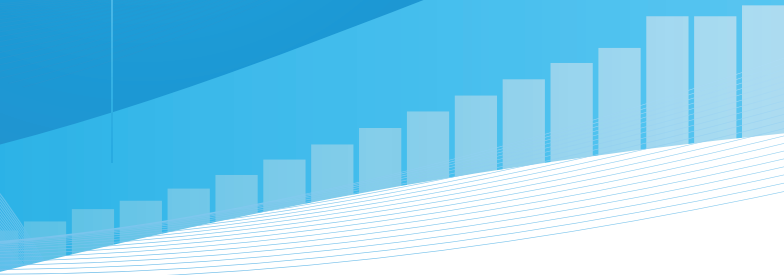


Are Your Allocations Right for RMDs?

1.556
1.56
1.579
1.611
1.623
1.689
1.712
1.736
1.801
1.817
1.837
1.891
1.91
1.923
1.944
1.956
1.967
1.99
2.023
2.34
2.359
2.557
2.67
2.700
2.799
2.817
2.834
2.856
2.877
2.89
2.910
2.922
2.932
2.935
2.95
2.959
2.968

2.551
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Are Your Allocations Right for RMDs?

Making sure your IRAs are allocated properly for required minimum distributions (RMDs) once you reach the age at which you must take them is as simple as following a bit of advice your parents probably used to tell you: live off your interest, don't touch your principal. That may sound simple enough, but there are many factors to consider in order to ensure the interest and dividends you're generating from your savings and investments are sufficient to cover your RMDs and satisfy your other income needs throughout retirement.

Again, RMDs are distributions the IRS requires you to make on your retirement savings each year after you've reached age 70-and-a-half. The amount changes each year in conjunction with your estimated life expectancy and the balance of your IRAs and other qualified plans as of December 31st the preceding year.

Ideally, an asset allocation right for taking RMDs should be able to generate at least 3.7% dividend or interest. If your interest and dividend income isn't sufficient to cover RMDs, then the distributions will most likely have to come from principal. Why is that so bad? Well, with average life expectancy rates today higher than they've ever been, most people need to plan for 30 years of retirement. That being the case, spending any principal at all, especially during the early years of retirement, can be a slippery and dangerous slope.

Consider a 30-year mortgage. When you first start making payments, you're not paying back much principal at all. Instead, you're paying primarily interest and just a small amount of principal. But as the years go on and the balance gets paid down, you pay a little less interest and a little more principal. The process continues until, after 30 years, your mortgage is thankfully paid off. But consider the process in reverse. Take a pool of savings worth \$1M, generating 5 percent interest – i.e. \$50,000 – a year. If you take even a little bit more than that \$50,000 each year, just a small amount of the

principal, that sum will be depleted within 30 years in much the same way a mortgage is paid off.

Today's Challenges

Unfortunately, in today's market it's not easy to generate the kind of interest or dividends you need to satisfy RMDs without touching principal. Interest rates in money markets are well below 3.7 percent, and most bond mutual funds aren't generating enough once you factor in management fees. What's more, bond mutual funds can also be tricky because, unlike individual bonds, they don't give you a fixed interest rate or fixed maturity date that guarantees the return of their face value, assuming there have been no defaults. When something happens in the bond market that causes bond values to drop, a portfolio of individually held bonds and a portfolio of bond mutual funds might drop similarly in value, but for the individual bond holder it's ultimately only a paper loss. For the bond mutual fund holder, on the other hand, it's a real loss.

Another important factor to keep in mind is that using a strategy to take your RMDs from capital gains or capital appreciation in your market-based investments is really no different than taking them from principal. That's because sometimes when you invest for appreciation you end up getting depreciation instead; you count on growth but end up getting shrinkage.

Admittedly, this was less a danger many years ago. During the 1980s and 90s, in the midst of the best long-term secular bull market our country has ever seen, investors could conceivably have satisfied their RMDs completely from capital gains rather than dividends without harming principal, but since the year 2000, the opposite has been true. In that time the market has seen two major drops (of nearly 50% from 2000-2003 and nearly 60% from 2007-2009), and, according to the lessons of market history, another major drop in the 50-60% range is a strong likelihood within the next 10 years.

Reverse Dollar Cost Averaging

Still, any of those options may be preferable to a diversified stock portfolio or stock mutual fund portfolio if the dividend you're earning there is less than 3.7 percent annually (which it likely is), and you end up selling shares each year to satisfy your RMDs. This is actually one of the most common and potentially disastrous financial mistakes made by retirees: the error of *reverse* dollar cost averaging.

Most people know what dollar cost averaging is, and have wisely used it in the course of saving over the years, typically by investing in a 401(k). The purpose of dollar cost averaging is to get your average cost or purchase price down to help you buy low and sell high, which is the cornerstone principal of smart investing.

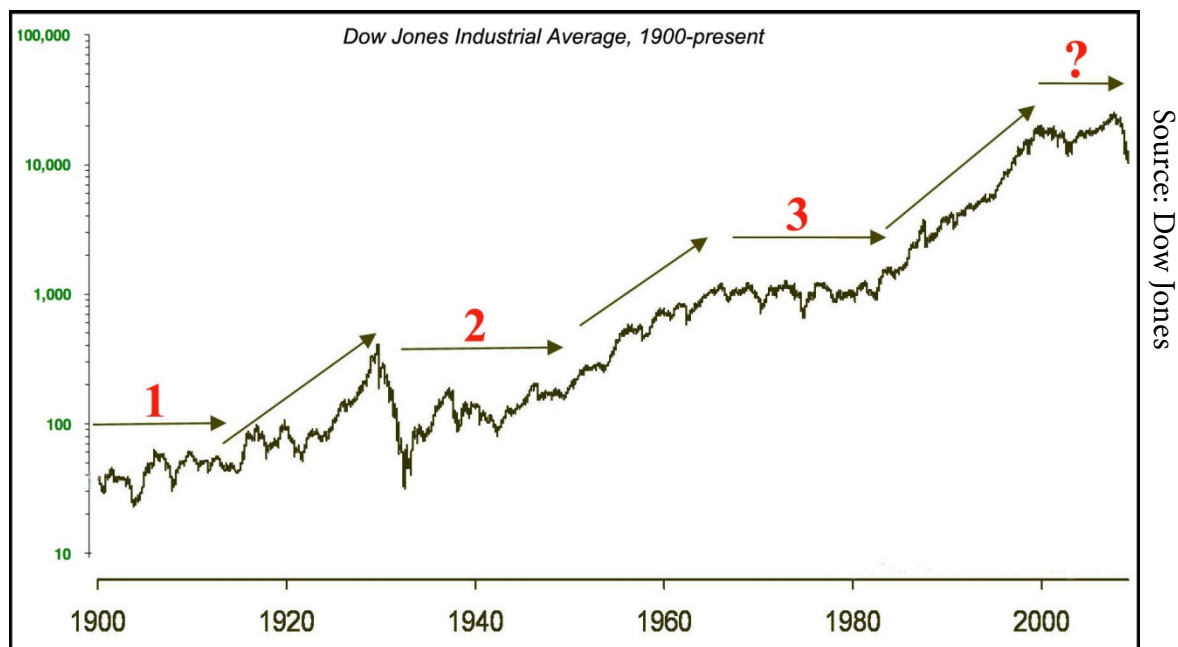
So, if you were to set out to buy \$100 per month of a mutual fund and the first month the fund was worth \$10 a share, you would buy ten shares. But what if the unthinkable happened and the second month the fund dropped to \$5 a share? Well, if you stuck with your plan you'd then have to buy 20 shares to get \$100 worth. So, after two months, your average cost per share would seem to be \$7.50, but in actuality it would be lower: \$6.66. That's because you bought twice as many shares at \$5, and half as many shares at \$10. Dollar cost averaging helps you get your average costs down.

The problem, however, is that once you're at a point where you're not saving into your fund but drawing from it in order to satisfy RMDs, the same principles apply but in the opposite direction. You start *reverse* dollar cost averaging.

Taking the same example, let's say that the first month you liquidate \$100 and you sell 10 shares, and the second month the unthinkable happens and the fund drops in half. Now, to withdraw your \$100, you have to sell twice as many shares, therefore you sold 20 shares. So now what's your average sales price per share? Again, the math is the same: now, instead of taking your purchase price down from \$7.50 to \$6.66, you've taken your *sales* price and pushed it down. You've been forced by the IRS to sell low.

Radical Question

So, while dollar cost averaging is a great strategy for saving, reverse dollar cost averaging is one of the most cancerous strategies retirees could embark upon. Which goes back to my original point: if you're going to have money in the stock market in your IRA during retirement, you want to make sure that you're earning enough dividends on that money to satisfy your RMDs. Once again, though, that's a major challenge in today's market – such a challenge in fact that it begs the question: should you have any money at all in the stock market – in your IRA, or 403(b), 401(k) or 457 plan – once



you've retired?

That may seem like a radical question based on what "the experts" and textbooks have always said: "Everyone needs to have some money in the stock market as a hedge against inflation." The unfortunate reality is that the stock market has never really been, on average, a very reliable inflation hedge. In the course of stock market history there have been long periods when it's been a decent inflation hedge but even longer periods when it hasn't. Historically speaking, there are certain periods when an IRA holder can, indeed, stay invested in the stock market and take his RMDs from fairly predictable gains and capital appreciation, but also times where those RMDs have to come out of principal because there are net gains in the market – or even losses.

As the chart above shows, these periods have been very predictable and repeatable throughout history – so much so that they need to be understood and considered as part of the process for determining whether your allocations are right and sufficient for RMDs.

Getting started is as easy as contacting a qualified financial advisor who specializes in the universe of non-stock market, income generating alternatives. These are all conservative or moderately conservative instruments designed to generate consistent income through interest and dividends – generally in the 3 to 7 percent range – and with substantially less risk than aggressive, market-based approaches like common stocks, stock mutual funds and speculative real estate investments. This is income that can provide cash flow for your retirement, or that can be reinvested to obtain growth organically, or, as I like to say, “the old-fashioned way.”

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Dollar cost averaging may help reduce per share cost through continuous investment in securities regardless of fluctuating prices and does not guarantee profitability nor can it protect from loss in a declining market. The investor should consider his/her ability to continue investing through periods of low price levels.