

Generating Retirement Income using a Systematic Withdrawal Plan

SPECIAL REPORT

Most investors spend the majority of their time thinking and planning around how best to save for retirement. But once you've built your investment portfolio, your focus needs to shift to how best to access your retirement savings – how best to convert your nest egg into the cash flow you need.

Many investments, by their very nature, are designed to provide some form of income. Bonds, for example, regularly pay interest income. Income trusts also provide regular distributions, and many common stocks offer dividends to their shareholders. Even some mutual funds are structured to provide regular distributions. But if you are looking for an additional means of generating cash flow from your investments, and you own mutual funds, a systematic withdrawal plan may be the answer.

WHAT ARE SYSTEMATIC WITHDRAWAL PLANS?

Primarily used within non-registered accounts, a **Systematic Withdrawal Plan (SWP)** is a tool that allows an investor to make a series of automatic withdrawals from a mutual fund investment portfolio. Withdrawals can be made on a regular basis – monthly,

quarterly, or annually, for example. Aside from choosing the frequency, you can also select how much you would like to withdraw from your mutual fund investment. The decision regarding how much to withdraw will be determined by a combination of how much cash flow you need and how much you require your portfolio to continue to grow.

To generate each SWP payment, mutual fund units are sold. Each sale of units will generate a capital gain or loss. Capital gains, when compared with other types of investment income (interest and dividends) receive preferential tax treatment – only 50% of capital gains are subject to tax.

A SWP enables you to convert a portion of your investment into tax-efficient cash flow, while allowing for the mutual fund portfolio to continue to grow.



This combination of cash flow and potential growth can provide a significant tax advantage over simply receiving income from fixed-income investments such as bonds and GICs where the annual income is taxed at your full marginal tax rate, without the additional opportunity for investment growth. **In other words, a SWP can help you to keep more money in your pocket after taxes.**

HOW IS A SWP DIFFERENT FROM A REGISTERED RETIREMENT INCOME FUND?

SWPs do share some similarities with Registered Retirement Income Funds (RRIFs) as both offer the ability to convert investment assets into cash flow (generally during retirement). However, there are some key differences.

- 1** A RRIF is a registered account, whereas a SWP can be set up for mutual funds held within both non-registered and registered accounts.
- 2** All withdrawals from a RRIF are fully taxable, whereas SWP payments receive preferential tax treatment. Remember that all withdrawals from your RRIF are fully taxable in the year you receive them because contributions to your RRSP were tax deductible during your working years.
- 3** Investors are required by law to withdraw a minimum fixed percentage from their RRIF every year.

Whether or not you set up a SWP is completely up to you, and the withdrawal amount is flexible, depending on your needs.

WHAT IS A RRIF?

A Registered Retirement Income Fund, or RRIF, is one of the maturity options for an RRSP. Like an RRSP, investments held within a RRIF are tax-sheltered. A RRIF operates like an annuity, in that it provides you with annual cash flow – it is subject to a minimum yearly withdrawal, commencing at age 70, mandated by the federal government. Annual withdrawals are included in taxable income.

EFFECTIVELY USING RRIFs

While a generation ago RRIFs were mainly viewed as drawdown vehicles with little need for growth, many of today's investors are living longer and healthier in retirement, suggesting that investors need to protect their RRIFs from the risk of prematurely running out of assets in their later years. Since the growth inside a RRIF continues to be sheltered from tax, it is generally recommended that investors take advantage of this tax-deferral opportunity for as long as possible by withdrawing only the minimum required by the government. If you have the ability to supplement your cash flow by first drawing from your non-registered investment portfolio using a SWP, you should almost always do so instead of increasing your RRIF payment.

OTHER OPTIONS TO GENERATE CASH FLOW FROM YOUR INVESTMENTS

There are a number of ways to generate cash flow from a non-registered investment portfolio. Principal amongst those is laddering your fixed-income securities, such as bonds and GICs. Laddering is when you stagger the maturity dates of your fixed-income securities so that not all of your money is locked in for the same length of time. For example, rather than purchasing a single bond or GIC worth \$50,000, you would buy five separate bonds or GICs of \$10,000 each, with terms of one, two, three, four and five years. As each bond or GIC matures, it is replaced with a new, five-year bond or GIC.

One of the main advantages to income-producing investments like bonds or

GICs is that by staggering their maturity dates, you may reduce your exposure to the risk of fluctuating interest rates. Instead of trying to guess where interest rates are heading, you can use a structured, proven approach to diversify your bonds or GICs by maturity date. Laddering your maturity dates will also ensure you have a portion of your portfolio available in cash each year if needed.

However, the primary disadvantage with this strategy is that in today's low interest rate environment, bonds and GICs alone may not provide sufficient cash flow to meet your cash flow requirements. Additionally, all income from bonds and GICs is classified as interest income, which is taxed at your full marginal tax rate.

DIFFERENCES BETWEEN SWPs AND MUTUAL FUNDS WITH REGULAR DISTRIBUTIONS (SUCH AS THE RBC CASH FLOW PORTFOLIOS)

After a decade of investing in a low interest rate environment with low fixed-income yields, it is becoming increasingly important to consider a broader range of investment options to help provide the cash flow you need from your investments. The key to enhancing cash flow lies in blending together different investments that will meet your needs now and in the future. Many mutual funds have been designed in recent years to provide investors with regular distributions to help provide the

mix of cash flow and growth that they require. The RBC Cash Flow Portfolios are a good example. The Portfolios provide a regular monthly distribution by combining a diversified mix of conservative mutual funds designed to produce regular distributions.

While the RBC Cash Flow Portfolios provide a simple and effective solution for many investors, there are occasions where a SWP may result in a better solution. Your advisor can help you determine what is the best solution for your personal situation. Consider the chart below, which highlights differences between SWPs and RBC Cash Flow Portfolios.



For more information on RBC Cash Flow Portfolios, including a discussion of the portfolio holdings, distributions and tax consequences, ask your advisor for the brochure “RBC Cash Flow Solutions.”

UNDERSTANDING THE DIFFERENCES BETWEEN SWPs AND RBC CASH FLOW PORTFOLIOS

	SWP	RBC Cash Flow Portfolios
Withdrawal amount	Chosen by you (\$ amount)	Fixed distribution (5 – 6%) annually
Frequency of payment	Monthly, Quarterly, Annually	Monthly
Taxability of payment	Tax-effective cash flow	Tax-effective cash flow (with some interest)
Equity exposure	Completely flexible	20 – 30% (based on underlying funds)
Accessibility	Fully liquid	Fully liquid





CHOOSING A SWP WITHDRAWAL AMOUNT THAT MEETS YOUR NEEDS

One of the benefits of a SWP is that you have the flexibility of choosing how much you withdraw from your non-registered assets. However, choosing a SWP withdrawal rate is a key decision that will determine how long your savings will last during retirement. The withdrawal rate largely depends on the amount of cash flow you need, the underlying investments within your portfolio, your time horizon, and the amount you wish to leave for your estate. In general, assuming a constant rate of return on your investment, the higher the withdrawal rate you select, the faster you will deplete your portfolio, as illustrated in the examples on the next three pages. Selecting the appropriate withdrawal amount to cover your retirement needs

for as long as you live can help to significantly reduce your exposure to longevity risk and market risk. The key in selecting a withdrawal amount is to draw only as much from your retirement assets as you need to supplement your current lifestyle. By working with your advisor, you can create a portfolio that offers an opportunity for growth and tax-efficient regular cash flow and that can also help protect you from risks in the marketplace.

HOW LONG WILL A SWP LAST?

The critical element of every SWP is the difference between the withdrawals going out of the portfolio and the portfolio's rate of return. At first glance, it seems that as long as withdrawals are equal to the portfolio's rate of return, the SWP could run forever. However,

there are a number of variables that can significantly shorten how long your SWP will last.

First, by using an average rate of return for your portfolio, you are assuming that markets always move in a straight line. The fact is – **markets fluctuate and never move in a straight line**. The success of your investment strategy largely depends on whether there are significant positive or negative movements in the markets in the first few years of your investment.

Second, **inflation reduces the purchasing power of your investment** dollars over time. If your portfolio withdrawal rate is equal to your portfolio's rate of return, the value of your invested dollars in the future will decline in today's dollars. A final variable that you need to manage is the taxes that you will be required to pay on any capital gains realized on your SWP redemptions.

In general, assuming a constant rate of return on your investment, the higher the withdrawal rate you select, the faster you will deplete your portfolio.

In general . . .

- › If the rate of return on the portfolio does not exceed the withdrawal rate, you may completely deplete the assets in your investment portfolio during your lifetime.
- › If the rate of return on the portfolio sufficiently exceeds the withdrawal rate, you may be able to maintain your SWP indefinitely.

CAPITAL PRESERVED IF RATE OF RETURN MATCHES WITHDRAWALS

Example 1 An investor starts off by investing \$150,000 in a mutual fund portfolio, and let's assume that the portfolio will experience a consistent annualized total return of 8%. If the investor wanted to set up a systematic withdrawal plan to match the 8% rate of annual portfolio growth, he/she would be able to withdraw \$1,000/month, or \$12,000/year. As you can see, over the course of 30 years, a total of \$360,000 has been withdrawn from the portfolio. **Given that the withdrawal rate matched the portfolio's growth rate, at the end of 30 years, the portfolio is still worth \$150,000.**

Year	Starting Value (\$)	Annual Growth (\$)	Value After Annual Growth (\$)	Annual SWP (\$)	End Value (\$)
1	150,000	12,000	162,000	12,000	150,000
2	150,000	12,000	162,000	12,000	150,000
3	150,000	12,000	162,000	12,000	150,000
4	150,000	12,000	162,000	12,000	150,000
5	150,000	12,000	162,000	12,000	150,000
10	150,000	12,000	162,000	12,000	150,000
20	150,000	12,000	162,000	12,000	150,000
30	150,000	12,000	162,000	12,000	150,000

Initial portfolio value – **\$150,000**
 Total withdrawals – **\$360,000** (\$12,000 x 30 yrs)
 Portfolio value at end of year 30 – **\$150,000**



TAX IMPLICATIONS

Taking this example one step further, let's look at the tax implications of the SWP. If we assume a starting unit price of \$10.00, a \$150,000 investment would mean 15,000 units were purchased in year one. As the market value of the units increases, fewer units need to be redeemed to create the \$12,000 SWP payment. Also, as the market value increases, so will the capital gain, and the tax payable on the gain. This results in a decreasing after-tax cash flow over the life of this SWP illustration. As seen in this example, after 30 years, taxes were deferred on \$145,914.30 of unrealized capital gains.

Year	Mutual Fund Units	Market Value/Unit at year-end (\$)	Units Sold For SWP	Realized Capital Gain on Sold Units (\$)	Tax Payable on Gain (\$)	After-Tax Cash Flow (\$)
1	15,000	10.80	1,111	889	200	11,800
2	13,889	11.66	1,029	1,712	385	11,615
3	12,860	12.60	953	2,474	557	11,443
4	11,907	13.60	882	3,180	715	11,285
5	11,025	14.69	817	3,833	862	11,138
10	7,504	21.59	556	6,442	1,449	10,551
20	3,476	46.61	257	9,435	2,121	9,879
30	1,610	100.63	119	10,807	2,432	9,568

$$\frac{\$12,000}{\$10.80}$$

$$(\$10.80 - \$10.00) \times 1,111$$

$$\$889 \times 50\% \times 45\%$$

Mutual fund units held after 30 years – **1,610**
 Market value of units after an 8.0% annual rate of return – **\$100.63**
 Unrealized capital gain after 30 years – **\$145,914.30** [1,610 units x (\$100.63 – \$10.00)]

Notes and assumptions:

1. This example is provided for illustration only and is not intended to reflect future values or returns on investment of any mutual fund or other investment product.
2. Actual returns will vary. Markets fluctuate and never move in a straight line. This example assumes that the portfolio has straight-line growth and that the funds within the portfolio have no distributions.
3. This example does not factor in the impact of inflation.
4. This example assumes a tax rate of 45% and a 50% capital gains inclusion rate. Actual tax rates will vary. As you can see in the table above, while the investor starts with an initial investment of \$150,000, after 30 years, there is still almost \$150,000 left, after \$360,000 in SWP payments. If, at the end of 30 years, the investor chooses to redeem all remaining units, there would be a capital gain of \$145,914.30, still leaving the investor with more than \$105,000 in after-tax dollars.

Preparing your portfolio is about finding the right balance of growth and income to keep your assets working for you throughout retirement. Ask your advisor for the brochure, "Investment Strategies to Maximize your Cash Flow in Retirement" for more information.

CAPITAL DEPLETED IF RATE OF RETURN DOESN'T KEEP UP WITH WITHDRAWALS

Example 2 The example below illustrates an investor who invests \$150,000 in a mutual fund portfolio with a consistent annualized total return of 7.5% and sets up a SWP to withdraw \$1,200 each month, or \$14,400 annually (9.6% per annum of the initial portfolio value).

As shown in this example, the investor's capital is depleted by year 22 as the withdrawal rate is higher than the annual rate of return.

Year	Starting Value (\$)	Annual Growth (\$)	Value After Annual Growth (\$)	Annual SWP (\$)	End Value (\$)
1	150,000	11,250	161,250	14,400	146,850
2	146,850	11,014	157,864	14,400	143,464
3	143,464	10,760	154,224	14,400	139,824
4	139,824	10,487	150,310	14,400	135,910
5	135,910	10,193	146,104	14,400	131,704
10	111,476	8,361	119,837	14,400	105,437
20	26,037	1,953	27,990	14,400	13,590
21	13,590	1,019	14,610	14,400	210
22	210	16	225	225	0

Initial portfolio value – \$150,000
 Total withdrawals – \$302,625
 Capital runs out – year 22

Notes and assumptions:

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2. Actual returns will vary. Markets fluctuate and never move in a straight line. This example assumes that the portfolio has straight-line growth and that the funds within the portfolio have no distributions.
3. This example does not factor in the impact of inflation.
4. This example assumes a tax rate of 45% and a 50% capital gains inclusion rate. Actual tax rates will vary. In this case, the withdrawal rate is in excess of the return earned on the portfolio and the capital runs out in year 22. As you can see in the table above, while the investor starts with an initial investment of \$150,000, over the 22-year period, more than \$300,000 was paid out.

SETTING UP A SWP

A SWP is easy to set up. There is generally a minimum mutual fund balance required (\$10,000 is a good guideline), and instructions can be provided to withdraw a certain dollar amount from a selected mutual fund(s), including portfolio solutions like the RBC Select Portfolios, on a regular basis. The amount withdrawn can be deposited directly to your bank account at the desired frequency. Speak with your advisor regarding specific setup requirements for your individual situation.

SWPs can be a very tax-effective method for providing a steady stream of cash flow, while, at the same time, providing the possibility of maintaining your original investment depending on your withdrawal rate. They can also provide flexibility because the rate of cash flow can be managed, the investment strategy can be altered and any remaining capital can be left to an estate. Work with your advisor to develop a coordinated plan that is based on your overall financial situation, leading to the appropriate mix of growth and cash flow.



RBC Funds

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