

Take this simple step as you approach retirement

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An important job in the two or so years leading up to retirement — right up there with figuring out your healthcare coverage and winding down your work activities — is building up a cash cushion. In addition to being there as a source of funding when you eventually retire, cash has the salutary effect of providing a buffer if you retire earlier than you expected due to unforeseen circumstances.

As you build out your Bucket portfolio, here's some guidance on the amount, source, and location of those liquid reserves.

Rightsizing Bucket 1

Your cash bucket should consist of one to two years' worth of portfolio withdrawals, not living expenses. That's because at least some of your living expenses will likely be coming from outside your portfolio — Social Security or a pension, for example. And the composition of those cash flow sources may well change throughout your retirement. Note

To set up your Bucket 1 initially, think through your cash flow sources for the first few years of retirement. Let's say a 66-year-old wants to retire in two years and expects that he'll need to spend \$80,000 per year, in total, from his \$1.5 million portfolio, at that time. He wants to delay filing for Social Security until age 70, so all of his spending will come from his portfolio in those first few years of retirement. After that, roughly half his spending needs will come from Social Security.

If he wanted to be conservative, he could build a cash cushion consisting of \$160,000 — his years 1 and 2 portfolio withdrawals. His Bucket 2 — high-quality bonds — would consist of eight years' worth of portfolio withdrawals, which at that point will be \$40,000 per year (his \$80,000 total spending less Social Security income). The remaining \$1 million and change could go into a globally diversified equity portfolio.

Where to put the money?

In addition to thinking through the size of your liquid reserves bucket, it's also worth considering the "where" of it. Will you hold cash in your taxable accounts, tax-sheltered accounts, or some in both? To help answer that question, you need to consider your sequence of withdrawals in retirement.

Taxable accounts are often first in the queue for retirement withdrawals because their ongoing tax costs are higher than those of tax-sheltered accounts. (In a taxable account, you enjoy long-term capital gains tax treatment on the sale of appreciated winners you've held for more than a year, but ordinary income is dunned at your higher ordinary income tax rate.) But some retirees may benefit from spending from their tax-deferred accounts early in retirement, with an eye toward reducing future required minimum distributions and tax bills. This is a good spot to get advice from a financial or tax adviser. Armed with the knowledge of where you'll turn for your spending in the first part of your retirement, you can then figure out where best to hold your liquid reserves.

Where to get the money?

Once you've determined how much of a cash bucket you plan to set aside and where you'll hold it, the next step is figuring out how to build it up. Ideally, you'd give yourself a couple of years to enlarge your cash position rather than having to find the money just before retirement. Many people moving into retirement will have a few options.

Additional savings>> For preretirees who are still saving, a logical way to begin bulking up cash is to direct new contributions into cash. Say, for example, the aforementioned retiree is making the maximum allowable 401(k) contribution of \$32,500 and putting another \$8,600 into an IRA. By directing two years' worth of contributions to cash in those two accounts, he could arrive at nearly half his target cash allocation (\$82,200 of his \$160,000 target) by the time he reaches his retirement.

Bonuses and inheritances>> If you've recently received a surprise cash injection, the assets are a logical source for bulking up cash reserves. They're probably already in cash and in a taxable account.

Rebalancing>> Trimming equities and adding those assets to cash and bonds provides a twofer for people closing in on retirement: It reduces risk and helps cover cash flows for the first few years of retirement. This kind of selling can trigger a tax bill, so get some tax advice and/or concentrate rebalancing in tax-sheltered accounts to lessen the impact.

Reducing risky positions>> Even if your portfolio's asset allocation doesn't need adjusting, you may still have problematic holdings in your portfolio: the employer stock you know you should scale back on, the individual-stock portfolio that's duplicative of what's in your mutual funds, or the costly active fund that hasn't earned its keep relative to an inexpensive exchange-traded fund. Such holdings can be ideal sources when building up your cash reserves, just mind the tax consequences if you're selling them from a taxable account.

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