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Tax Smarts for Retirees

Shifting some money out of retirement accounts in the initial years after leaving the work force can pay off over the long run, this adviser says

By SHEFALI ANAND

Many people head into retirement with most of their assets in tax-deferred accounts. They should consider finding a new home for some of that money in the initial years after they leave the work force, even if it means accelerating the payment of taxes on the transferred funds, says Jonathan Guyton, a financial planner in Edina, Minn.

The reason: tax rates.

When people retire, their taxable income and tax rate usually drop significantly. But retirees often move into a higher tax bracket years later, when they begin collecting Social Security and are forced to start taking withdrawals from traditional company retirement plans and individual retirement accounts.

So retirees who qualify for the current bottom 15% rate on ordinary income could benefit by gradually moving money they don't need to live on out of 401(k)s and traditional IRAs and into accounts such as Roth IRAs, says Mr. Guyton.

With Roth IRAs, contributions come from after-tax money but "withdrawals are tax-free, and you are not forced to take any money out," says Mr. Guyton. In contrast, contributions to 401(k) accounts and traditional IRAs usually come from pretax money, but withdrawals are taxable and participants generally are required to start taking distributions after they reach age 70½.

In this column, we feature model portfolios from prominent financial advisers who invest in mutual funds and exchange-traded funds. Mr. Guyton has been an adviser since 1986 and founded Cornerstone Wealth Advisors Inc. in 2003. The firm manages $140 million and charges an asset-based fee ranging from 0.30% to 1%, depending on client assets.

Here Mr. Guyton shares a model portfolio for a typical retired client who withdraws 5.5% of his portfolio annually. Such a portfolio has gained 14.4% over one year and 3% annualized for the five years ended June 30.

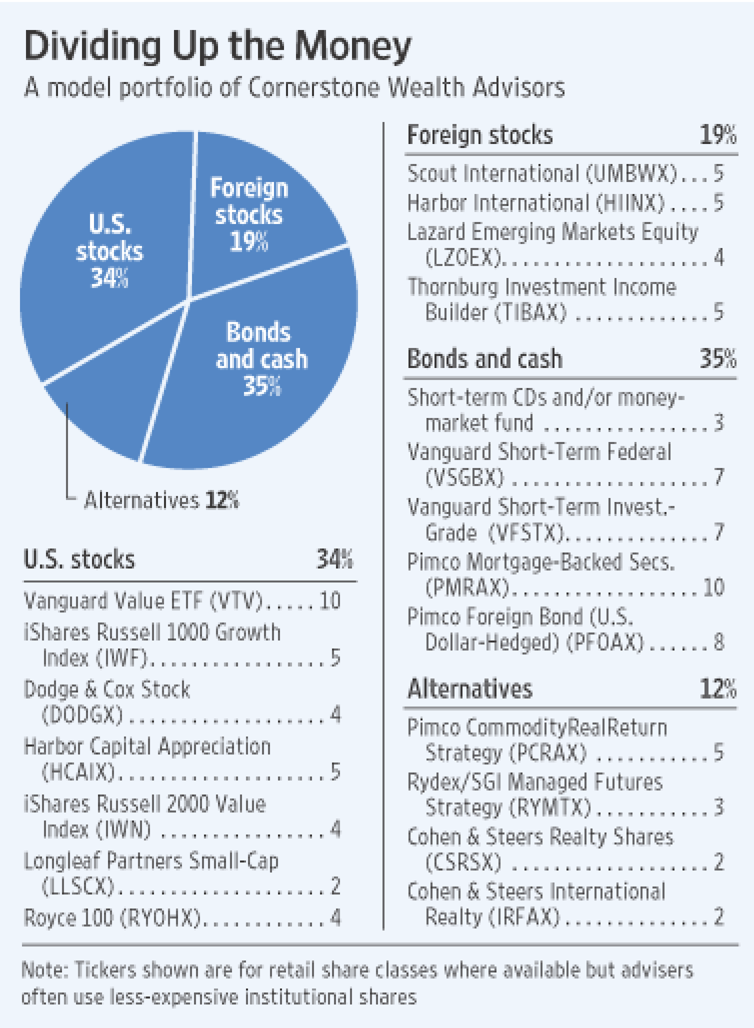
U.S. STOCKS: The portfolio has a 34% allocation to U.S stocks, more than half in index ETFs. Ten percent of the portfolio is in Vanguard Value ETF, which buys large-company stocks that are considered cheap. Five percent is in the large-company iShares Russell 1000 Growth Index, and 4% is in small stocks through iShares Russell 2000 Value Index.

The remaining U.S.-stock investments are in actively managed funds. The adviser uses two large-company stock funds, Dodge & Cox Stock, at 4%, and Harbor Capital Appreciation, at 5%, and two funds that buy small-company stocks, Longleaf Partners Small-Cap, at 2%, and Royce 100, at 4%.

"The burden of proof is on active management to show that it can outperform the passive approach," says Mr. Guyton. He says his selected funds "are examples, by and large, of managers that have…[consistently been] outperforming by a small amount."

Typically, Mr. Guyton buys actively managed funds in an IRA, because sometimes these funds pay a lot of capital-gains distributions, such as they did at the end of 2007.

FOREIGN STOCKS: About a third of the portfolio's total stock portion has long been dedicated to foreign stocks. Mr. Guyton allocates 5% each to Harbor International and Scout International. For exposure to stocks of developing countries, he buys Lazard Emerging Markets Equity, at 4%.



There is a 5% allocation to Thornburg Investment Income Builder, which invests a third of its portfolio abroad and favors stocks with higher-than-average dividends and corporate bonds.

BONDS AND CASH: The 2007-09 downturn underscored the importance of bonds and cash as a cushion in a portfolio. Here, they are 35% of the total. "The lesson I've learned is to pay even more attention to how your fixed-income securities would respond to situations that could put your equities into the tank," says Mr. Guyton. He says he would be extra careful now about buying "junk" bonds or bonds of emerging markets, which can lose value when stocks decline. Mr. Guyton hasn't owned these types of bonds for at least five years.

Seventeen percent of the portfolio is in short or very short-term bonds—7% each in Vanguard Short-Term Federal and Vanguard Short-Term Investment-Grade, and 3% in short-term certificates of deposit or a money-market fund.

Pimco Mortgage-Backed Securities, which invests in mortgage bonds of government-backed companies Fannie Mae and Freddie Mac, gets 10% of the portfolio. The remaining 8% goes to Pimco Foreign Bond (U.S. Dollar-Hedged).

ALTERNATIVES: The 12% allocation to alternatives is aimed at getting exposure to assets that typically perform differently than stocks and bonds. Four percent is evenly split between Cohen & Steers Realty Shares and Cohen & Steers International Realty.

In 2006, Mr. Guyton started buying a commodities fund, Pimco CommodityRealReturn Strategy, in which he currently puts 5%. He allocates 3% to Rydex/SGI Managed Futures Strategy, which trades in commodities and futures, among other things. Mr. Guyton expects the fund to be uncorrelated to the stock market and generate slightly better returns than bonds. The fund gained in 2008 but has been losing money lately. Mr. Guyton is still holding onto it.

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