



FINANCIAL PLANNING ADVISORY:

*Balancing Retirement  
With Wealth-Transfer Goals*

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*William Blair & Company®*

## *Balancing Retirement With Wealth-Transfer Goals*

With the volatile markets of recent years, now is a good time for anyone to revisit their portfolio and make adjustments as needed to stay on track with their goals. But those who are nearing—or already in—retirement have some unique challenges and opportunities that make a portfolio review even more critical.

Perhaps the most time-sensitive opportunity comes with estate tax law changes under the 2010 Tax Relief Act. The act's \$5 million gift-tax exemption per individual provides an unprecedented chance to transfer large portions of wealth to the next generation tax-free. But the window is small: The exemption will drop to \$1 million in 2013, unless Congress extends the \$5 million amount.

However, before transferring assets to take advantage of the exemption, you need to ensure you will not give away too much, harming your retirement lifestyle and perhaps even your financial security.

That is why a thorough portfolio review is so critical. The review needs to take into account not only what you have now and how it is invested, but also what you are going to need in the future. Unfortunately, in the current economic environment, determining how much you need can be a challenge. There are a wide variety of factors to consider when analyzing portfolio longevity, such as:

- inflation (especially healthcare costs)
- tax effects on your portfolio and potential tax law changes
- market volatility

Only after you have reviewed your portfolio in light of these factors can you determine how much wealth can prudently be transferred to take advantage of the \$5 million gift-tax exemption. Alternatively, you might discover that you need to boost your retirement savings or take other steps to achieve your goal.

William Blair & Company is a full-service provider of investment expertise for high-net-worth individuals, families, business owners, and executives. Since 1935, our firm has advised our clients with the resources of a large, full-service firm, while still maintaining the personal approach of a boutique. Our experience and proven track record is in customizing client portfolios with a wealth management strategy designed to meet each client's financial goals. Our investment advisors collaborate with clients and work with a team of experts to help families grow and protect their wealth for generations.

Please contact your William Blair & Company advisor with any questions.

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## What You Have Now:

# Resources to Fund Your Retirement Years and Wealth-Transfer Goals

The first step in a portfolio review is to inventory all the assets you have available to fund your retirement years and wealth-transfer goals. There are many ways to think about your assets, but one helpful strategy is to look at them based on income-tax treatment.

Taxes can have a major impact on how much you can accumulate and the net amount available for your use—or for the benefit of your loved ones.

Taxable Resources	
Cash	<ul style="list-style-type: none"> <li>Interest earned is taxable at ordinary income tax rates.</li> </ul>
Stocks, bonds and mutual funds	<ul style="list-style-type: none"> <li>Short-term gains, interest, and nonqualified dividends are taxed at ordinary-income rates.</li> <li>Long-term capital gains and qualified dividends are taxed at a lower rate than ordinary income.</li> </ul>
Business interests and real estate	<ul style="list-style-type: none"> <li>Business and rental income generally is subject to tax at ordinary income rates.</li> <li>Tax on growth is deferred until you sell the asset (longer if you implement tax-deferral strategies) and generally subject to long-term capital gains rates if you held the asset more than 12 months.</li> </ul>
Tax-Deferred Resources	
Traditional IRA	<ul style="list-style-type: none"> <li>Ability to deduct contributions phases out at a low income-level if you or your spouse participates in an employer-sponsored retirement plan, but you may be able to make nondeductible contributions. Account grows tax-deferred.</li> <li>Distributions are taxed at ordinary-income rates. After age 70½, you must begin taking annual required minimum distributions (RMDs).</li> </ul>
Traditional defined-contribution plan	<ul style="list-style-type: none"> <li>Examples include profit-sharing plans, 401(k)s, 403(b)s, 457s, SIMPLEs, and SEPs.</li> <li>Contributions are pretax and account grows tax-deferred. Employer may provide profit-sharing or matching contributions.</li> <li>Distributions are taxed at ordinary-income rates. After age 70½ (unless you are still working and not the owner of a 5% or larger interest in your employer), you must begin taking RMDs.</li> </ul>
Defined-benefit plan (pension)	<ul style="list-style-type: none"> <li>The employer funds the plan and bears the investment risk. It is important to know what you are expected to receive and what factors may affect your future benefits.</li> <li>There are no income-tax consequences to you when the plan is funded. You pay tax at ordinary-income rates when you receive distributions.</li> </ul>
Nonqualified deferred compensation	<ul style="list-style-type: none"> <li>If the plan is properly structured and administered, tax on the compensation will be deferred until paid out.</li> <li>The funds are not protected from the employer's creditors. If the company goes bankrupt, you may never get a penny of the deferred compensation.</li> </ul>
Employer-provided restricted stock	<ul style="list-style-type: none"> <li>You pay ordinary income tax when the restrictions lapse (such as if you remain with the company for a certain period of time or the company meets certain performance goals).</li> <li>You can elect to instead recognize the income when you receive the stock, which may be beneficial if the stock's value is negligible or has great appreciation potential.</li> </ul>
Employer-provided stock options	<ul style="list-style-type: none"> <li>No tax is owed when the options are granted; the tax treatment at exercise depends on whether you have <i>incentive</i> stock options (ISOs) or <i>nonqualified</i> stock options.</li> <li>It is important that you understand your plan and the potential tax consequences so you can plan for how and when to exercise the options and sell the stock.</li> </ul>
Tax-Free Resources	
Roth IRA	<ul style="list-style-type: none"> <li>Contributions are after-tax, but higher-income taxpayers are not allowed to contribute.</li> <li>Qualified distributions are tax-free. RMD rules do not apply (except if you inherited the Roth IRA).</li> <li>There are no longer income-based limits on who can convert a traditional IRA to a Roth IRA. The converted amount is taxable in the year of the conversion. For more information, see our August 2010 Financial Planning Advisory, "<b>Roth IRA Conversions: A Powerful Wealth-Transfer Tool</b>" (<a href="http://www.williamblair.com/pwm-resources">www.williamblair.com/pwm-resources</a>), or request a copy from your William Blair advisor.</li> </ul>
Roth 401(k), 403(b), 457 plan	<ul style="list-style-type: none"> <li>Contributions are after-tax, and there are no income-based limits on designating Roth contributions.</li> <li>Qualified distributions are tax-free. After you reach age 70½, you must begin taking RMDs. However, you can avoid them by rolling over to a Roth IRA.</li> </ul>
Municipal bonds and municipal bond funds	<ul style="list-style-type: none"> <li>Interest on state and local government bonds is excludible on federal returns.</li> <li>If the bonds were issued in your home state, interest also may be excludible on your state return.</li> </ul>

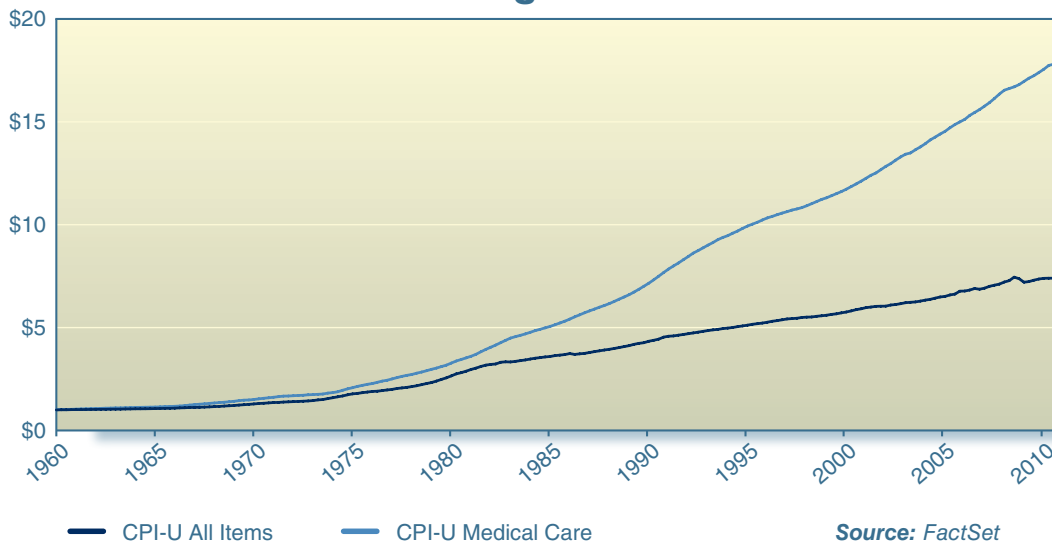
## Factors Affecting Your Portfolio's Longevity

Once you have defined what you have, you should consider the factors that will have an impact on how long your assets will last during the decumulation phase—the period during which you are living off your retirement plan assets and other investments rather than earning income and building these resources. Three major factors to consider are inflation, taxes, and market volatility.

### INFLATION

While inflation is currently low, consider that even a low inflation rate can have a major impact over time. Assuming an inflation rate of only 2.25%, for example, what costs \$150,000 today will cost \$261,621.95 in 25 years. Higher inflation rates—which, given history, are likely to occur at some point during your retirement—would, of course, have an even larger impact.

### Healthcare Costs Rising Faster Than Inflation



Source: FactSet

Of all the wild cards involved in planning for your retirement, however, perhaps the biggest unknown and most difficult to control is your future healthcare costs. Healthcare costs are rising much faster than the overall inflation rate: As shown in the chart, what cost \$1 in 1960 generally cost about \$7.50 in 2010. But for healthcare expenses, what cost \$1 in 1960 cost nearly \$18.00 in 2010, and it is unlikely that these costs will abate anytime soon. Moreover, as we age, we tend to consume more healthcare products and services. At the same time, better healthcare is resulting in longer life spans for many Americans. If you are fortunate to be among them, you could be spending many years in the retirement phase. That means your assets will need to last longer than you may have initially thought. Nevertheless, inflation is not to be feared; rather, it is simply something to be taken into consideration.

### TAXES

Tax rates on ordinary income (including interest), qualified dividends, and short- and long-term capital gains will all go up in 2013 if Congress does not extend the current rates. Given increasing concerns about the growing federal deficit, there may be a good chance that the higher rates will, indeed, be allowed to go into effect.

In addition, the healthcare reform act signed into law last year includes a provision that will increase taxes on unearned income beginning in 2013: Taxpayers with modified adjusted gross income (MAGI) over \$200,000 (\$250,000 for joint filers) will pay an additional 0.9% Medicare tax on *earned* income and a new, 3.8% Medicare tax on *unearned* income, such as interest, dividends, rents, royalties, and certain capital gains. (The taxes do not apply to retirement plan distributions.)

As a result, planning for taxes during retirement is critical. Even if you are in a lower tax bracket during retirement, your effective tax rate may not be much lower than it is now—or it may even be higher. For example, the rate for the second-highest tax bracket is currently 33%, but it is scheduled to increase to 36% in 2013—higher than the current highest tax rate of 35%.

Also remember that traditional retirement plan distributions are subject to ordinary-income tax rates, not long-term capital gains rates. Beginning in 2013, qualified dividends will again also be subject to ordinary-income tax rates rather than long-term capital gains rates. This may have

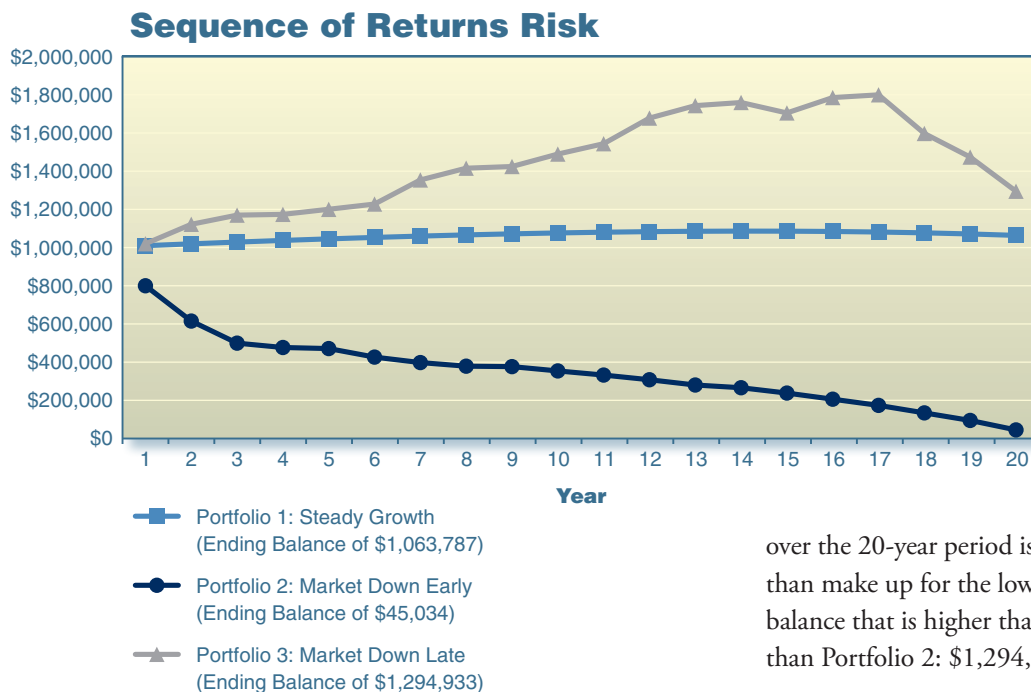
What Is the Top Marginal Income Tax Rate?	2011-2012	2013
Ordinary income	35%	39.6%
Qualified dividends	15%	39.6%
Capital gain on assets held:		
• 12 months or less ( <i>short term</i> )	35%	39.6%
• More than 12 months ( <i>long term</i> )	15%	20%
Long-term gain that would be taxed at 15% or less based on taxpayer's ordinary-income rate	0%	10%

a significant effect on many retirees, whose portfolios often contain more income-producing investments than those of taxpayers who are still in the accumulation phase and more focused on growth.

## MARKET VOLATILITY

During the accumulation stage, as you are saving and investing for retirement, you are less dependent on each year's return on your investments as long as the long-term average of these returns is positive. In other words, there may be periods of positive returns and periods of negative returns, but if they average out to a positive long-term return, you benefit from the long-term compounding effect of your savings and have the potential to increase the size of your portfolio.

However, during the retirement, or decumulation, phase (when you begin to withdraw assets from your retirement portfolio to create income), the magnitude of those negative returns—as well as *when* they occur—significantly affects your overall plan. The impact of timing, or “sequence of returns,” is highlighted in the example below:



The chart shows three portfolios, all of which have:

- a beginning balance of \$1 million
- an average return of 5% over 20 years
- a starting withdrawal rate of \$40,000, which is then adjusted for inflation by 2.25% annually

The portfolios differ based on whether there are periods of volatility and, if so, when those periods occur:

**Portfolio 1** experiences steady growth of 5% annually, and the ending balance after 20 years is \$1,063,787. Even with withdrawals, the principal is maintained, with some room to spare. In real life, however, it would be very difficult to maintain steady 5% growth over 20 years. Therefore, while Portfolio 1 is valuable to consider for comparison purposes, Portfolio 2 and Portfolio 3 are potentially more realistic examples of what a portfolio might experience.

**Portfolio 2** experiences negative returns in the early years and higher returns in the later years. After only three years, the combination of negative returns ranging from -12% to -20% and withdrawals reduce the principal by more than 40%. As a result, growth over the remaining 17 years is on a significantly smaller base amount than in Portfolio 1, whose principal, despite withdrawals, has grown slightly after three years. Although the average return over 20 years is still 5%, the low returns in the early years combined with the withdrawals have a substantial negative impact, resulting in an ending balance of only \$45,034.

**Portfolio 3** experiences high returns in the early years and negative returns in the later years. After only three years, with annual returns ranging from 6% to 14%, the principal has grown by nearly 17% despite the annual withdrawals. As a result, growth over the remaining 17 years is on a larger base amount than in Portfolio 1, and a significantly larger base amount than in Portfolio 2. Although again the average return

over the 20-year period is 5%, the higher returns early more than make up for the low returns later, resulting in an ending balance that is higher than Portfolio 1 and significantly higher than Portfolio 2: \$1,294,933.

As you can see, while you may be on a steady course of even withdrawals during your retirement, volatility will influence the longevity of your portfolio. Portfolio longevity analyses with your William Blair team on a regular basis are essential so that adjustments may be made. The bottom line is that volatility matters, and it matters even more in retirement.

## What You Need: Identifying Core Assets vs. Surplus Assets

How do you determine if, given the various factors that will affect your portfolio's longevity, you have what you need to fund both your retirement and wealth-transfer goals? You can work with your William Blair team to distinguish your core assets from surplus assets. By using projection models, you and your advisors can better determine how much you may need to ensure a greater probability that you will be able to maintain your desired level of income during retirement and achieve your wealth-transfer goals as well.

Models also incorporate a variety of spending assumptions. These may include basics such as housing and medical care coverage, as well as other expenses that will help you maintain the lifestyle you desire, such as travel and entertainment. Other inputs include sources of risk and your personal risk tolerance.

The goal is to make sure your resources outlive you. So constructing a fundamentally sound portfolio that neither overestimates returns nor underestimates lifespan is likewise critical. The William Blair team uses a process of assumptions and inputs that are conservative yet realistic.

Lastly, capital market assumptions, developed by a third-party consultant, employ both historical returns and proprietary models to forecast future returns considering current market and economic conditions. The use of third-party forecast data ensures objectivity when developing portfolio structures.

After all modeled simulations are analyzed, results are categorized into percentiles and interpreted depending on an individual's situation. William Blair financial planning advisors believe it is most prudent not to rely on outperformance to support living needs. Therefore, the forecast returns

are intended to represent beta, or broad market index returns. However, if outperformance should occur, opportunities for additional wealth transfer may arise.

### SURPLUS?

If a significant surplus exists, you may be in a good position to take advantage of the current \$5 million gift-tax exemption to transfer assets to heirs. Remember, this potentially is a limited-time opportunity because the exemption is scheduled to drop back down to \$1 million in 2013.

There are many techniques you can use, from outright gifts to various trust strategies. For more information, see our January 2011 Financial Planning Advisory, *"Estate Planning Strategies in an Environment of Change"* ([www.williamblair.com/pwm-resources](http://www.williamblair.com/pwm-resources)), or request a copy from your William Blair advisor.

### INSUFFICIENCY?

If your retirement resources are insufficient to meet your desired lifestyle or your wealth-transfer goals, it may be necessary to consider the following:

- increasing pre-retirement savings
- retirement date adjustment
- reducing retirement spending plans
- adjustments to the portfolio allocation, including enhancing liquidity where possible
- part-time employment during retirement

2011 Retirement Plan Contribution Limits	Limit for Taxpayers Under Age 50	Additional "Catch-up" Limit for Taxpayers Age 50 and Older
<b>Employer-Sponsored Plans</b>		
401(k)s, 403(b)s, 457s and SARSEPs <sup>1</sup>	\$16,500	\$5,500
SIMPLEs	\$11,500	\$2,500
<b>Plans for Business Owners and the Self-Employed<sup>2</sup></b>		
Profit-sharing plan	\$49,000	\$5,500 <sup>3</sup>
SEP	\$49,000	\$0
<sup>1</sup> Includes Roth versions where applicable <sup>2</sup> If you have employees, they generally must be allowed to participate in the plan, provided they work enough hours <sup>3</sup> Plan must include a 401(k) arrangement <b>Note:</b> Other factors may further limit your maximum contribution.		

For example, if you are age 50 or older and are still working, you can take advantage of “catch-up” contributions to further build your tax-deferred or tax-free retirement savings. If you are a business owner or self-employed, you may be able to set up a plan that will allow you to make even larger contributions, such as a profit-sharing plan or SEP.

*By using projection models, you and your advisors can better determine how much you may need to ensure a greater probability that you will be able to maintain your desired level of income during retirement and achieve your wealth-transfer goals as well.*

If you face a deficiency in resources to fund your desired retirement lifestyle or wealth-transfer goals, your William Blair advisors can assist you with determining strategies to address the shortfall.

## **BENEFITS OF A PORTFOLIO REVIEW**

A portfolio review with your William Blair advisors can help you determine whether your assets are sufficient to help you achieve both your retirement and estate planning goals or if there are changes you should consider making.

Significant estate planning opportunities are available through 2012. But before you give away assets to take advantage of them, you need to make sure you can do so without harming your own financial security or desired retirement lifestyle.

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## **Asset Allocation Webinar**

Whether your goal is to accumulate, preserve, transfer, or spend wealth—or some combination of these—creating the appropriate mix of equities, bonds, cash, and alternative investments is essential to achieving these objectives. After a portfolio review, a change in asset allocation may be necessary to stay on track with your goals.

William Blair & Company recently presented “Understanding Asset Allocation Within Your Portfolio” as part of their Financial Talk Series. In this interactive webinar, Ryan Dimas (CFA, CAIA, Principal) provides an overview of asset allocation. In addition to discussing the risk and return characteristics of the various asset classes, Ryan explains the role diversification plays in reducing volatility within a portfolio.

To access the replay of this webinar, please visit [www.williamblair.com/PWM-resources](http://www.williamblair.com/PWM-resources).

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