Kiplinger's RETIREMENT REPORT
Your Guide to a Richer Retirement

SPECIAL REPORT

Take Charge of Your Investment Portfolio

Your retirement savings need to last for decades. These steps will stretch your nest egg.

MOST PEOPLE TRANSFER THEIR 401(K) OR OTHER company retirement savings directly to an IRA in one lump sum when they retire. This move makes sense: It postpones taxes, allows assets tucked inside the rollover IRA to continue growing tax-deferred and gives heirs the right to use generous distribution rules.

Rollovers aren't always required. Depending on your age and what your plan's rules are, you may have alternatives. Sometimes you can leave the account where it is or arrange to get it paid out gradually as an annuity. Or you can elect to take the cash outright and pay income taxes on the entire distribution.

Whatever choices you're offered, consider them from the perspective of a decades-long retirement. Postponing taxes is usually the savviest thing you can do, but it requires some familiarity with the rules governing lump-sum distributions.

In order to continue tax deferral, arrange to have the lump sum transferred directly to an IRA or other plan that accepts rollover distributions. Once you are 59½ years old, withdrawals from an IRA are not subject to the 10% early-withdrawal penalty.

If you decide to roll your 401(k) or other plan to an IRA, you have several options:

Do the rollover yourself. You have 60 days after you withdraw the money to put it in an IRA. The main drawback is that your employer is required to withhold 20% of your money for income taxes. That will make it difficult to roll over 100%. If you can come up with the extra cash from other sources, you can recoup the withholding when you file your tax return. If you roll over just 80%, though, the 20% withheld for taxes is considered taxable income, and you will be penalized 10% if you're under age 55.

Arrange for a trustee-to-trustee rollover. Unless you need some of the money right away, the best course is to have your money transferred directly to the IRA. If the money is never in your possession, there is no 20% withholding. Once the money is in the IRA, you aren't required to take anything out until April 1 of the year after you turn 70½.

There's an extra consideration if you have made after-tax contributions to the company plan. You can roll the full amount into an IRA, as long as the IRA sponsor will account for the after-tax money separately. In this case, a portion of every IRA withdrawal will be tax-free. Or you can choose to roll the after-tax money directly into a Roth IRA. Or you can retrieve all of your after-tax money before the rollover and pocket it tax-free.

Leave your money in the account. If you like your plan's investments and have at least $5,000 in the plan, you can leave your money in the 401(k) until distributions are required at age 70½.

Roll over to a Roth IRA. Workers can roll assets from company plans to Roth IRAs. The rollovers are taxable, but no 20% withholding is required. You do not have to take required minimum distributions as you must if you leave the money in a 401(k) and move the assets to a traditional IRA. The assets in the Roth can grow tax-free indefinitely. Find money outside the account to pay the income-tax bill. If you use funds from the 401(k), you'll stunt the tax-free growth.

Take out company stock. If your company puts its own publicly traded stock into your retirement plan, you may have another choice that can save you a bundle in taxes: Cut the stocks out of the rollover and put only the non-stock balance in an IRA.

Rolling highly appreciated stock into an IRA locks in a high tax rate for that appreciation. You'll owe

taxes on the full value of the stock at ordinary income-tax rates as you sell it and take distributions from the IRA. There's a better way to transfer the stock.

Here is an example of how you might save: Let's say you have $1.1 million in a retirement plan that includes company stock worth $100,000. The source of the stock was your employer's contribution of $10,000.

You take $1 million (the part not held in company stock) and roll it into an IRA, and you transfer the company stock to a separate taxable account. You will owe income tax on the stock, but the tax is based on its cost basis—the value of the shares when your employer put them into your account, in this case $10,000. When you sell the stock from the taxable account, you will report a long-term capital gain. If the sales price is $150,000, you have a taxable long-term capital gain of $140,000 ($150,000 minus $10,000). Assuming a 20% capital-gains rate, the tax is $28,000.

Had you rolled the entire $1.1 million into the IRA and then withdrawn $150,000, you would owe income tax on the entire distribution in your highest tax bracket. Assuming it's taxed in the 37% bracket, the distribution would cost you $55,500.

If you own the stock when you die, not having it in the IRA creates a windfall for your heirs. Outside the IRA, appreciation after the distribution becomes tax-free; the gain not taxed at the time of the distribution is taxed at the long-term capital-gains rate. If the stock was in the IRA, the full value would be taxed as income in your beneficiary's top tax bracket as it is withdrawn.

Allocating Your Assets

If you have retirement savings in an IRA and a taxable account, you must decide which investments belong where. The factors that influence your decision should include your age, income-tax bracket, income needs and estate plans, and whether you own individual stocks or mutual funds.

Those with adequate pension and Social Security income can supplement resources by spending income generated in taxable accounts and letting the investments in an IRA grow tax-deferred until withdrawals are required. Once required distributions have begun, some retirees reinvest those proceeds in taxable accounts rather than spending them.

Review your allocations to stocks, bonds and cash, and then fine-tune the mix to balance your need for both income and long-term growth. Put investments that generate taxable income—such as Treasuries, corporate bonds and real estate investment trusts (REITs)—into your IRA. Put municipal bonds, index funds and long-term stocks into a taxable account.

With the tax rate on most stock dividends capped at 20%, your IRA may not be the best place for dividend-paying stocks. And remember that although stocks in taxable accounts may generate capital-gains taxes when you sell, the top long-term rate is 20%.

It's essential to create a portfolio that's diversified among many asset classes, from small-company domestic stocks to international equities, from bonds to commodities. It may seem that during the 2007-09 bear market, asset diversification did not work because most asset classes declined.

But diversification did work. An all-stock portfolio would have declined 48.2% between January 2008 and February 2009, according to Fidelity Investments. A diversified portfolio of 70% stocks, 25% bonds and 5% short-term investments would have declined 33.9%. Even though the all-stock portfolio posted bigger gains during the rebound, diversification lessens volatility.

As you grow older, you should shift your holdings to more-conservative investments. Someone in late retirement may want to hold at least 50% in bonds and 10% in cash. The balance should be in a diversified stock portfolio.

Advice for Bond Buyers

Buying or selling a bond is different from buying or selling a stock. When you buy a stock, it's easy to see what it is selling for on an exchange, and what you see is what you pay. You also know what you're paying in commissions.

The pricing of bonds is too often out of the public eye. Dealers and brokers include their markups in the spread—the difference between the price that buyers are willing to pay (the bid price) and the price that sellers are seeking (the ask price).

Shopping around for bonds can save you hundreds on commissions and markups. If you are a buy-and-hold investor with at least $50,000 to spend, consider assembling a portfolio of high-quality corporate and

ONLINE BONUS

✓ Read ***Retirement Report*** anywhere you have Internet access.

✓ New issues appear online days earlier than printed issues sent by mail.

✓ Includes a library of past issues — you get more ***Retirement Report*** at no extra cost!

Visit www.kiplinger.com/go/getdigital

Treasury or municipal bonds. Mutual funds offer one-stop bond diversification, but a portfolio of them typically costs more to maintain than a portfolio of individual bonds.

Establish a relationship with at least two brokers. Then check with each before placing your order. Using the Internet to compare prices and yields can give you bargaining power. A good place to start looking is the market data section of www.finra.org. Also, check out Fidelity's bond market (go to www.fidelity.com and enter "bonds" in the search field).

Whether you use an individual broker or an online service, try to get as much information as possible before you buy, including the bond's rating. Ask the following questions:

What is the spread between the bid and ask price? The closer you buy to the bid price, the smaller the markup will be. Also, a wide spread may serve as a warning that the bond may not be easy to sell quickly later on. Different brokers may quote you different spreads, so it pays to check with several before you place an order. Another way to get an idea of the spread is to call several brokers and ask them what they would pay you for the bond if you sold it today.

Is the bond callable? Bonds may be called (that is, redeemed by the issuer) when falling interest rates make it worthwhile for the issuer to pay off old bonds and issue new ones at lower rates. If a bond is callable, request the yield-to-worst call, which is the lowest potential yield. Any yield above that should be considered gravy. A broker should get that yield for you using a computer program or calculator.

Which yield are you quoting me? The coupon? Yield to call? Yield to maturity? If a bond isn't callable, ask for its yield-to-maturity.

Be ready to haggle. Brokers expect customers to bargain with them and will usually accept a smaller commission rather than none at all. If you don't feel comfortable haggling over prices, you may do better buying U.S. Treasuries straight from the government or, if you are in a high tax bracket, by buying new issues of municipal bonds. Snapping up a newly issued corporate or muni bond is usually the only way to get the same price that big institutions pay.

Resources for Bond Buyers

The market data section of the Financial Industry Regulatory Authority website (www.finra.org) offers bond information. If you're looking for corporate bonds, you can search for an issuer by typing the name of a company in the search field. In addition, the website provides information on municipal bonds. Also check www.emma.msrb.org, the Electronic Municipal Market Access website.

Treasuries are issued and sold at auction by the U.S. Treasury and resold by brokerages. They include bills, notes and bonds in various durations. Check out www.bloomberg.com/markets/rates-bonds. Prices are updated during the day. You can also check prices at www.finance.yahoo.com/bonds.

At TreasuryDirect (www.treasurydirect.gov), you can buy Treasury bills, notes, bonds and Treasury inflation-protected securities (TIPS) directly from the government with no fees and manage them in a free online account. If you buy U.S. savings bonds, you can also buy and manage them in your TreasuryDirect account.

Income From a Bond Ladder

In retirement, you can use a bond ladder to smooth out the inevitable ups and downs of interest rates. With a five-year bond ladder, for example, you might buy bonds that mature in one, two, three, four and five years. As each bond "rung" matures, you buy another batch of bonds that mature in five years to keep the ladder going.

When rates are rising, you benefit because you are buying into the higher rate when that year's portion of your holdings mature. When rates are falling, you are cushioned by having the rest of the ladder invested in higher-yielding bonds. In other words, you sacrifice a bit on the upside and downside in exchange for a more even ride and flexibility.

Although investors are confronted with low Treasury yields these days, a five-year ladder is still a good choice for new retirees and should be a core holding in most portfolios. Whatever the current yield, Treasuries are as close to a risk-free investment as you can buy. You could use Treasuries that mature in 2020 for the first rung and move on up to 2024.

If a Treasury ladder won't generate enough income, don't tinker with it. Rather, divert some of the money into alternative fixed-income investments, such as agency, municipal or corporate bonds. Consider stocks with plump dividends, such as electric utilities or real estate investment trusts (REITs), which are companies that own and manage office buildings, shopping centers and apartments.

Retirees in high income-tax brackets should consider laddering insured munis. Use the calculator at www.bankrate.com to find the equivalent yields between a tax-free municipal bond and a taxable bond. Buy geographically diverse munis, and find out whether the bonds can be called before they mature. Finally, review your bond ladder periodically and consider judicious adjustments when your financial picture or personal situation changes substantially.

It's a (Re)balancing Act

You've known all along not to put all your investment eggs in one basket and have made the basic decision about how to apportion your savings among various asset classes. If initially you put 60% of your

savings in stocks and 40% in bonds, eventually one of those investments will outperform the other, throwing your allocation out of whack. To restore it, you sell one type of security whose worth has risen and invest the proceeds in another type of security that has underperformed.

The chief benefit: narrower swings in the value of a portfolio, which is crucial for retirees who regularly withdraw money from savings that are supposed to last for decades.

Investors who let their portfolio become overloaded with bonds and bond funds face risks. When interest rates rise, the value of fixed-income investments will fall and investors who sell will suffer a loss. If bonds have taken over your portfolio, consider trimming them back to their former allocation.

Rebalancing does not necessarily guarantee better returns compared with leaving your portfolio alone, and it won't recapture the losses incurred in the last bear market. Rather, it reduces your portfolio's volatility by smoothing out its ups and downs. Lower volatility is important because if the value of your portfolio drops sharply, selling investments to live on will deplete it much more quickly than anticipated.

However, most investors don't maintain the same allocations to stocks and bonds as the years go by. They change the way they invest according to their age and tolerance for risk. For instance, if you allocated 60% of your savings to stocks when you retired five years ago at age 65, you might be more comfortable now with 50% invested in stocks.

One mechanical method for rebalancing and shifting stock and bond allocations as you age: Your stock allocation plus your age should equal at least 100 but no more than 110. At age 69, that's at least 31% in stocks and no more than 41%. Each year, you might get 1% more conservative and sell or buy stocks when your allocation moves outside those ranges. Of course, you may find it is easier to sell stocks when the market is riding high than it is to buy them during a bear market.

Don't bail out of one category of investment entirely with the idea of jumping back in when things get better. That sort of market timing defeats the purpose of asset allocation and the discipline of rebalancing. No one can predict with certainty when the market for an investment will rebound, and missing just a few days of an upswing in prices could be costly.

It makes sense to rebalance only when your portfolio is substantially out of kilter, perhaps when stocks or bonds exceed your previously set allocation by 5% or more. Rebalancing when the shifts are narrower than 5% generates unnecessary trading costs.

Rebalancing annually is adequate for most people, and having a preset review date helps take some emotion out of the decision to sell. Disciplined and active investors with big portfolios may prefer to rebalance more often, such as quarterly or twice a year.

First, rebalance inside tax-deferred IRAs or tax-free Roth IRAs to get their allocations back on track. Such buying and selling transactions are tax-free. If you don't want your IRA to get overstuffed with one kind of investment, you may have to rebalance your taxable accounts, too. Start with income you receive from stocks and bonds, such as dividends, interest and capital-gains distributions. Reinvesting that income can boost allocations that have fallen below your target percentages. You can also invest required minimum distributions from your IRA, which will be taxed anyway. To make this investment strategy work for you, be prepared to bite the tax bullet. Sell what you should, and don't let your distaste for paying income taxes dictate your actions. **K**

Save 61% on *Kiplinger's Investing for Income*

Earn 5% to 7% cash yields in any economic climate.

Regular price for one year/12 issues: ~~$199.00 + $5 first-class postage.~~

Your price: Just $79. You save 61%.

FREE Special Report with your subscription:
Safe Ways to Boost Your Cash Yield in any Kind of Market

❑ Check enclosed (payable to *Kiplinger's Investing for Income*)

❑ Visa ❑ MasterCard ❑ American Express ❑ Discover

Card #: ______

Exp. Date ______

Signature ______

Name ______

Address ______

City/State/ZIP ______

Phone ______

E-mail ______

Mail To: Kiplinger's Investing for Income, P.O. Box 420308, Palm Coast, FL 32142-0308.
Or call 1-866-610-1671.

Special Offer Code: 6OPRMR

KRTC0320