

Register



Do the Right Thing, the Right Way, at the Right Time

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Best Practices

Considerations for Qualified Accounts

On Wednesday, April 6, 2016, the United States Department of Labor (DOL) issued a new set of rules governing advice by financial professionals relating to qualified retirement money (IRA, 401(k), etc.).

Central to this rule is the notion that advisors must work in the best interest of their clients rather than their own. Essentially, this “Best Practices” approach is meant to ensure that the interests of a retiree are held above all others. While this seems a very reasonable concept, the law as written is fraught with problems and internal contradictions, and is being challenged in court. Nonetheless, until it is changed or repealed, it is the law of the land.

Central to the DOL Rule is the preservation and growth of qualified retirement accounts (IRAs, 401(k) plans, etc.) for retirees. Specifically, achieving a Best Practices result should focus on three specific goals:

1. Maintaining sufficient return to offset or exceed the schedule of Required Minimum Distributions (RMDs) throughout the average life expectancy of a retiree (from the IRS life tables, ages 70-86).
2. Minimizing account volatility.
3. Reducing the RMDs (operative words here being “required minimum”) without sacrificing the opportunity to take more than the required minimum if desired.

Minimum Required Return

A retiree starting RMDs at age 70, living to the “official” (IRS life table) life expectancy of 86, requires an average annual return of just under 5%. If that person lives to age 90, the return necessary to offset the RMDs climbs to nearly 5.3% per year. However, it’s not enough to compute raw average return. Return without consideration to volatility is only half the picture. In order for a return of 5% to offset the schedule of RMDs, that assumes a constant return of 5%. Unfortunately, when an account is subjected to volatility, the bigger the swings from high to low, the more average return is needed to offset the RMD schedule. It’s math. This is another reason why market exposure is not beneficial to the long-term sustainability of an IRA facing RMDs. Thus,

unless one can find a level, guaranteed real return of 5.3% (through age 90), a more realistic minimum required return would be closer to 5.5% without significant market volatility and 6.0% or more per year with it.

Reducing Volatility

The compounding benefit of dollar-cost averaging — making regular contributions to purchase new shares — is well documented. However, the exact reverse occurs when an account facing RMD withdrawals is exposed to volatility (the swings in value from positive to negative). For example, assume a \$100,000 IRA with 4% RMD (\$4000). After the RMD, the account, now worth \$96,000, must experience 4.17% growth to regain the initial \$100,000 (note 4% growth on \$96,000 is only \$99,840). But RMDs are calculated on last year’s value, subtracted from the current. This means if the markets fall, the RMD is not recalculated and the previous RMD must be subtracted from the lesser account value. For example, suppose markets fall 25%. That same \$4000 RMD is subtracted from the new account value of \$75,000 (net RMD of 5.33%), further reducing the account to \$71,000. To recover the initial \$100,000, a one-year return of 40.85% is required. In short, an IRA facing RMDs cannot be exposed to market risk. Even portfolio diversification cannot reduce “Systematic Risk” (the risk associated with broad market collapses), as occurred repeatedly between 2000 and 2016.



Minimizing RMDs

At first blush this seems impossible. The table of RMDs, published by the Internal Revenue Service (IRS), offers no variance. However, a unique crediting strategy offered by some members of the insurance industry through Fixed Index Annuities (FIAs) actually provides a way to accomplish just this.

As an overview, FIAs credit growth through an indirect measurement to market indexes. While annuity owners get to participate in the upside movement of markets with interest credits because there is no actual market investment, they have no market loss exposure.

Right away, this strategy provides an obvious way to reduce volatility. But a quirk of math with crediting strategies used by some carriers, offers more. This occurs when the carrier tracks market values daily but credits (locks in) less often than annually (e.g., 2 or 3 years). In other words, the accounts simultaneously reflect two different values: a “real time” value from daily tracking and an “official” value at the point of lock-in. Thus, while daily tracked “real time” values may fluctuate, they cannot fall below the previous locked in values and thus, cannot lose from their previous “official” value. With rising markets, each new lock-in resets the “official” value higher but only on the policy’s anniversary (lock-in) date.

Under this situation, in the “odd years” when real time values have not locked in, the real

time value can be higher than the previous locked in value (but never lower). However, the IRS only regards the “locked in” value for calculating RMDs. Therefore, the “odd year” RMDs come out against a lesser value than actual “real time”. This means the mandatory withdrawn amounts are smaller than they would otherwise be, including account reduction from the previous RMD, which while growing in real time is not being reported until the next lock in. This differential creates a “saw-tooth” pattern of RMDs.

Graph 1 Illustrates how a biannual reset strategy would fare against a traditional account of identical return. Note how the “saw-tooth” pattern of RMDs in the annuity (red) results in less mandatory withdrawal in the “odd” years compared with that required under a more traditional account strategy (blue). The difference is the undistributed amount that remains in the account, continues to compound through time and results in a greater total return to the account.

Graph 2 Illustrates the resulting benefit to the account from this phenomenon. While actual results will vary based on many variables, given an assumed constant return of about 6% from age 70 through 90, this “saw-toothing” results in a net average savings of about 2% per year and more than 4.2% increased total return in the account. Mathematically, the differences between the saw-tooth and traditional strategies proportionally increase with greater market volatility.

If more than the RMD is desired, that may be taken but when the RMD is not needed, being able to conserve even a little of it (and thereby not pay taxes on that portion) results in a significant long-term benefit.

The result of these three attributes is to increase the total return and minimize risk to an IRA after RMDs have begun. Considering the principal objective of the Best Practices ruling is to maximize total benefit for a client, it’s difficult to imagine how any other strategy might be superior. ☐

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