

# Financial Planning

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## From Accumulation to distribution

*How do you make a retirement portfolio produce consistent cash flow? Very, very carefully--and with an eye toward preventing market drops from draining assets. Harold Evensky explains his preferred method in this chapter from his new book, co-edited with Deena Katz.*

By Harold Evensky

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From *Retirement Income Redesigned: Master Plans for Distribution*, by Harold Evensky and Deena B. Katz:

We developed the Evensky & Katz Cash Flow Reserve Strategy (E&K-S) in the mid-1980s. At that time, the traditional solution to providing cash flow from an investment portfolio was either a traditional income portfolio or a form of reverse dollar-cost averaging from market investments. We had already concluded that the constraints of the traditional income portfolio made no sense, and we were uncomfortable with the obvious disadvantages of reverse dollar-cost averaging (transaction costs, negative tax consequences, volatility drain and the related conversion of the benefits of dollar-cost averaging into a negative).

At the time, our firm had a long-established five-year philosophy. The mantra "five years, five years, five years" was frequently repeated to our clients to remind them that we believed the real risk faced by investors was having to sell at the wrong time. Consequently, we discouraged making any investment unless the client expected that the funds could remain invested for at least five years. For example, for a client with a \$1 million portfolio, who indicated a need for \$100,000 for a special purpose in three years, we would design a \$900,000 total-return portfolio and a separate portfolio with \$100,000 invested for a target maturity in three years. With a five-year window for the investment portfolio, we believed that it would be very unlikely that a client would have to sell a portion of his or her portfolio at a significant loss.

Although our mantra had been developed to protect a significant liquidation of corpus, we thought that the same concept might be applicable to our clients' regular, but more modest, cash flow needs. We first considered simply carving out five years' worth of our clients' cash flow needs, similar to the carve-out we would have proposed for a single goal. Unfortunately, our calculations indicated that the opportunity cost would exceed the benefit. As we modeled various alternatives, we concluded that a two-year cash flow reserve's carve-out was both economically and behaviorally optimal.

## The Strategy

Conceptually, E&K-S is very simple. "The Accumulation Portfolio" below shows a proposed portfolio allocation for Mr. Kiran, who has \$1 million of investable assets. The planning process has determined that a 40% bond/60% stock portfolio allocation will meet his long-term goals.

"The Distribution Portfolio," also below, shows the modification to the allocation for a client with the same assets, but with a 5% annual cash flow need.

In implementing this strategy, we establish three separate accounts. One is the cash flow reserve (CFR) portfolio, the second is the investment portfolio (IP) and the third (which generally already exists) is a local checking account. In this example, we've funded Mr. Kiran's CFR portfolio with \$100,000 and his IP with \$900,000. The allocation to equities in the IP has been increased by \$60,000 to offset the opportunity cost associated with placing the \$100,000 reserves in lower-return, short-term liquid investments. Mr. Kiran understands that the IP is long term, that is, it's being managed as a total-return portfolio with all dividends, interest and capital gains reinvested and that the CFR portfolio is going to be the source of his cash flow.

#### The \$1 Million Accumulation Portfolio

POSITION	INVESTMENT (\$)	(%)
<b>Bonds</b>		<b>40</b>
1-3 years (short term)	130,000	
3-5 Years (short-intermediate term)	135,000	
5-10 years (intermediate term)	135,000	
<b>Stock</b>	<b>600,000</b>	<b>60</b>

#### The \$1 Million Distribution Portfolio

POSITION	INVESTMENT (\$)	INVESTMENT PORT. (%)	TOTAL PORT. (%)
<b>Cash Reserve</b>			
Money market	50,000		<b>10</b>
Short-term bonds	50,000		
<b>Bonds</b>		<b>27</b>	<b>24</b>
1-3 Years	80,000		
3-5 Years	80,000		
5-10 Years	80,000		
<b>Stock</b>	<b>660,000</b>	<b>73</b>	<b>66</b>

Presenting the strategy to the client goes something like this:

Mr. Kiran, based on our discussions, we've mutually concluded that you need about \$4,200 per month (in real dollars) to supplement your other income [for example, Social Security benefits, pension, part-time work, rental income] to maintain your current lifestyle. Also, over time, you need to earn about 5% real return on your investments to maintain your lifestyle for the balance of your life. Here's how we're going to manage this.

We've opened three accounts for you: Kiran's cash flow reserve portfolio, Kiran's investment portfolio and Kiran's local checking account. In the CFR account, we left \$50,000 in money market funds and invested \$50,000 in a very low-cost bond fund investing in high-quality short-term (duration about one year) municipal bonds. The CFR account is the one you can look to for your grocery money. Think of the CFR as your payroll account. Once a month, write yourself a paycheck for \$4,200 and deposit it into your checking account (increasing the withdrawal over time to compensate for inflation). You won't have to worry about where your next meal's coming from if the market's way down; the cash will be sitting there waiting for you. The balance of your investments is in the IP account, and we've invested that money in the bonds and stock funds we discussed earlier.

As we go forward, our job will be to monitor and manage your IP, and your job will be to go out and enjoy your life. However, just to be sure you remain on course, we'll regularly review your IP to ensure that it remains properly invested. At the same time, we'll also look at your CFR balance. If we conclude that we need to make some changes in your IP, we may take the opportunity to fill your CFR back up to the original \$100,000. If we determine that the IP is fine and requires no attention and your CFR is funded with at least a year's worth of your cash flow needs, we won't do anything.

As time goes on, we may go for more than a year with no need to change your IP, but by then your withdrawals from your CFR portfolio may have reduced it to less than a year's reserve. If so, we'll review the positions in your IP, and if we can carve out funds without significant losses, we'll do so and bring the CFR balance back up to the two-year reserve of \$100,000.

What could go wrong? Because markets are fickle and occasionally treacherous, it's possible that we may go for well over a year when both stocks and bonds have significant losses. Should that happen--which is unlikely--we would then look to the short-term and short-intermediate-term bond investments in your IP. We refer to these funds as your second-tier emergency reserves. No matter how bad the markets get, these bond investments are unlikely to sustain significant losses, so we would begin to fund your CFR account by liquidating a portion of the bond positions. In doing so, there is a risk that the equity allocation might exceed our target; however, we will be buying valuable time to defer the sale of stock in the midst of a bear market. Between the initial CFR allocation (\$100,000) and the IP bond positions (\$240,000) you're covered for approximately five years. Once again, although there are no guarantees, this five-year window is likely to be long enough to ensure that your cash flow needs are never likely to require a sale of assets at a significant loss in a bear market.

## Evaluation

Let's evaluate the E&K-S and see how well it protects against the risks we discussed earlier in this chapter.

- **Purchasing power risk.** As the reserve requirement is reviewed regularly (in our practice, the review is quarterly), it's quite easy to increase the reserves to adjust for inflation. The strategy also provides the flexibility to increase the reserve by variable amounts to reflect an inflation factor unique to each client.
- **Volatility.** By providing significant control over the timing of investment liquidations, most volatility drain related to cash flow can be eliminated.
- **Financial flexibility.** The strategy provides extraordinary flexibility in meeting the unique and changing needs of real clients. Experience has demonstrated that the most frequent adjustment required is to reduce the frequency and size of transfers to the CFR account. In the early stage of planning, in an effort to be conservative, many investors overestimate their needs. Many cash flow strategies generate cash flow whether needed or not. The reinvestment of this unneeded cash flow results in unnecessary transaction and tax costs and, occasionally, in opportunity costs.
- **Client needs--financial.** By providing for total flexibility, the E&K-S enables the practitioner to carefully calibrate and adjust the client's need for real cash flow. It also minimizes the frequency of transactions (reducing transaction costs) and enables an adviser to manage more efficiently the tax consequences of funding the client's cash flow needs.
- **Client needs--behavioral.** Cash flow to the client is consistent and independent of market volatility. The source of the cash flow is visible and reliable (money market and short-term high-quality municipal bonds). Clients understand the strategy, and it frames the accounts in a manner consistent with a client's separate-pocket mentality.

## Does It Work?

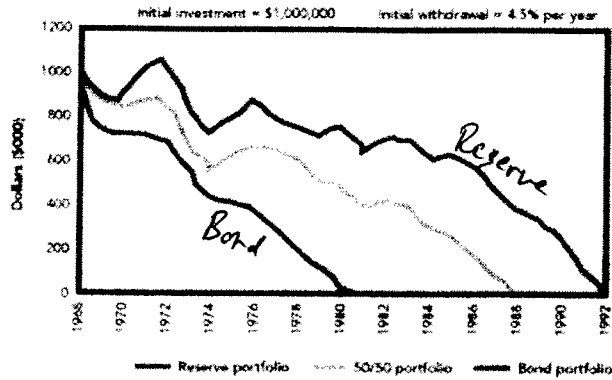
Indeed, the E&K-S works very well. We've used this strategy, with minimal modification, for more than a decade. It was seriously tested by two very different but equally trying market conditions--the panic after Black Monday in October 1987 and the bear market of 2000 to 2002. Our cash flow-dependent clients weathered these events without undue discomfort, and most attributed a significant degree of credit for that outcome to the E&K-S. They may not have understood what was going on in the market, but they did know that the funds for their next meal were safe, sound and available in their money market accounts. Given that emotional anchor, our clients were able to appreciate our counsel: Although their IP was suffering along with the broad market, they owned small investments in thousands of companies around the world and the firms had not all gone bankrupt. Given time, the economy would recover--and our clients had time to recover with it.

I recognize that although the strategy was tested during the short but precipitous 1987 drop and the recent long and painful equity bear market of 2000 to 2002, we have not had occasion since the inception of the E&K-S to test it during a period similar to the early 1970s, when both bonds and stocks were devastated and inflation was rampant. So I prepared a hypothetical stress test for this period and compared the results of three strategies--income from an all-bond portfolio, regular equal withdrawals from a portfolio balanced 50% bonds/50% stock and an E&K-S portfolio. The hypothetical investments were made in January 1968 and consisted of one or a combination of money market, Putnam Income Fund (for bond allocations) and Fidelity Fund (for stock allocations). The cash flow withdrawal was set at a real annual after-tax rate of 4.5%, and withdrawals were monthly. Inflation was set at the rate for 1968 (slightly less than the subsequent 30-year average). The rebalance parameter for the two bond/stock portfolios was set at 10%, and the tax rate set at 30% for ordinary income and 20% for long-term capital gains. Commissions were eliminated. The results of this comparison are quite dramatic.

As shown in "Over Time, the Reserve Strategy Protects Assets," below, an attempt to provide real cash flow via withdrawals from a fixed-income portfolio ended with the complete erosion of the original investment by the close of 1980. The 50/50 balanced portfolio had a significantly longer survival rate; however, it met its demise by 1988. The good news is that the E&K-S portfolio was clearly a superior strategy during these trying times: It managed to sustain the real cash flow until 1992. The bad news is that it, too, could not overcome the early portfolio erosion and it ultimately failed.

### OVER TIME, THE RESERVE STRATEGY PRESERVES ASSETS

A series of withdrawal strategies during the 70's bear market



No withdrawal strategy can guarantee protection for investors requiring income for life. (Of course, immediate annuitization is a potentially complementary strategy.) Reducing the withdrawal rate is certainly the most effective technique; however, for most investors, that's not a viable option. I believe the next best strategy is some form of an E&K-S. It provides significant behavioral benefits resulting in greater client comfort during trying market conditions, minimizes the impact of taxes and transaction costs, maximizes the withdrawal period and maximizes planning flexibility.



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