

The Morningstar Grand Generation Retirement Guide

Tips for investors in retirement.

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You're retired—or at least semi-retired. Your biggest money concerns these days involve making sure that your nest egg lasts through your retirement—and in some cases, beyond. Perhaps you're looking for new ways to generate retirement income, or are still unsure how much income you can tap from your investments each year. Or maybe you're wondering whether you're taking on too much risk, or too little.

We designed *The Morningstar Grand Generation Retirement Guide* to help retired investors manage their portfolios.

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Ride the Retiree Wave with Dividends

By Josh Peters, CFA

It's no secret what's about to crash onto the shores of the American economy. Rather than working for money, the massive baby boom generation expects to have its hard-earned money work for it.

At the same time, another megatrend is rolling through corporate America. Despite all-time record profits, big business isn't investing in new factories, stores, and workers the way it usually does—and the cash is piling up.

If this sounds like a dream scenario for dividend investors, well, it just might be real. We're certainly focusing on these trends in *Morningstar DividendInvestor*, which I edit.

But we can't just buy any dividend-paying stock and expect the newly retired to run it up; a lot of traditional income sectors like real estate investment trusts and utilities are already expensive. If we're going to ride the wave from here, we need an unconventional strategy:

- 1 Buy dividend potential, not just current yield
- 2 Look for unconventional sources of income

Demand Side: Pay Up or Get Dumped

In the effort to sustain their standards of living, the 80 million boomers face unprecedented challenges. As a group, they haven't accumulated enough savings in their working lives. Long-term interest rates remain low, compounding the challenge of extracting sufficient income from nest eggs.

Are stocks the solution? These retirees already own a huge chunk of the market's wealth. While the bull market of 1981-2000 added handsomely to their assets, the bear market of 2000-2002 taught these folks that touch-and-go capital gains can't be trusted to provide regular income.

But there's good news here. While companies in the S&P 500 paid \$200 billion in dividends last year, they earned \$700 billion and generated something like \$500 billion in free cash flow. The market's yield, though higher at 1.9% today than it was five years ago, remains too low to fund retirees' need for income.

One way or the other, the stock market's yield has to go up. One way would be to see the boomers dump their stocks in search of income wherever it can be had. Since falling prices instantly translate to higher yields, that'd be one way to solve the problem. But faced with the prospect of a widespread dumping of stocks, corporate America may have little choice but to take payout ratios substantially higher.

Supply: Means and Motive

The good news for retirees—and all investors—is that the corporate sector has ample means to pay higher dividends. The payout ratio—35% for the S&P 500 at the end of 2005—is as good a place to start as any, and it is substantially below the market's long-run average of 50%. Bringing today's payout ratio up to historical norms implies a yield on the S&P of about 2.5%.

Yet the market payout ratio plays only one part in my case. Looking out across the myriad of shifts in the economy over the last few decades all points to more cash for dividends:

Falling capital intensity. The American economy isn't the world's metal bender the way it once was. Think of the giants of U.S. business in 1950—**U.S. Steel X**, **General Motors GM**, **AT&T T**, and the like. Expanding productive capacity to keep up with population and rising incomes forced massive outlays of cash for steel mills, assembly plants, and copper wires. As a result, the net cash content of reported earnings from the 1950s to the 1970s—free cash, of course, being what investors are really interested in—was much lower than it is now. Today, with knowledge-based standard-bearers like **Microsoft MSFT** and **Johnson & Johnson JNJ**, American industry doesn't need to reinvest nearly as much of its reported profits to support growth.

Rising returns on equity. Conventional wisdom (among economists, anyway) suggests that when returns on corporate equity are high—as they are today, I estimate 18% for the S&P 500—companies have an incentive to reinvest and grow faster. But faster reinvestment by business doesn't necessarily accelerate growth; more likely, it depresses returns. With today's returns on equity so high, future growth is less costly to fund—again, leaving more cash available for dividends.

Realignment of management incentives. None of the above would matter much if CEOs were only oriented toward earnings growth. But no longer do

you find most CEOs compensated on the basis of sales or earning per share growth alone. Much more often, you'll find performance evaluated on the basis of return on invested capital (or ROIC, a close cousin of return on equity), profit margins, and free cash flow. And if high returns and cash flow are the basis of incentives, that's what most managers are going to deliver.

An increasingly payout-friendly tax code. When marginal tax rates for dividends and capital gains were very high, it made sense to retain as much profit as possible, using those funds to invest and increase earnings, which would then be passed on to investors via long-term unrealized (tax-deferred) capital appreciation. But as you reduce the tax rate on the cash corporations pay out to investors, the incentive trends in favor of paying out more.

Any one of these factors might not motivate greater free cash flows or higher dividend payouts. But put together, they're practically a landslide shift in favor of dividends.

Riding the Wave

Investors' newfound preference for income is already in evidence—just look at the massive runup in prices for utilities and REITs in the past few years. Yet not every dividend-paying stock—even those with high yields—stands to benefit from the trends I've just discussed.

For example, I can't see most utilities stocks riding this wave. Most of their yields are already below those of long-dated Treasuries. And with

the industry already paying out 65% of earnings and well over 100% of free cash flow (underscoring how much it costs utilities to grow), there's not much room for stepped-up payout ratios. Exceptions exist, but as a rule, they're already giving about all they have to give.

I'd rather spend my time on companies with high free cash-flow yields but still-modest dividend payouts. Take **Illinois Tool Works** ITW, a superb industrial manufacturer. ITW is obviously committed to its dividend—it's raised it 43 years in a row. Better yet, its return on equity over the past 10 years suggests ITW could pay a significantly higher dividend and still obtain good earnings and dividend growth.

I'm also on the hunt for firms with big buyback programs that could be diverted to dividends instead and I like the prospects for well-chosen master limited partnerships (MLPs). In the long run, buying undervalued stocks is the best route to higher total returns.

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How to Manage Risk in Retirement

By Sue Stevens

In the course of being an advisor, I talk about risk a lot—the risk the market will fall, the risk inherent in any one stock, the risk that your money won't keep up with inflation, and so forth. There are a couple of risks unique to retirement that I'd like to spend some time on today—the risk of outliving your assets (longevity risk) and the risk of overspending in your retirement years.

Longevity Risk

One of the common concerns I hear from people approaching or in retirement is the fear of running out of money too soon. It's tough (okay, impossible) to know just how long a life expectancy you should plan for. When I run retirement projections for people, I'm now using age 97 as the default life expectancy. If I know that long lives run in a client's family, I may shift this even further out. For example, I have one client whose mother is 101 and going strong. So we built a very long life span into my client's future planning, too.

When you're planning for your retirement years, you'll want to err on the conservative side of life expectancy, meaning that you should plan as though you're going to live to a ripe old age. When you look at tables showing average life expectancies based on your current age, remember they are just averages.

You probably want to add several years to the average to account for a higher-than-average life expectancy. You also want to consider the advances in medical care not only now but into the

future. It's really not unusual to see people living into their late 80s and 90s today. Statistics also show that if you are married, you should add on even more years.

Let's look at an example. For a couple aged 65 and about to retire, there is a 50% chance that one of them will live to age 91 and a 25% chance that at least one of them will live to age 96. That's more than 30 years of retirement to finance. Look at your own family history. That's the best indicator of what your genes have to say about longevity. But remember too that with medical advances, you may very well live longer than your parents and grandparents did.

Historically, women have lived longer than men. That may be changing somewhat as women have entered the workforce in greater numbers and are subject to many of the same risk factors as their male counterparts. However, in general, women should plan for a longer life expectancy than men. You also need to factor in women's longer life expectancies if either of you has a pension plan that allows you to choose a single life annuity or a joint and survivor annuity. In most cases with married couples, you'll want to choose the joint and survivor annuity, which will cover both spouses' lives. Many annuities have "pop-up" features that allow the annuity payout to pop up to the higher single life annuity amount should one spouse die prematurely. If you have a pension plan at work, you should investigate if this is an option you can choose at retirement.

There are protections you can put in place to guard against longevity risk. One is purchasing or electing an immediate annuity. If you have a pension plan that offers annuities, choose the option that insures both lives. That will guarantee (as long as the insurance company is solvent) that you won't outlive your income stream. If you don't have a pension plan, you can still purchase an immediate annuity. It's not necessary to purchase an immediate annuity to cover all of your expenses. Perhaps you can just cover your fixed expenses. You may still want a portion of your portfolio invested in stocks for growth. Also consider purchasing inflation coverage if you buy an immediate annuity. That increases the amount you get in your check each year and eliminates one of the downsides of an annuity.

To sum up, give some thought to what life expectancy is not only reasonable, but practical given your personal family history and your current health. Err on the side of too long rather than too short. Consider an immediate annuity to address outliving your assets.

Spending Risk

If you read lots of retirement surveys, as I do, you'll see patterns and trends. People are living longer in general and spending more money in retirement than previous generations. In particular, people are spending more on gasoline, entertainment, travel, and health care.

When you think about your retirement years, you may find it helpful to divide them into two stages:

your younger retirement years, when you want to be more active, and your older years, when physical limitations may prohibit a more active lifestyle and your health-care costs will likely increase. You need to plan adequately for both of these stages. It used to be that planners talked about an income-replacement ratio of 70% to 90% to cover retirement living expenses. I rarely reduce my clients' projected living expenses simply because they'll be in retirement.

Most of my clients expect to spend about the same, or perhaps even more, in retirement than they do now. That's because they want to travel, play more golf, or spend more time on hobbies. One way of thinking about expenses is to group them by essential (fixed) costs and lifestyle (discretionary) costs. I like the idea of using an immediate annuity to cover the fixed costs. You could also do the same thing with assets like Treasury Inflation Protected Securities. You would just purchase enough TIPS to generate interest equal to your fixed expenses. Unlike other bond types, TIPS have the advantage of never falling behind inflation. While we're not seeing much inflation now, I doubt that will always be the case.

Don't forget to budget for the one-time big expenses too—like new cars periodically or special trips you've been planning. Many people also want to make sure that there is something left to pass on to their children or grandchildren. Any of these factors will mean that you may need to adjust your level of spending in retirement. And let's not forget about health-care expenses. The

Employee Benefit Research Institute estimates that a couple (with both spouses age 65) could require as much as \$295,000 to cover health insurance premiums and out-of-pocket expenses if they live to their life expectancy. If they live to age 95, that number jumps to \$550,000.

This high cost of health-care comes at a time when a record number of employers are cutting back their retiree health-care insurance coverage. The percentage of large employers (those with 200 or more workers) that offer retiree health-care coverage has been decreasing—from 66% in 1988 to just 35% in 2006. And don't think your former employer can't cut your health-care coverage once you are already retired. I've seen that happen.

Although we aren't seeing a large increase in inflation overall, there is marked inflation in health-care costs. Studies show that while the annual overall inflation rate from 1987 to 2006 is 3.1%, the health-care inflation rate is 5.1%. Careful planning long before you retire can help address this risk before you find yourself awash in medical bills.

No discussion of the spending risks in retirement would be complete without touching on the cost of long-term care. Home health care is a popular option that is increasingly covered by long-term care insurance. According to a paper distributed by the National Bureau of Economic Research, 44% of women and 27% of men aged 65 should expect to spend some amount of time in a nursing home. This research also shows that the average stay for a woman is two years and for a man is 1.3 years.

But patients suffering from Alzheimer's often require as many as eight or more years of assisted living and/or nursing home.

According to the MetLife 2006 Survey of Nursing Home and Home Health-Care Costs, the average rate for a private room in a nursing home is about \$200 a day or about \$75,000 a year. As you think about countering the risk of spending in retirement, there are several things you can do to protect yourself:

Run your retirement projections out to a reasonable life expectancy. Plan for a longer-than-average life.

Add up what you're spending now if you are about to retire or if you are in retirement. Remember to include less frequent expenses like travel, cars, and real estate taxes. Plug those expense numbers into your retirement projection to see how long your assets last.

Try to generate enough income from fixed sources (like TIPS or an immediate annuity) to cover fixed costs.

Make sure your retirement budget has adequately prepared for health-care costs in retirement, which may include long-term care.

A version of this article appeared in the July 2007 issue of *Morningstar Practical Finance*.

How to Deploy a Big Cash Stake

A retired couple plots a strategy for getting back into the market.

By Christine Benz,
Director of Personal Finance

Bob and Janet Callahan (not their real names) find themselves in a very familiar investment pickle. They know they have too much cash in their portfolio but they're not sure what to do with it. To be sure, the couple hasn't been complaining about all that cash, at least until recently. As global stock markets were almost uniformly depressed until early March 2009, their cash position offset weakness in their equity holdings. Longer-term, however, the Callahans are concerned about missing out on a rebound in stocks.

They're both in their late 60s. Janet is a homemaker, while Bob is an engineer who still provides part-time consulting services for his former employer. They have three grown children, all of whom have left the nest and are financially stable. Bob and Janet are both in generally good health. The couple is concerned that, with a too-tame investment mix, their portfolio may not last through what they expect to be a long and fruitful retirement.

Investors can end up with big cash stakes for a variety of reasons. Receiving an inheritance or some other financial windfall is one of the most common triggers. Bob and Janet wound up

with a lot of cash for a different—but perhaps no less common—reason.

Up until early 2008, the pair had roughly three fourths of their assets in stocks with the rest in cash and bonds. But as the subprime crisis worsened and stocks headed south in the first quarter, Bob got nervous about the toll that market turmoil was taking on the pair's assets. He shifted much of the couple's equity holdings into cash and retained only the natural-resources and emerging-markets funds that were holding up well at that time. As the couple's remaining stock funds got roughed up, Bob became paralyzed with indecision.

As a result, Bob and Janet's portfolio currently has a schizophrenic look. On the one hand, they have small positions in some very aggressive region-specific holdings, which slid substantially during 2008 but have mounted a comeback recently. Meanwhile, the bulk of their portfolio is parked in cash and bonds.

The pair would like to know whether they should hang on to their niche stock funds. At the same time, they'd like to invest their cash so that they can obtain some growth. Another goal for Bob is to create a stable portfolio that he can live with through a variety of market environments. He's been an active trader for much of his investing career but acknowledges that he's had mixed success. In the future, he'd like to spend more time on relaxation than portfolio management, and he'd also like to worry less.

Holding	Ticker	Star Rating	Category	Holding Value	Expense Ratio %
iShares FTSE/Xinhua China 25 Index	FXI	★★★★★	Pacific/Asia ex-Japan	67,317	0.74
iShares S&P Latin America 40 Index	ILF	★★★★	Latin America Stock	92,108	0.5
Loomis Sayles Bond	LSBRX	★★★★	Multisector Bond	276,534	0.97
Cash				843,072	
Total				1,279,031	

Holding	Ticker	Star Rating	Category	Holding Value	Expense Ratio %
Dodge & Cox Stock	DODGX	★★★★	Large Value	300,000	0.52
Vanguard Primecap Core	VPCCX	★★★★	Large Growth	220,000	0.55
Masters' Select Smaller Companies	MSSFY	★★★	Small Growth	85,000	1.31
Tweedy, Browne Global Value	TBGVX	★★	Foreign Sm/Mid Value	100,000	1.37
Vanguard Total Int'l Stock Index	VGTSX	★★★★	Foreign Large Blend	50,000	0.27
Metropolitan West Total Ret Bond	MWTRX	★★★★★	Int-Term Bond	250,000	0.65
Loomis Sayles Bond	LSBRX	★★★★	Multisector Bond	100,000	0.97
Vanguard Short-Term Bond Index	VBISX	★★★★★	Short-Term Bond	100,000	0.18
Cash				74,031	
Total				1,279,031	

Finding an appropriate stock/bond split is the first step for Bob and Janet. The pair are currently covering their monthly living expenses—with money to spare—thanks to a combination of Bob's consulting income and Social Security. Therefore, current income isn't a concern. Nonetheless, increasing their bond stake will bring added stability to their portfolio, thereby ensuring that it won't be at a low ebb when they begin tapping their assets. (Bob expects to leave his consulting position within the next few years.)

I'm a big fan of the Callahan's sole bond fund, **Loomis Sayles Bond** LSBRX, but think it's too aggressive to serve as the couple's core fixed-income holding. The Loomis Sayles fund includes big doses of emerging-markets and high-yield (junk) bonds, both of which are prone to big fluctuations and sold off sharply in 2008. I'd recommend that they put the bulk of their fixed-income assets in a higher-quality bond fund like **Metropolitan West Total Return Bond** MWTRX. (**Harbor Bond**

HABDX would also fit well here). For further stability, I'd recommend that the pair keep a portion of their bond assets in a high-quality short-term fund like **Vanguard Short-Term Bond Index** VBISX.

Both the Loomis Sayles and Met West funds are truly active, meaning that the managers aim to go where the best opportunities are rather than sticking with a single market sector through thick and thin. That makes them a good fit for Bob, who's not content to sit on his hands when the market is choppy. Essentially, he's delegating the portfolio management he once handled himself to active managers.

I think the pair should extend that concept to their equity holdings. Performance at **Dodge & Cox Stock** DODGX has been terrible over the past few years, but its deep, experienced management team exemplifies topnotch active management. For growth-leaning exposure with a similarly contrarian mind-set, it's hard to do better than the Primecap team. **Vanguard Primecap Core** VPCCX features highly experienced managers as well as a rock-bottom expense ratio.

On the international side, I'd recommend that the Callahans sell their Latin America and China offerings and supplant them with broad-based international funds. The managers of **Tweedy, Browne Global Value** TVGVX use a prudent, value-oriented approach and attempt to deliver a positive return through all market environments. That fund's managers hedge all of the fund's currency

exposure, meaning that if foreign currencies appreciate versus the dollar, the fund doesn't participate. To help give the Callahan's portfolio at least some exposure to foreign currencies and developing markets, I'd recommend a smaller stake in an unhedged foreign-stock index fund like **Vanguard Total International Stock Market Index** VGTSX. Because that fund includes some energy and basic-materials exposure, I'd cut loose their dedicated natural-resources fund.

Almost as essential as reshaping their holdings is the strategy that Bob and Janet employ as they do it. Rather than make these changes all at once, I'd recommend that they use a dollar-cost averaging strategy. By that I mean that they'd put equal amounts into the new funds for each month over the next 12 to 18 months. That strategy reduces the chance that they'll put a lot of money to work only to see stocks fall further still.

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Income Alternatives for Retirees

By Morningstar Analysts

Longtime stock investors often have a tough time embracing bonds. Yet as these investors approach and cross over into retirement, they need to figure out how to live off their portfolios. Very often, retirees buy bonds so they can spend the income that the bonds generate.

There are other ways to generate income in retirement, though. In fact, you might find some of the alternatives more to your liking. While bonds will typically provide more income than the securities discussed here, these bond alternatives hold out the promise of higher long-term returns. They offer income and growth potential.

Why Not Bonds?

Bonds are the traditional retirement investment, because retirees can live off their income and simultaneously avoid the volatility of stock investments. The catch is that you have to have a lot of money in bonds to generate a sizable enough income stream to cover your retirement costs.

Say you need \$50,000 per year to live on. You own an intermediate-term bond fund yielding 5%. You'd need to have \$1,000,000 invested in that fund to receive \$50,000 worth of income. And a few years down the road, you'll probably need more than \$50,000 per year to live on, thanks to inflation. If that 5% yield was enough before, it may no longer be.

The following income alternatives will do a better job of keeping ahead of inflation than bonds—they

offer more potential for greater overall return. They typically won't pay as much income as bonds, though. As a result, you will likely have to tap into your portfolio to meet your income needs.

Dividend-Paying Stocks

Many companies reinvest their profits to fuel future growth. Some mature companies, however, have limited growth potential. They may already dominate their industries and have little opportunity for expansion. Because of that, these companies pay out their profits to shareholders in the form of dividends.

You can either choose your own dividend-paying stocks or buy a mutual fund that focuses on these securities. Find a list of dividend-paying companies with a stock screening tool, like the one offered by Morningstar.com.

If you want to invest via a mutual fund, begin your search with large-value funds. Large-cap value funds tend to own well-established companies that have fewer opportunities for growth and therefore pay dividends.

Preferred Stocks

A preferred stock gets its name because its shares get preference when a company pays out dividends. These stocks are higher in the company's capital structure than ordinary or "common" stocks. In fact, preferred shares may offer dividends while common shares pay no dividend at all.

Is there a cost to preferential treatment? Yes. Preferred stocks offer less capital-appreciation potential than common stocks. Investors buy preferreds mostly for income, not for capital appreciation.

If you want to buy preferred stocks yourself, you'll have a tough road ahead of you. Unlike common stocks, preferreds can be difficult for individual investors to trade; institutional investors tend to trade the shares among themselves rather than on the open market.

A few closed-end funds, including **John Hancock Patriot Preferred** HPI focus on preferreds.

Convertibles

There are two types of convertibles: convertible bonds and convertible preferred stocks. Both are hybrids of stocks and bonds. Convertibles are income-producing investments that can be converted into shares of the company's stock. They offer much of the income of bonds with some of the capital-appreciation potential of stocks.

If you want to buy convertibles yourself, good luck. Thanks to the relatively small size of the market, do-it-yourself convertibles investing is well nigh impossible. We recommend that investors look into convertible-bond mutual funds instead. To narrow down a list of possible options, using an online tool such as Morningstar Investment Research Center's Fund Screener. You can also read our Fund Analyst Picks for ideas, too.

Reap Capital Gains

Whether you explore these income alternatives or not, remember that your income in retirement does not have to come exclusively from dividends. Consider harvesting some of your capital gains to cover your living expenses—your income-generating securities may not generate enough income to cover all of your costs anyway.

In years when your investments have made especially strong gains, you may consider drawing out more than you need for living expenses and keeping the excess in a money-market account. That way, you can pull from that account when your funds are down and you need to supplement your income. You'll avoid turning paper losses into real ones.

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How to Manage Risk in Retirement

By Christine Benz,
Director of Personal Finance

The recent market downturn has been hard on all investors, but none more than retired and pre-retired individuals. In a recent issue of my newsletter, *Morningstar PracticalFinance*, I helped a soon-to-be-retired couple position their portfolio to last over what they hope will be a long and fruitful retirement.

Walter and Wilma Ludwig (not their real names) are just starting down the road of what they hope will be a long and happy retirement. Walter, 65, recently retired from a major manufacturing firm, and Wilma, 68, sold her small retail business a few years ago.

Both plan to work part-time through this year to supplement the income they're currently receiving from Social Security and Walter's small pension.

The pair, who don't have children, plan to fully retire in 2010. They love to travel, and they're looking forward to spending more time at their vacation apartment in Europe.

Like many retirees, they have seen their portfolio battered by market storms over the past year. After watching the equity funds in his 401(k) plan plummet by 48%, Walter recently moved his 401(k) assets into a cash/cash-equivalent fund. As a result of this shift, roughly two thirds of the pair's assets is now in cash or cashlike assets. That big cash position has provided peace of mind and cushioned their portfolio recently, but Walter and Wilma are concerned about their portfolio's ability

to last through their retirement years if it's earning only a meager rate of return.

They're looking for guidance on how to improve their portfolio's upside potential while keeping it on a fairly even keel. And while they're not currently tapping their retirement assets for living expenses, they'd also like help establishing a portfolio and withdrawal strategy for when they do retire in 2010.

Holding	Ticker	Value (\$)
Can Slim Select Growth	CANGX	2,234
T.Rowe Price Eq Inc	PRFDX	88,614
Weitz Value	WVALX	1,784
Fidelity Contrafund	FCNTX	12,374
Bridgeway Aggressive Inv	BRAGX	5,333
Dodge & Cox Income	DODIX	13,502
Fairholme	FAIRX	6,969
iShares MSCI Emer Markets	EEM	12,600
Perkins Sm Cap Value	JSCVX	1,449
Cash		255,141
Total		400,000

Cash takes up roughly two thirds of the Ludwigs' portfolio currently, and the rest of the assets are primarily invested in stock funds. The pair has a relatively small position in a single bond fund, **Dodge & Cox Income** DODIX. In all, their portfolio is notably light on bonds and bond funds given the couple's ages and life stage.

In addition, the couple's two homes, which together have a value of more than \$1 million, take up a substantial portion of their net worth. They don't hold mortgages on either property. Walter says that they plan to sell their primary residence, currently valued at roughly \$800,000, within the next three years and buy a condominium or apartment for approximately \$250,000 to \$300,000.

Walter and Wilma have just nine long-term mutual funds in their IRAs and taxable account, making their portfolio positively svelte relative to those of most other couples at their life stage. Nearly all of their funds are Morningstar Fund Analyst Picks. The pair's equity portfolio has a strong bias toward the value column of the Morningstar Style Box, however, and it also has a bigger emphasis on small- and mid-cap stocks than is the case with the broad market. In addition, the couple's portfolio lacks exposure to developed foreign markets. Their sole international holding is **iShares MSCI Emerging Markets** EEM.

Walter and Wilma's Portfolio—After		
Holding	Ticker	Value (\$)
Dodge & Cox Income	DODIX	100,000
T. Rowe Price Eq Inc	PRFDX	30,000
Fidelity Contrafund	FCNTX	40,000
Vanguard Short-Term Bd Idx	VBISX	30,000
Perkins Sm Cap Value	JSCVX	20,000
Fairholme	FAIRX	25,000
Tweedy, Browne Global Val	TBGVX	20,000
Vanguard Inflation-Prot Sec	VIPSX	35,000
Cash		100,000
Total		400,000

Job one for the Ludwigs is to move some of their cash off of the sidelines. Their equity allocation seems reasonable for now, but I'd recommend that Walter and Wilma deploy a sizable portion of their cash position into bonds. As I've written in the past few months, I think bonds represent a terrific happy medium for investors who are nervous about the current market environment but worried about missing out on a rebound. Corporate and mortgage-backed bonds are arguably still trading cheaply relative to Treasury bonds right now. The Ludwigs' fixed-income fund, Dodge & Cox Income, is a fine core bond fund that includes exposure to both sectors. I would also recommend smaller positions in **Vanguard Inflation-Protected Securities** VIPSX and **Vanguard Short-Term Bond Index** VBISX. Enlarging their bond position will also increase their portfolio's income stream when Walter and Wilma begin taking withdrawals from their retirement accounts.

I like all of the Ludwigs' stock funds, but their core holdings should take up a bigger share of their portfolio, and I'd like to see more balance between value and growth. Thus, I'd enlarge their position in **Fidelity Contrafund** FCNTX. I would also recommend jettisoning the dedicated emerging-markets ETF and instead building a position in a broad international fund that focuses primarily on developed markets. **Tweedy, Browne Global Value** TBGVX is one of my favorite picks for retirees.

To help enact these changes, I'd recommend that Walter roll over his 401(k) plan into an IRA, to

allow for many more investment choices than are currently available to him in his 401(k) plan. Because the Ludwigs have a big share of their net worth tied up in the value of their homes, I was encouraged to hear that they're planning to downsize to a smaller home within the next few years. In so doing, they'll free up roughly \$500,000 to \$550,000 in investable assets. Of course, the decision about whether to downsize is a personal one based on factors both financial and nonfinancial. In this case, though, selling the home will greatly improve the chances that Walter and Wilma's portfolio will last throughout their retirement. Once they have the cash from their home sale, the Ludwigs should deploy the assets proportionately across their holdings.

Walter and Wilma haven't yet begun to withdraw assets to pay living expenses, but when they do, they should start with their taxable accounts. For that reason, they should reposition their taxable holdings, which are currently stock-heavy, to encompass cash and other fairly liquid securities. Once they sell their primary residence and have the cash in hand, they should have an easy time meeting their income needs of \$60,000 per year with a combination of Social Security, Walter's pension, and a withdrawal rate from their portfolio totaling 3% per year.

A version of this article appeared on Morningstar.com on March 19, 2009.

Income Worksheet for Retirees

Figuring out how to make your retirement nest egg last your lifetime is a challenge. Follow the steps below to determine how much you can spend in retirement.

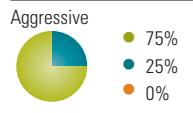
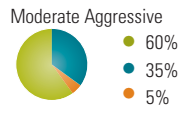
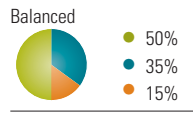
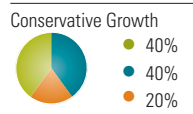
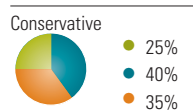
Part 1: Determine Your Withdrawal Rate

- Circle which asset mix comes closest to your current allocation.
- Circle how long you plan to tap this portfolio in retirement.
- Circle how confident you are in your portfolio's ability to last.
- Find where your asset mix, number of years in retirement, and confidence level intersect. This is your withdrawal rate.

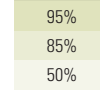
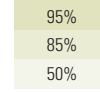
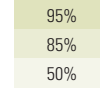
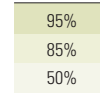
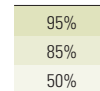
Assumptions:

- Expected real compound rates of return are: large-cap stocks 5.5%, mid/small-cap stocks 6.5%, international stocks 6.0%, bonds 3.0%, cash 1.5%
- Withdrawals increase annually by rate of inflation
- \$0 in portfolio at death

Target Asset Mix



Level of Confidence



Years Expected in Retirement /Withdrawal Rate

	10 Years	20 Years	30 Years	40 Years
Conservative	9.7%	5.3%	3.9%	3.3%
Conservative Growth	10.5%	5.9%	4.4%	3.8%
Balanced	11.8%	6.9%	5.3%	4.5%
Moderate Aggressive	9.4%	5.3%	4.0%	3.3%
Aggressive	10.4%	6.1%	4.6%	4.0%
	12.2%	7.3%	5.8%	5.0%
	9.0%	5.2%	4.0%	3.3%
	10.3%	6.1%	4.7%	4.0%
	12.4%	7.6%	6.0%	5.3%
	9.0%	5.2%	4.0%	3.3%
	10.3%	6.2%	4.8%	4.1%
	12.7%	7.9%	6.3%	5.6%
	8.7%	5.0%	3.9%	3.3%
	10.2%	6.1%	4.9%	4.3%
	12.9%	8.1%	6.6%	5.8%

Part 2: Calculate How Much You'll Spend in the First Year of Retirement

What are your investable assets?

<i>Taxable Account Balances</i>	<input type="radio"/> Brokerage accounts	\$ _____
	<input type="radio"/> Mutual funds	\$ _____
	<input type="radio"/> Stocks	\$ _____
	<input type="radio"/> Bonds	\$ _____
	<input type="radio"/> Other	\$ _____
<i>Tax-Deferred Account Balances</i>	<input type="radio"/> IRAs	\$ _____
	<input type="radio"/> 401(k)s	\$ _____
	<input type="radio"/> 403(b)s	\$ _____
	<input type="radio"/> 457s	\$ _____
	<input type="radio"/> Other	\$ _____
Total Investable Assets		\$ _____

How much will you withdraw from your investable assets during your first year in retirement?

Total Investable Assets	\$ _____
Withdrawal Rate Factor (from Part 1)	% _____
Withdrawal Amount for First Year	\$ _____

Which fixed sources of income will you have in retirement?

<i>Social Security (Annual):</i>	<input type="radio"/> Me	\$ _____
	<input type="radio"/> My Spouse	\$ _____
<i>Pension (Annual):</i>	<input type="radio"/> Me	\$ _____
	<input type="radio"/> My Spouse	\$ _____
<i>Other Fixed Income (Annual):</i>	<input type="radio"/> Me	\$ _____
	<input type="radio"/> My Spouse	\$ _____
Total Fixed Sources of Income (Annual)		\$ _____

Which fixed sources of income will you have in retirement?

Total Fixed Sources of Income (Annual)	\$ _____
Withdrawal Amount for First Year	\$ _____
Total Income (pretax)	\$ _____

What is your total after-tax income in your first year in retirement?

Total Income (pretax)	\$ _____
Taxes	\$ _____
Total Income for First Year (aftertax)	\$ _____



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