Income Discovery
For a Full & Rich Retirement

Unlocking an Advisor's Gamma for Optimal Retirement Income Distribution Strategies

Executive Summary

In today's challenging financial landscape, retirees can significantly enhance their financial well-being when financial advisors go beyond *tax-minimized* investment portfolio management and adopt *tax-managed* retirement income distributions.

- This shift from *tax-minimization* for working clients to optimized *tax-targeted* distributions during retirement is crucial for retirees and can set an advisory firm apart in the competitive market.
- To successfully implement tax-targeted distributions at a household level, Wealth Management technology platforms must adapt and evolve. This paper identifies five key evolutionary capabilities necessary to achieve this goal effectively.
- The concept of an advisor's gamma, representing the additional investment return required to match the benefits of an optimal retirement income strategy, is explored in a case study. The results demonstrate a substantial gamma of up to 275 basis points.

In the past two decades, portfolio management services for private wealth clients have introduced numerous tax-efficient features that generate additional returns beyond the market, called alpha. These features have advanced in various aspects including trading with tax efficiency, strategically utilizing tax losses within an account, and coordinating tax events across multiple accounts using Separately Managed Accounts (SMAs), Unified Managed Accounts (UMAs), or Unified Managed Households (UMHs). However, there is one crucial area where these capabilities have not fully addressed the needs of retirees - tax-optimal distributions during retirement that take into account the household's total taxation when determining sourcing of withdrawals.

Optimal Tax-Targeted Withdrawals During Retirement

A gap exists because current capabilities were built for clients in their working years when a client's marginal tax rate is determined primarily by their salary. During those years, the industry focuses on reducing the tax drag from the portfolio because private wealth clients typically have a high marginal tax rate on ordinary income and a capital gains tax rate of 15-20%. But during retirement, especially during the early phase of retirement where Social Security may not have been claimed yet (or only one spouse has claimed), the client's taxable income may be lower, allowing them to withdraw from qualified, tax-deferred accounts at lower rates and managing non-qualified, taxable accounts to strategically realize capital gains free of federal taxes.

During retirement, the objective changes from **minimizing current year taxes to finding an optimal tax rate to target** for clients.

Tax-Targeted Qualified Disbursal: a superior alternative to Roth Conversion

Current financial planning tools have started to model strategies for partial Roth conversions targeting a tax bracket. These strategies ignore an important point - if the advisor is going to practice Roth conversions at the end of the calendar year while following the standard withdrawal sequencing of non-qualified–qualified–Roth accounts for income, the advisor may be generating more capital gains than necessary if a low incremental effective tax rate could be used instead to withdraw from a household's qualified accounts for income.

By using a dynamic withdrawal order with optimal tax-rate targeting, an advisor may be able to provide a better outcome for clients. Focusing only on minimizing taxes in the short term may have an adverse effect on the long term taxes and success of a client's retirement income plan. Strategically taking taxes at an optimal rate with a long-term focus can have a significant positive impact on the plan as shown below.

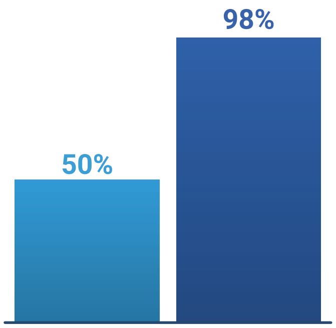
Anne, 62,
retiring this year,
$2,500 in Social Security at full retirement age

Ben, 62,
retiring this year,
$3,000 in Social Security at full retirement age
$600K lump-sum pension

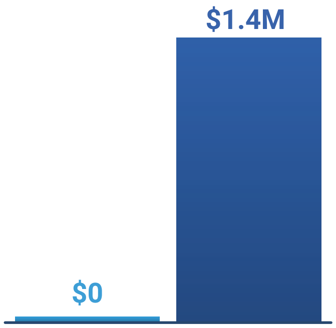
Total assets of $1.1M:
$350K in non-qualified taxable accounts and
$750K in qualified retirement accounts

Desired after-tax spending of $95K/year
(increasing 1% less annually than general inflation) and an additional $10K/year in health care expenses (increasing 2% annually above general inflation).

Probability of success went from



After-tax legacy went from



Current

Optimal

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Client Case Study to Demonstrate Additional Value

Current Strategy and Plan

Anne and Ben, lacking the guidance of an investment advisor, may face challenges in effectively generating their desired retirement income. By following a common approach taken by non-professionals, which involves claiming Social Security at retirement, forgoing insurance/ annuity products, sticking to their conservative investment allocation and a conventional withdrawal order, their chances of successfully generating their desired income are limited to a mere 50%. Furthermore, this strategy would typically result in a minimal or nonexistent bequest on average.

Optimal Strategy and Plan

By collaborating with a knowledgeable advisor and embracing a comprehensive approach that encompasses all retirement income sources and incorporates dynamic tax-targeted strategies, Anne and Ben can confidently achieve their desired income goals. This optimized strategy presents a 98% probability of success. Moreover, they can expect to leave an average bequest of over $1.4 million in today's purchasing power. The key components of this optimal strategy include deferring Social Security benefits until age 70 for both individuals, allocating 40% of their assets towards purchasing an income annuity, rebalancing their remaining investment accounts to a moderate risk portfolio, implementing capital gains management (CGM) strategies, and strategically targeting distributions from qualified accounts (TQD) at a 12% incremental effective tax rate.

Dynamic Strategies

To provide a better understanding, let's explain two dynamic tax-targeted strategies:

1. Tax-Targeted Qualified Disbursals

Tax-Targeted Qualified Disbursals (TQDs) take money out of qualified (tax-deferred) accounts on a discretionary basis at or below a target incremental effective tax rate. TQDs include both dynamic withdrawals to meet annual retirement income and for Roth conversions. The biggest opportunity for TQDs is typically in a person's 60s, after retirement but before beginning Social Security and required minimum distributions (RMDs).

It is important to find a household's optimal target rate by evaluating multiple target rates along with all other available levers in a holistic retirement income plan. Each year, an advisor must determine the maximum total distribution from qualified accounts at or below the target effective rate, taking into consideration all effects of the distribution (including Social Security taxable portion, post-tax basis of tax-deferred accounts, and capital gains taxation).

2. Systematic Capital Gains Management

Systematic **Capital Gains Management** (CGM) is the dynamic implementation of a set of rules for a household's taxable, non-qualified (NQ) investment accounts.

CGM determines account-by-account NQ disbursals in order to minimize realized gains. It also determines the optimal way to rebalance and looks for opportunities to harvest losses and realize tax-free gains.

Advisor's Gamma for Optimal Retirement Income Distribution

Advisors typically quantify their alpha - the after-tax investment returns they are able to generate over and above the market returns. Similarly, we quantify the gamma, the value of a better retirement income plan and distribution for the client.

In this case, we define gamma as additional investment return that needs to be generated to provide similar performance from the Current strategy as can be generated from the Optimal strategy.

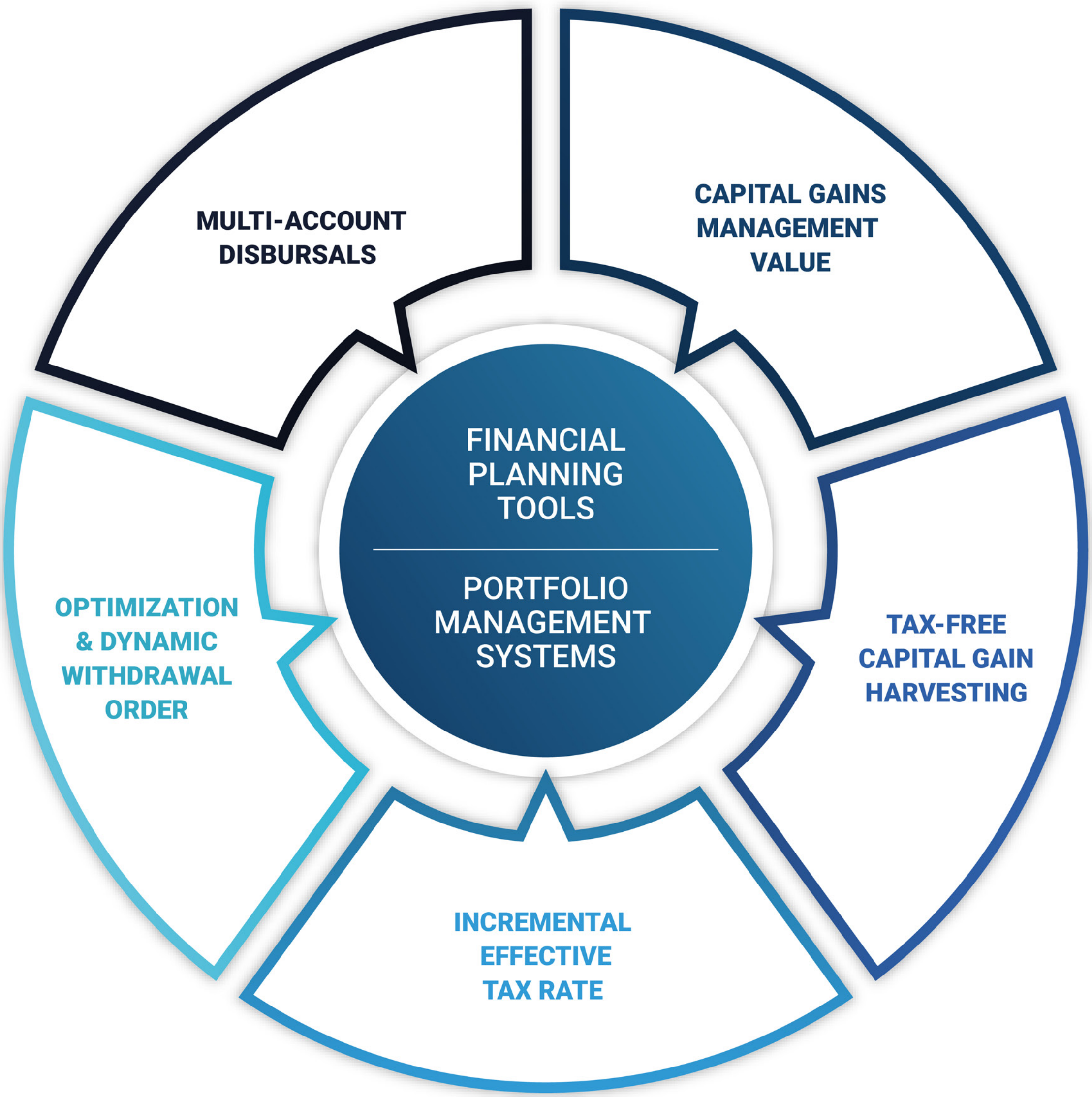
By same performance, we mean generate the desired spending with at least 90% probability of success while generating the same average bequest.

Using the example client case above, for the advisor to meet the desired income at a high level of safety (90% probability of success or better) and match or exceed the average legacy of the Optimal strategy ($1.4M), they would need to generate additional investment returns of at least 275 basis points per year for the household's 30+ year retirement income plan.

Therefore, the advisor's gamma from recommending and executing an optimal retirement income strategy is 275 basis points.

Wealth Management Tech Platform Evolution to Serve Retirees

To enhance the capabilities of the current wealth management tech platform, it is essential for advisors to deliver tax-optimized distributions to their clients. This necessitates the expansion of both financial planning analytics and portfolio management analytics. Income Discovery's intelligent analytics engine, AIDA, offers a solution by providing an expanded capability for Financial Planning Tools (FPTs) and Portfolio Management Systems (PMS). With the integration of AIDA, advisors can effectively deliver a gamma of 275 basis points by using the following techniques.



1. Capital Gains Management Value

To cater to investors in the accumulation and growth phase, the industry has traditionally depended on separate technologies for financial planning and portfolio management, resulting in siloed approaches. Financial Planning Tools (FPTs) typically simulate a model portfolio using average returns and corresponding volatility. However, they often overlook capital gains generated from portfolio rebalancing and distributions in non-qualified accounts, leaving these details to the PMS to handle and generate trades.Therefore, clients are not being effectively shown the benefits of capital gain management strategies, such as minimizing gains during distribution and ongoing tax-loss harvesting during the planning phase. This represents a gap in demonstrating the value of such strategies. AIDA, Income Discovery's advanced analytics engine, can bridge this gap by showcasing the value of these strategies and their impact, enabling clients to better understand the benefits.

2. Tax-Free Capital Gain Harvesting

Currently, most PMS lack the capability to support tax-free capital gains harvesting. These valuable opportunities often arise for clients during their retirement phase and can be reliably identified towards the end of each calendar year. AIDA excels at recognizing and pinpointing these opportunities. For PMS to fully leverage and accommodate these opportunities, they will need to enhance their capabilities to incorporate and support the insights provided by AIDA.

3. Using Incremental Effective Tax Rate

During retirement, it is advisable to employ a TQD strategy when making distributions from qualified accounts. This strategy aims to target an incremental effective tax rate, considering the nonlinear nature of federal marginal brackets. These brackets encompass capital gains taxes that can range from 0% to 15% to 20%, along with the possibility of additional taxation on Social Security benefits due to increased qualified distributions. AIDA plays a crucial role in determining the optimal tax rate for each client household. It offers comprehensive analytics and insights through an API, which can be effectively utilized by FPTs and PMS. By leveraging AIDA's capabilities, FPTs and PMS can enhance their services by incorporating precise tax optimization strategies tailored to each client's specific needs.

4. Optimization and Dynamic Withdrawal Order

To enhance the capabilities of FPTs, it is essential to incorporate comprehensive and detailed tax-targeted dynamic withdrawal strategies. These strategies aim to identify and optimize the optimal tax rate to target for each individual client. It is important to note that this optimization cannot be carried out in isolation. In fact, all the levers available to advisors or clients, such as Social Security claim decisions, pension settlements, annuity allocations, and the optimal tax rate target, need to be co-optimized. These factors interact with each other in a complex manner, impacting both tax and non-tax aspects of the financial plan. AIDA stands out with its extensive optimization capabilities, taking into account all these levers and their interactions. By leveraging AIDA's capabilities, FPTs can achieve a holistic approach to optimization, ensuring that the entire financial plan is optimized for maximum benefit across various dimensions.

5. Multi-Account Disbursals

Typically, PMS primarily concentrate on managing one account at a time. Even when they offer Unified Managed Household (UMH) capabilities that cover multiple accounts, the main objective is often focused on portfolio growth while minimizing taxes.The existing systems lack the crucial element of effectively coordinating distributions from multiple accounts during retirement for optimal results. In contrast, AIDA provides multi-account distribution instructions that specifically target an optimal tax rate for discretionary qualified distributions and minimizes capital gains associated with withdrawals from non-qualified accounts. AIDA ensures that the responsibility of generating cash through trading remains with the PMS, while its advanced capabilities enable the coordination of distributions across multiple accounts for superior outcomes.

To see the assumptions used in this paper, request the appendix by emailing sales@incomediscovery.com

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