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THE ADVISOR

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Credit Spreads & Other Factors Continue to Help Income Investors

Last month, we explained how something called credit spread compression helped dramatically minimize the negative impact of rising interest rates for income investors in February. As long-term rates rose higher in March, income investors continued to benefit from the natural "softening" effect of credit spread compression. In addition, some income portfolios benefitted further from other market forces during the month.

Since the start of 2021, long-term interest rates have climbed quite steadily, with the yield on the 10-Year Treasury rate jumping from 0.93% on January 1st to 1.45% on March 1st. By the last day of March, it had risen to 1.73%.[1] The trend has sparked some concerns about inflation and led to a tiny bit of nervousness on Wall Street, although ultimately the stock market has risen rather steadily since the beginning of the year.[2] The rise in rates has also prompted the usual dire warnings about tumbling bond values by some pundits — but only the ones who don't really know much about bond investing.

The fact is, many income investors have done very well since the beginning of the year despite the well-known inverse relationship between bond values and interest rates (meaning when rates rise, bond values drop and vice-versa). They've done well because interest rates aren't the only things that affect bond values, and they certainly aren't the only things that dictate the performance of a diversified, actively-managed portfolio of bonds and bond-like instruments. Another important factor is credit spread compression.

The Natural Softener

Remember, when we talk about bond values going down when interest rates go up, it needs to be the interest rate commensurate with that specific class of bonds. So, if you have a risk-free US treasury bond, it tracks the US treasury rate. However, if you have a triple-B corporate bond, the rate that affects your bond is the one commensurate with triple-B corporates, not the US treasury rate. That's important because when interest rates fall, it's typically because investors are worried about the economy, and when rates rise it's because investors are becoming more confident. When you're worried, the amount of extra interest you might require to go from a risk-free US treasury to a corporate bond is likely to be much higher than if you were confident. That's the credit spread, and

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Retirement Withdrawal Rates

When planning for retirement, most people are focused on how much they need to save today. They tend to spend less time thinking about how they'll make their nest egg last once they stop working. After all, with total savings in the hundreds of thousands or even millions of dollars, it may seem that your money will last forever. Unfortunately, it's just not that simple.

Few people are wealthy enough to not worry about how much money they withdraw from their savings every year. Below, we cover some of the most important things you need to know about retirement withdrawal rates and how to make your savings last a lifetime.

The 4% Rule

To avoid the danger of draining your savings, you need a plan. That means knowing how much you can withdraw from your portfolio every year. This is called your retirement withdrawal rate. There's a pretty simple rule of thumb to estimate how much you can safely take from your savings: the 4% rule.

The 4% rule says that you can withdraw roughly 4% of your portfolio every year and have enough money to last for a 30-year retirement (assuming you are invested in a 60-40 mix of large-cap stocks and intermediate-term government bonds). So, if you had a total retirement portfolio of $1 million, you

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Credit Spreads

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when interest rates rise due to investor confidence — like they have been — risk premiums shrink or compress, creating a "natural softener" for actively-managed income portfolios.

So, even though the yield on the 10-Year Treasury rate has gone up by over eight-tenths of a percent since the start of the year, the rate on certain corporate bonds may have gone up by much less. For you, that means even though long-term rates overall have soared, your specific allocation has kept your portfolio values from dropping; the impact has been greatly softened, thanks to credit spread compression. To explain further, if you were invested in a 10-Year Treasury bond, the value of your bond has dropped by about 7% since the start of the year, mathematically speaking. However, if you're in a diversified portfolio of bonds and bond-like instruments, will you see your portfolio down by 7% in your April statement? No. Depending on your allocation and strategy, your portfolio may be down just slightly, or may not have dropped in value at all. It might even be slightly up on the year, and the softening effect of credit spread compression is only one reason why.

REITs and BDCs

Certain types of investments, such as Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs), have performed extremely well since the start of the year for the same reason that interest rates have risen: investor confidence. Even though these vehicles carry more risk than individual bonds on a stand-alone basis, when peppered throughout an income portfolio, they can actually lower your risk when interest rates are rising. Many income investors with a higher risk tolerance who are using a stock dividend strategy have also enjoyed strong year-to-date returns. So, again, while the current interest rate climate does create some challenges for income investors, it also shows how these challenges can be addressed with the right strategy, and even turned into opportunities in some cases.

Of course, the main point is although occasional drops in value in an income portfolio are almost inevitable due to market forces, with an income strategy you know it's only a temporary paper loss. You know that the par value of your bond is more secure, and that you can count on getting your income return regardless of market conditions!

[1]YCharts.com

[2]"Wall Street Ticks Higher, Led by Tech and Smaller Stocks," AP News, March 31, 2021

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Avoid These Withdrawal Mistakes

During your working years, your emphasis was to accumulate as much as possible for retirement. As you near retirement age, you need to start thinking about how to withdraw those funds to maximize your income. To help accomplish that, avoid these mistakes:

- **Not understanding all available options.** Each retirement option, such as 401(k) plans, profit-sharing plans, and individual retirement accounts (IRAs), has different tax and plan rules regarding withdrawals. Review all your options to select the best choice for your circumstances. In many cases, your selection will be irrevocable.
- **Not using reasonable estimates to calculate your withdrawal amounts.** The amount you should withdraw annually can be calculated based on how much principal you want remaining at the end of your life, your life expectancy, your expected long-term rate of return, and your expected long-term inflation rate. If you don't use conservative estimates, you run the risk of depleting your assets before you die. Even with conservative estimates, review these factors annually so you can adjust the withdrawal amount if necessary.
- **Not withdrawing funds in a tax-efficient manner.** Before beginning withdrawals, review all your retirement assets, including pension plans, IRAs, and taxable investments, to determine the most tax-efficient strategy for withdrawals. This can add years to the life of your retirement funds.
- **Retiring early without considering the financial implications.** Retiring even a few years earlier than planned can significantly impact the amount needed for retirement. Make sure you'll have sufficient funds for your entire retirement before opting to retire early.
- **Taking a lump-sum distribution in your name.** When rolling over a lump-sum distribution from a 401(k) plan or other qualified plan, transfer the funds directly to your new account's trustee. Otherwise, your former employer will withhold 20% for taxes when the funds go directly to you. You will then have to replace the 20% from your own funds within 60 days or the 20% withholding will be considered a distribution, subject to income taxes and possibly the 10% federal penalty.
- **Not taking required minimum distributions.** Once you reach age 72, you must take required minimum distributions from traditional IRAs and other qualified plans or pay a 50% excise tax on the amount you should have withdrawn. If you are still working, you can delay withdrawals from qualified plans, but not from traditional IRAs, until you retire.
- **Not selecting proper beneficiaries.** The proper selection of beneficiaries can make a significant difference in the amount of taxes owed when you die.
- **Not seeking advice.** Determining how much to withdraw from your retirement investments and the best way to make those withdrawals can be complicated. Since the decisions are often irrevocable and can have a major impact on your retirement lifestyle, seek guidance first. Please call if you need help with these decisions.

Withdrawal Rates

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could withdraw about $40,000 every year and probably have enough money to last until you turned 95.

Combined with Social Security and pension income, your 4% withdrawal rate could provide you with a respectable, though not necessarily lavish, income. If you wanted to enjoy an annual income in the six figures in retirement, you'd have to save quite a bit more.

Does the 4% Rule Matter?

There's a lot to be said for the 4% rule, but it's not the be-all and end-all of retirement planning. In fact, some retirement experts have said today's retirees should forget about the 4% rule, or at least apply it with caution. Low interest rates are one reason, because they mean retirees aren't earning as much on their relatively safe investments (like government bonds) as they would if they'd retired a couple of decades ago (when the 4% rule was first proposed).

Another problem is what is called sequence of returns risk. Basically, the 4% rule assumes you earn relatively stable average returns throughout your retirement. Unfortunately, that's not how the real world works. Returns fluctuate, sometimes wildly, from year to year. If you are unlucky enough to hit a bad patch in the early years of retirement, the value of your portfolio may fall, and you may never be able to make up the loss.

Finally, there is something called the sequence of consumption risk. The 4% guideline assumes your spending is relatively steady throughout retirement. But recent studies indicate that's not the case for most retirees. You're likely to spend more money in the early years of retirement (when you're still relatively young and active and eager to do all the things you couldn't do while working), less in the middle years of retirement, and more in the final years of your life (when healthcare costs often pile up). Spend too much in the early years and you could find yourself running out of money in the later years.

A Guideline, Not a Rule

Rather than treating a 4% retirement withdrawal rate as a hard-and-fast rule, it's better to think of it as a starting point. Thinking about living on 4% of your portfolio every year is a good way to get a rough idea of how far your retirement dollars will go. But by itself, it won't be enough. To really determine how much you can withdraw from your savings every year, please call to discuss this in more detail.

What Kind of Retirement Do You Want?

We all know the process. Estimate how much is needed in retirement (which can range anywhere from 70% to over 100% of preretirement income), determine available income sources, and then calculate how much to save annually to reach those goals. As you go through this largely mathematical exercise, however, don't forget the most important part. You need to give serious thought to the type of retirement you want — visualize what retirement will be like.

Retirement is no longer viewed as a time to slow down, but considered a new beginning in life. That means your current living expenses may have very little to do with your retirement expenses. To help you visualize your retirement so you can estimate retirement expenses, consider these questions:

- When do you want to retire? Will you realistically have the resources to retire at that age?
- Do you plan to stay in your current home, trade down to a smaller one, or move to a different city? If you plan to move, is the cost of living there more or less expensive than your present city?
- Will your mortgage be paid off by retirement? What about other debts?
- Will you continue to work after retirement? If so, will you work part- or full-time? Where will you work and how much can you expect to earn? Do you have any hobbies or interests that can be turned into paying jobs? Are you planning to start a business after retirement?
- How will you spend your free time? What hobbies will you pursue? How much and where will you travel? How much will all these activities cost?
- How will you pay for medical costs? Will your employer provide health insurance or will you need to purchase insurance to supplement Medicare coverage?
- Do you have any medical conditions that are likely to impact your quality of life in retirement? What would you do if you became physically disabled? Would your spouse take care of you, would you move in with your children, or would you go to a nursing home? How will you provide for long-term-care costs?
- How much of your income will be provided by personal investments, including 401(k) funds? Are you confident those investments will last your entire retirement?
- What would happen financially if your spouse dies? If you die, would your spouse be able to support himself/herself financially?

Answering these questions should give you a clearer picture of what your retirement will be like. If you'd like to review these questions in more detail, please call.

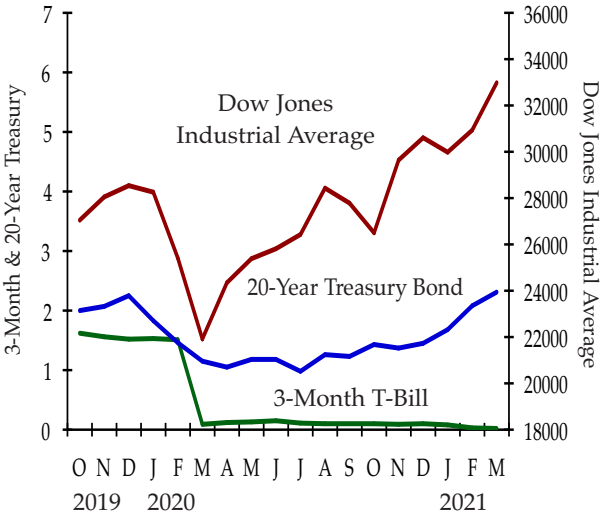
Business Data

Indicator	Month-end Jan-21	Feb-21	Mar-21	Dec-20	Mar-20
Prime rate	3.25	3.25	3.25	3.25	3.25
3-month T-bill yield	0.08	0.03	0.02	0.10	0.09
10-year T-note yield	1.11	1.44	1.74	0.93	0.70
20-year T-bond yield	1.68	2.08	2.31	1.45	1.15
Dow Jones Corp.	2.04	2.32	2.42	1.93	3.81
GDP (adj. annual rate)#	-31.40	+33.40	+4.30	+4.30	+2.10

Indicator	Month-end Jan-21	Feb-21	Mar-21	% Change YTD	12 Mon.
Dow Jones Industrials	29982.62	30932.37	32981.55	7.8%	50.5%
Standard & Poor's 500	3714.24	3811.15	3972.89	5.8%	53.7%
Nasdaq Composite	13070.69	13192.35	13246.87	2.8%	72.0%
Gold	1863.80	1742.85	1691.05	-10.4%	5.1%
Unemployment rate@	6.70	6.30	6.20	-7.5%	77.1%
Consumer price index@	260.47	261.58	263.01	1.1%	1.7%

— 2nd, 3rd, 4th quarter @ — Dec, Jan, Feb Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
October 2019 to March 2021



Essential Tips for Saving for Retirement

For many people, saving for retirement is an anxiety-producing process. Some struggle just to pay for monthly expenses, so saving for retirement can seem difficult. Here are four essential tips for saving for retirement.

Start Early — This is perhaps the most important point about saving for retirement. Many people think that starting to save once they're age 30 is a good idea, but the only way to ensure a stress-free future is to start when you're in your 20s if possible. Why start this early? You'll benefit significantly from compound growth, you'll get more out of employer contributions, and you'll be able to save a fair amount of money on your tax bill. Years and years of this can result in a significant retirement fund.

Stick to Your Savings Goals — A common saving mistake people make when getting started is putting money away for a few years and then slowing down with their contributions. Family emergencies, tuition bills for children, and everything in between can add up to create a load of stress that makes saving for retirement seem like less of a priority. Do whatever you can to stick to your savings plan.

Get a Matched 401(k) Plan — A 401(k) plan can be an excellent tool for helping you to save significant amounts of money for retirement. Why? In many cases, your employer will match a portion of your 401(k) plan contributions. It's without a doubt one of the most effective ways to quickly build a retirement fund, especially if you're able to contribute the maximum amount each month. If your employer offers a 401(k) plan, you'll benefit from getting set up in the program as soon as possible.

Work with a Financial Planner — The job of a financial planner is to help get you set up for retirement in as swift and effective a manner as possible. FR2020-1223-0199

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