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Trust UPDATE

CITIZENS BANK
A Bank Built For You

July 2021

Retirement income management

Timing may be more important than many realize.

Investor truism: Time in the market is more important than timing the market.

For those with a long-term time horizon, volatility in the financial markets is relatively unimportant. Imagine that a portfolio has an average 10-year return of a modest 5%, but the yearly returns are 25%, 18%, 3%, -4%, -28%, -2%, 8%, 10%, 12%, and 8%. Does it matter when the bad years occur?

It does not.

Table One below shows what would happen to $500,000 over ten years. On the left, the bear market comes early, pushing the portfolio into loss territory, from which it recovers only after eight years. Putting the bull market first, as on the right, causes the portfolio to soar, but when the inevitable bear market ensues the losses apply to a much higher base. After 10 years, the portfolios arrive at the same final total.

For savers, the sequence of returns makes no difference at all. During the accumulation years of the financial life cycle, the important factor is being invested for as long as possible, to be confident of participating when the markets enjoy good years. Although one might hope to move the portfolio

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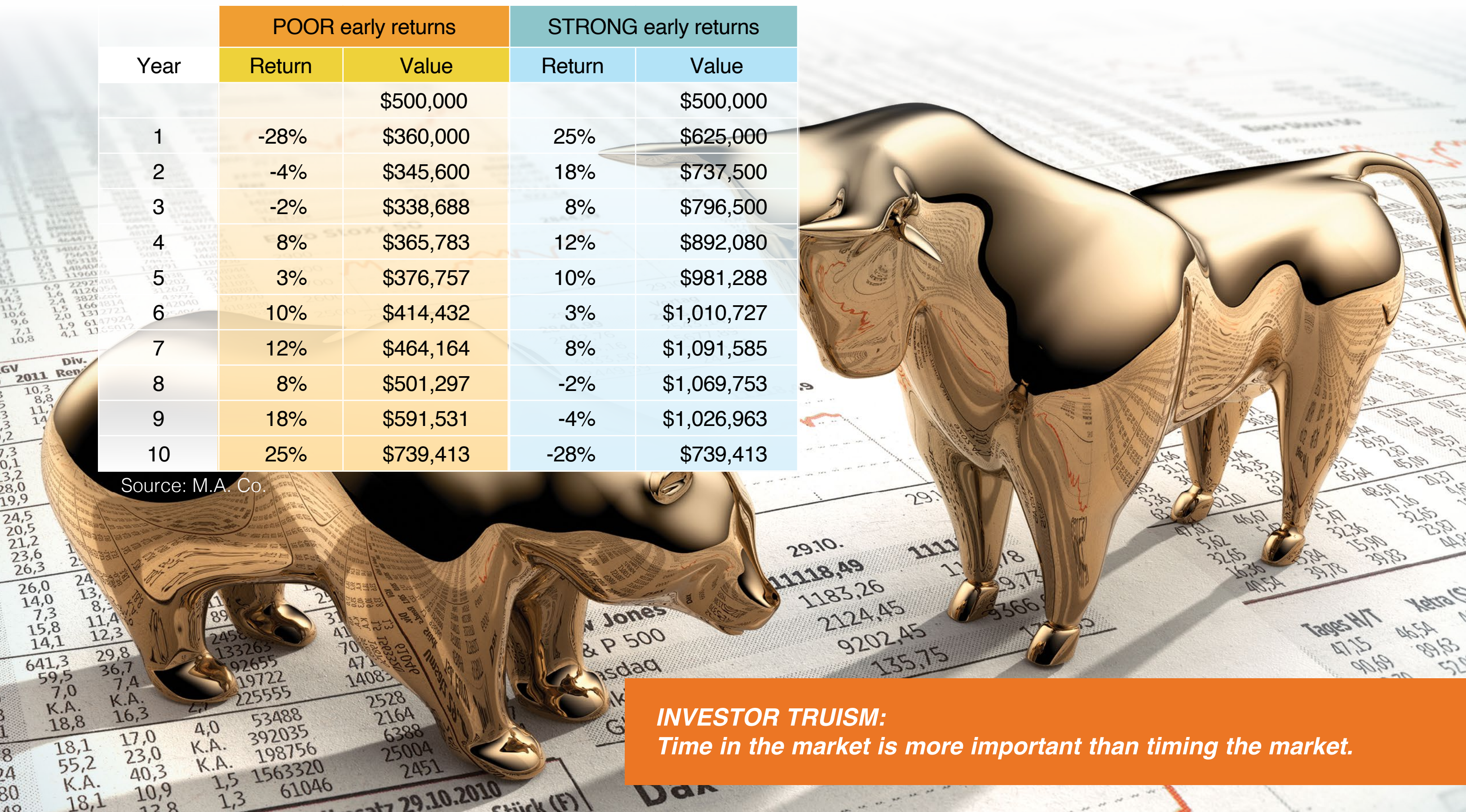
TABLE ONE

The sequence of returns for savers doesn't matter

	POOR early returns		STRONG early returns	
Year	Return	Value	Return	Value
		$500,000		$500,000
1	-28%	$360,000	25%	$625,000
2	-4%	$345,600	18%	$737,500
3	-2%	$338,688	8%	$796,500
4	8%	$365,783	12%	$892,080
5	3%	$376,757	10%	$981,288
6	10%	$414,432	3%	$1,010,727
7	12%	$464,164	8%	$1,091,585
8	8%	$501,297	-2%	$1,069,753
9	18%	$591,531	-4%	$1,026,963
10	25%	$739,413	-28%	$739,413

Source: M.A. Co.



INVESTOR TRUISM:
Time in the market is more important than timing the market.

to cash at the top of the market, to avoid the bear market losses, very few investors have been able to do that successfully. Studies have shown that the most important market moves happen on just a very few days. The risk of market timing is being out of the market when another major uptick occurs.

A very different story for retirees

Retirees are concerned about outliving their financial resources, and with good reason. There are not many options for a retired person to boost his or her income other than selling assets. What is a sustainable withdrawal rate for a retiree? At what withdrawal rate can a retiree be reasonably confident that he or she won't exhaust the available retirement capital?

Timing is everything, in trying to answer this question. If retirement commences during good economic times, the nest egg has a good chance of lasting decades. But retirement during a down year can wreak havoc on a retirement portfolio.

Let's begin with the $739,413 that was saved in the earlier example. Assume that the retiree will need to draw down $50,000 annually, less than 7% of the account's value. If there is a bull market when the withdrawals begin, the account will continue to grow despite the partial consumption. Table Two below uses the same sequence of investment returns as the savings examples.

After taking $500,000 out of the account over 10 years, a retiree who begins taking distributions during a bull market still has $667,639 to work with for the balance of the retirement.

However, a colleague who retires during a down market is not so fortunate. At the 10-year mark, this retiree's portfolio is just 1/3 the value of that of one who retired during a bull market. The years of high returns are applied to a much lower account balance. When even modest withdrawals are coupled with poor investment return, a retirement nest egg can shrink quickly.

What can one do?

The choice of a start date for one's retirement will be influenced by many personal factors. The health of the financial markets is typically low on the list of concerns, but these tables suggest that perhaps it shouldn't be. There are steps that can be taken to protect against market vagaries.

- ***Augment capital.*** Sell the house; move to smaller quarters; pocket $250,000 worth of capital gains tax free ($500,000 for couples) to supplement retirement capital.
- ***Reduce spending.*** Someone who already has retired doesn't have the luxury of becoming "unretired." Unpleasant though it may be, when the markets head south, some spending plans may have to be deferred or eliminated.
- ***Smooth portfolio volatility through sound asset allocation.*** By balancing portfolio assets among a variety of investment classes—large stocks, small stocks, short-term bonds, long-term bonds and so on—expected returns may fall within a narrower range. The lowest lows will be avoided—along with the highest highs—and the risk of outliving one's money may be reduced.

We can help you

Unbiased investment management is an integral part of our service as trustee. But you don't need to fund a trust to be able to call upon our professional expertise. We manage investment portfolios for a fee for individuals and families in a wide variety of situations.

This month, why not schedule a meeting with us to learn more? ☐

TABLE TWO

The sequence of returns for retirees is critical

	POOR early returns			STRONG early returns		
Year	Return	Withdrawal	Value	Return	Withdrawal	Value
			$739,413			$739,413
1	-28%	$50,000	$482,378	25%	$50,000	$874,267
2	-4%	$50,000	$413,082	18%	$50,000	$981,635
3	-2%	$50,000	$354,821	8%	$50,000	$1,010,165
4	8%	$50,000	$333,207	12%	$50,000	$1,081,385
5	3%	$50,000	$293,203	10%	$50,000	$1,139,524
6	10%	$50,000	$272,523	3%	$50,000	$1,123,710
7	12%	$50,000	$255,226	8%	$50,000	$1,163,606
8	8%	$50,000	$225,644	-2%	$50,000	$1,090,334
9	18%	$50,000	$216,260	-4%	$50,000	$996,721
10	25%	$50,000	$220,325	-28%	$50,000	$667,639

Source: M.A. Co.
Returns are hypothetical and do not represent any particular investment

The scary word for retirees: Inflation

The last time Americans experienced double-digit inflation was 1981, 50 years ago. Roughly half of the Americans alive today were not yet born. Most people today don't remember what it is like to live with sustained inflation.

But retirees do. They were in college or starting careers in the 1970s, the period of "stagflation," with low economic growth and relentless price increases. They were grappling with double-digit interest rates when shopping for a mortgage for their first home. They understand that once the inflation genie is unleashed, it is very hard to put back into the bottle.

That may help explain the widespread coverage of inflation in the financial press in recent weeks. The graph below charts the "sticky" core inflation rates of the 1970s and the low rate of price increases since the Reagan presidency.

The debate

The astonishing spring price increases in lumber and used cars triggered the conversation about inflation. Then the May Consumer Price Index (CPI) came in with numbers not seen in a decade or more, 5% above the year-earlier level. Even the core inflation rate, excluding food and energy, was well above the Fed's inflation target.

The initial thought was that the price spikes were transitory. In some sectors, such as airline tickets and hotel rooms, the increases were simply a return to pre-pandemic levels after the drastic medicine of lockdowns. There was a release of pent-up demand by many after the long period of isolation. What's more, the pandemic had also led to supply chain bottlenecks, notably in semiconductors, that were rippling through the economy in unexpected ways. These problems would be resolved, they would be temporary.

On the other hand, as the economy returned to normal and then began heating up, employers were faced with an unanticipated labor shortage. Some people, having learned to love working from home, decided to quit when their employers called for a return to the offices. The response to a labor shortage, at least in the short term, has been as expected, an increase in wages.

Taken individually, wage increases are wonderful. But in the aggregate, they may fuel sustained inflationary pressures. In June, the Fed acknowledged that interest rate hikes will be coming sooner than earlier predicted—but probably not until 2023, not until after the next election.

Housing

The CPI does not quickly capture changes in the price of housing because that is not a routine purchase for consumers. The S&P CoreLogic Case-Shiller National Home Price Index tracks average home sale prices in major metropolitan areas. In March the index rose 13.2%, the highest annual growth rate since 2005. The Commerce Department reported that in April that the median home sale price had risen 20.1%. Anecdotally, there are many stories of bidding wars developing for available houses, and homes being sold for well over list price.

The good news in this development is that a pre-retiree who plans to sell a larger home so as to downsize upon entering retirement may have significantly more retirement capital than expected, especially given the $250,000 exemption from the tax on capital gains for a sale of a principal residence ($500,000 for married couples). The downside, however, is that this higher cost of shelter will eventually work its way into the inflation picture, and as with wage increases it won't be easily extracted.

That suggests that inflation should be a more important factor now in planning the retirement investment portfolio. If you need help with that task, call on one of our investment professionals at your earliest convenience. ☐

Source: Federal Reserve Bank of Atlanta, Sticky Price Consumer Price Index less Food and Energy [CORESTICKM159SFRBATL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CORESTICKM159SFRBATL, June 16, 2021.

Marriage, Israeli style

Semone Grossman, a German Jew who had survived Nazi concentration camps, immigrated to New York after the war. He had a successful life. At his death in 2014, Grossman left the bulk of his $87 million estate to Ziona, his wife of 27 years, with whom he had had two children. However, the IRS denied the estate's marital deduction and demanded some $35 million in estate taxes and over $7 million in accuracy-related penalties.

Wait, what?

Ziona was Semone's third wife. He married his first wife, Hilda, in 1955, and they had two children. However, they separated in 1965, and Semone made regular payments to Hilda. In 1967, Semone started a new relationship with Katia. Before marrying her, Semone traveled to Mexico to obtain a divorce from Hilda. Although the marriage to Katia also produced two children, it ended by 1974.

That year Hilda filed a lawsuit to have the Mexican divorce declared null and void, a lawsuit that she won following a trial in 1976. The marriage to Katia was nullified, and Hilda was again the legal spouse of Semone. However, the couple never again cohabited, nor filed joint tax returns.

In 1986, then 56 years old, Semone became engaged to Ziona. Both of them had relatives in Israel, and they decided to marry there. Before the ceremony, Semone asked Hilda to cooperate in obtaining a divorce under Jewish religious law. She agreed. They appeared before a rabbi and obtained the necessary paperwork, which Semone brought with him to Israel. The Israeli religious authorities found everything in order, and permitted the wedding to go forward. After the marriage, the couple returned to New York where they lived as a married couple for the rest of Semone's life.

After his estate tax return was filed, the IRS somehow noticed that Semone and Hilda had never formally, legally divorced under New York law. Therefore, the Service reasoned, Hilda was the surviving spouse, not Ziona, even though Semone and Ziona had filed all their tax returns as married filing jointly, even though Hilda had filed all of her tax returns as a single person, and even though Hilda had not attempted to claim her marital share under New York law after Semone's death. Under New York law, the IRS contended, Hilda remained the spouse. Hence, no marital deduction for property passing to Ziona.

The Tax Court concluded that the rule in New York has long been that the validity of a marriage is determined by the place of its celebration. Semone and Ziona had satisfied Israel's fairly strict rules for having a marriage in that country, and public policy generally favors recognition of second marriages.

Semone and Ziona probably could not have legally married in New York. That was in part the basis for the IRS denying the marital deduction. The Tax Court holds that fact was irrelevant to whether they could be legally married elsewhere. ☐