses the returns from a hypothetical portfolio during the same period is going to get into trouble and will likely deplete.
- <u>The use of these assumptions is the reason why most historical studies show portfolios depleting unless the withdrawals are kept low and is the source of the 4% safe withdrawal.</u>

The Problem With Inflation Assumptions

- Does it make sense to increase withdrawals each year based on the CPI and do retirees actually do that?
- In practice our clients rarely ask for increased monthly distributions. Not once in 34 years in the industry, has a client cited to me or any of the five other members of our planning staff, that the CPI was a benchmark or reason for any increase in cash flow from a portfolio.
- We chose not to adjust the portfolio withdrawals in our study each year based on the CPI. We instead chose to smooth out the changes by using ¾ of the 47 year CPI average.

Conclusions?

The need for an inflator of withdrawal amounts in these studies is clear; however the need to use the actual CPI as that inflator, is less clear

The probability that retirees will make a change in withdrawals every year, based on the CPI, is very low

The Real Wildcard - Longevity

- Current life expectancy tables on which many planners rely may be incorrectly calculating average life expectancies
  - All the historical big killers are off the radar screen.
  - Cancer and cardiovascular disease mortality rates are improving.
  - Life expectancy assumptions have not been adjusted.
  - More people will live longer
  - Many people will live VERY long.
  - We assume people live to 100.

Underinvesting – The Greatest Risk For Retirees

- Investors are focused primarily on portfolio risk when their greatest danger is outliving their money.
- Higher returns are essential if cash flow is to be sustained.
- Lower volatility is essential so that portfolios are less likely to suffer steep declines
- Can you have both?

Why DIESEL Works

- The D.I.E.S.E.L. system is based on historical evidence that properly diversified portfolios containing an optimum mix of asset classes and sub classes have generated an average total return greater than a bond or mostly bond portfolio and have done so with acceptable volatility

Why DIESEL Works

Disclosure:

Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values or eliminate the risk of fluctuating prices and uncertain returns. Past performance is no guarantee of future results. There are no assurances that any withdrawal is sustainable. It is important to understand that there is no guarantee that proceeds will be generated in a down market or if an investment experiences loss.

Rebalancing investments may cause investors to incur transaction costs and, when rebalancing a non-retirement account, taxable events will be created that may increase your tax liability. Investing based upon strategies or models, including rebalancing, does not assure a profit or guarantee against loss. Indexes are unmanaged and investors are not able to invest directly into any index. Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Past performance is not a guarantee of future results.

Why DIESEL Works

- The D.I.E.S.E.L. portfolio's goal is to combine investments that can potentially produce modest but consistent total returns in a low volatility portfolio from which occasional "liquidating" can occur. This "liquidating" process generates the cash flow needed to fund "monthly distributions."
- This can be attributed to the relative low volatility combined with returns that were higher than certain less 'risky' alternatives.

Properly Asset Allocated Portfolio?

- Properly asset allocated means <u>it must contain all four asset classes</u>
  - Equities
  - Debt
  - Hard Assets
  - Cash Equivalents

Risk – A Closer Look

- Understanding risk and explaining it to clients is paramount.
- The range of returns of portfolios for rolling periods is the appropriate pedagogical tool for this
- Performance metrics of the DIESEL portfolio show that perception of risk by most investors is greater than the reality.
- Alpha is important! The newest metric is Alpha2 or AlphaAlpha

The DIESEL System

How We Do It?

Consolidation!

- Consolidation allows easy, one stop shopping for all investment and financial activities.
- Consolidation has huge benefits for retirees primarily related to the simplification of overall money related responsibilities.
- Simplification becomes increasingly important as retirees age and become less interested in the details of their financial processes.

Consolidation!

- To the extent possible, all investment and banking accounts should be transferred to a consolidation account at a single institution.
- IRA's 401ks, 403b's, etc. should be consolidated to one IRA when these accounts are available for transfer.
- Other, non qualified banking, brokerage and mutual fund accounts should also be placed at the same institution.
- We also recommend direct deposit of all other retirement income such as pensions and social security to the consolidation account thus allowing the retiree a full and complete picture of his or her money flows.

Generating Retirement Distributions

- D.I.E.S.E.L. cash flow is produced by maintaining a balance in a "withdrawal account" (usually the consolidation account's cash equivalent checking account) equal to 6 months of the retiree's cash flow requirement. [This allocation is in addition to what would be designated for the cash allocation pursuant to the client's Investment Policy Statement (IPS)].
- Retirees can get their monthly distribution by having money electronically transferred to an operating checking account each month or by simply writing checks from the withdrawal account.

Liquidating & Rebalancing

- Once the client has been designated a "D.I.E.S.E.L. Income Recipient" (DIR), agreed upon a monthly withdrawal amount, and the withdrawal account has been seeded, withdrawals can begin.
- The account is reviewed every 90 days to determine how much needs to be added to the withdrawal account to bring it in line with the 3 month threshold figure. Once this amount is determined, our portfolio managers review the account for appropriate "liquidation" candidates.
- Generally, these liquidations are done in such a way as to rebalance the portfolio back to its target allocation by liquidating positions that are out of proportion, out of favor, or will generate a needed tax loss.

Liquidating & Rebalancing

- Although "liquidating" occurs quarterly, distributions are generated monthly. This allows a monthly withdrawal while minimizing transaction costs and allowing for smaller balances in low yielding money market funds.
- Since the differences between quarterly and monthly were minor in our study, we chose quarterly to limit transactions, paperwork and record keeping.
- Taxes can be withheld from these "distributions," often obviating the need for those pesky quarterly estimated payments and adding further to the convenience of account consolidation.

Types of Investments?

- D.I.E.S.E.L. works best when a portfolio is invested in things other than stocks.
- Investment companies allow for efficient asset allocation, reinvestment of distributions and incremental liquidity that lends itself to cash flow generation and rebalancing.
- D.I.E.S.E.L. works best in a fee based, no transaction fee (NTF) environment or a wrap arrangement.

What About Taxes?

- Taxes associated with the D.I.E.S.E.L. system depend on a number of factors.
- Obviously in qualified accounts there are no real tax planning opportunities. However, in taxable accounts tax efficiency is a consideration.
- In seasoned accounts that have been invested for more than one year, and using the average share cost method for gain calculations, most liquidations of securities will result in long term capital gain treatment on a portion of the proceeds with the remainder being non taxable return of principal.

Conclusion?

Investors can develop a systematic withdrawal program that produces monthly distributions. This program requires account consolidation, an asset-allocated portfolio, properly trained support personnel, and some client education.

Thank You!