When an Ounce of Discretion(ary) Is Worth a Pound of Core

by Jonathan Guyton, CFP®

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We've all been there with a retired client.

The "paycheck" from their retirement is being deposited regularly. The taxes it will generate are being withheld. This total annual income distribution meets our definition of one that seems quite safe and sustainable for the remaining retirement years. From a cash flow, distribution, and tax planning standpoint, everything is going according to plan.

Then it happens: Our client couple tells us they need to take out some extra money for a one-time expense that their regular income won't quite cover. However, this isn't the first time; in fact, it seems that there's a different one-time request more years than not. How are we to assess this situation and respond?

For starters, it's important to recognize what is occurring here contains both exterior and interior dimensions. These are integrated and significant. In addition, the healthiest response— for now as well as the longer term— requires us to consider this situation's theoretical, operational, and client communication aspects. As is often the case, their intersection is likely to be something of a holistic sweet spot.

One-time Withdrawals Affect Long-term Sustainability

Starting with the exterior dimensions, these additional one-time withdrawals affect the long-term sustainability of the client's retirement income because they are drawn from the same assets that are being asked to generate income month after month, year after year. A withdrawal is a withdrawal whether it goes for regular monthly income, income tax withholding, or a one-time want. And repeated additional withdrawals, even if they don't occur every year, increase the withdrawal rate—perhaps to an unsafe level.

For example, consider the client who has taken one-time distributions of $5,000, $8,000, nothing, $10,000, and $7,000 over the past five years. Assuming that the client's monthly pre-tax withdrawal in the next year would rise to $3,250, a planner would be wise to calculate the current withdrawal rate based on an annual distribution of $45,000 (the $3,250 for each of 12 months plus the average of the additional disbursements) rather than $39,000. The extra $6,000 could make what otherwise would have seemed a safe withdrawal rate considerably less so.

It could be tempting to assume that the pattern of the previous five years is not permanent, especially if the client couple is in their most active years of retirement. This pattern will stop eventually, right? Well, not only might it not (or at least not in time), it also could just as easily increase in magnitude considering nearly 60 percent of the additional distributions have occurred in the most recent two years.

Create an Improved "Choice Architecture"

So, while applying retirement distribution theory to the external dimensions of this situation is quite helpful in diagnosing its dangers, leaving the internal dynamic unexplored will likely leave any solution beyond our reach. Rationally, things couldn't be clearer. Very few clients want to go down a path fraught with financial danger. That many do flirt with this possibility calls our attention to the internal dimensions, and to the opportunity to create an improved "choice architecture," to borrow a phrase from Richard Thaler and Cass Sunstein.

Notice the unfortunate framing in this situation and the unhealthy impact it can have on the advisory relationship. The planner is in the untenable position of needing to predict the client's future behavior

(the amount of additional one-time distributions) to render advice on the impact of their current behavior (this year's additional distribution). Furthermore, the client has already decided to make the extra expenditure before the planner even knows about it. And should the planner's advice be that doing so would raise a real chance of adverse consequences, she must almost certainly present her view either from a scarcity perspective ("continuing to do this could cause you problems in the future") or by choosing sides if one partner in the couple is opposed to the expenditure.

From the client's perspective, it may seem that a heretofore unknown boundary existed that only became known once it had been crossed. This is because they have previously heard the planner's message of "you can do almost anything within reason unless I say that you shouldn't." Of course this isn't the planner's message at all, but it may be perceived as such.

The problem here is that the planner has too much responsibility for the achievement of the goal (a sustainable lifetime income) and the client does not have enough. The planner can help this situation and the client by establishing some broad yet specific boundaries early on, and then empowering the client to make and be responsible for their choices—with as much or as little help from the planner as desired.

How so? By having the client establish a separate and distinct discretionary portfolio that stands apart from their separate and distinct core portfolio.

Discretionary vs. Core Portfolios

In describing them, it may be easier to begin with the core portfolio. These are the investment assets responsible for sustaining the client's income and lifestyle for as long as they live. Ideally, ongoing distributions from the core portfolio are taken in accordance with the safe withdrawal policies or approach that the planner has recommended and the client has accepted as the means to achieving this purpose. There are no additional distributions (one-time or otherwise) from the core portfolio, for to make such distributions would create a chink in the armor of the client's long-term financial security.

The assets in the discretionary portfolio (which some of our clients nickname their "slush fund") are expressly designated for any and all additional expenditures (one-time or otherwise) that the client may wish to make and that are unable to be funded by their core, ongoing income.

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Notice how this structure turns the client-adviser dynamic on its head. The discretionary portfolio gives the client a clear boundary to define the amount of extra expenditures they can afford, at least for the foreseeable future. More importantly, the client gets to determine which purposes are worthy of tapping these assets. When the client is a couple, this choice can spark significant conversation about what they truly value and which "wants" matter most. Clients report that these conversations are rich; in fact, one deemed this "the best advice you've ever given us." Almost as a by-product, the planner is freed from the most untenable aspects of his or her role in this situation's former framing. Moreover, the planner may discover things about her client that she's never previously known by simply listening to the client's stories about tapping (and not tapping) these assets.

Having the Conversation

When introducing this structure with a client, begin with conversation about the challenges that surround one-time special needs for money. The client's periodic "how do we know if we're still okay?" is answerable with much greater clarity if this structure is implemented. A bit of humor about "one-time wants that seem to occur every year" combined with lots of listening can go a long way to discovering how well this idea resonates. Given some space to reflect, most clients will respond with a high level of honesty and self-awareness.

When advising clients on the amount of their assets to place in a discretionary portfolio, their core income (from their core portfolio combined with Social Security, pension, and other sources) should be able to fund a retirement worth living rather than merely a bare-bones lifestyle; thus, the core portfolio must be sufficiently large. For example, if a client couple has said they would like to spend at least $10,000 annually on travel, then a full $10,000 should be included in their core spending to be funded from these sources. However, years of extraordinary travel plans beyond this level would be funded from the discretionary portfolio.

It is natural to believe that some clients cannot afford to designate even 2 percent to 5 percent of their assets in this way. Interestingly, our firm's experience

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has been that clients who see value in this approach are more than willing to adjust their core spending plans to make it possible. And it doesn't take much. Assuming a 5 percent withdrawal rate, designating $50,000 for a discretionary portfolio reduces core annual spending by $2,500, about $200 each month before taxes.

Operationally, it is vital that the assets in a discretionary portfolio be housed in account(s) that are unique from the core portfolio. Even better, report this as a separate "household" or "client" to show these assets as truly distinct from the core portfolio. Although designing a discretionary portfolio to hold exclusively after-tax assets is most appealing, do not let an inability to do so derail this planning. Furthermore, tax planning for the core income—with attention on its impact on the amount of Social Security inclusion, taxable income, and opportunity to do Roth IRA conversions—should take precedence. Even if discretionary assets need to be entirely pre-tax, so be it if this is the only way to create such a structure for the client. Lastly, it is likely that the investment strategy for a discretionary portfolio will have a somewhat lower equity allocation than for a core portfolio, because of the possibility of a fairly aggressive draw-down to fund the client's plans and priorities.

For both client and planner, there are additional benefits beyond those that may initially meet the eye. Here are just three:

- Because retirees quite naturally like to consider additional spending in the early years of retirement, the core/discretionary framework swims with the tide of such desires—and with boundaries.
- Should a child of a client make an especially large funding request, the core/discretionary structure readily frames the decision for the parent(s); this is particularly powerful if saying yes would nearly deplete the discretionary assets or even require dipping into core assets.
- Most approaches for generating sustainable income seek a "safe" withdrawal rate that generates very high probabilities of success; in other words, there is a high probability that the amount associated with this withdrawal rate will ultimately prove too low. Even if a client exhausts their discretionary portfolio in as little as five to seven years, this could be enough time to determine whether or not core portfolio income could be recalibrated to a higher "safe" level to accommodate additional discretionary spending. Conversely, if after several years the planner became seriously concerned about the sustainability of the core portfolio income, it could be shored up by adding assets from the discretionary portfolio.

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Sometimes, in the confluence of a client challenge and the theory and practice of holistic financial planning, we find a way to harness the very forces we've been tacking into as headwinds so we can instead run with them downwind. And that nearly always makes for good advice! ■