MarketWatch
THE WALL STREET JOURNAL.

2 must-have financial plan documents

These statements are the 'financial parents' of your retirement plan

By J. Cameron Morgan

In many parts of the country, lilacs are blooming; in all parts of the country, neckties and barbecue grills are on sale. Yes, the smells and sales of spring mean just one thing: Mother's Day, followed closely by Father's Day. In May and June, our parents are in the spotlight.

Like the young adult who has left the parental nest, your financial portfolio has grown up, too. With your steady care and a (mostly) generous equity market, your little nest egg has finally matured into an income-generating highflier! It's enough to bring a sentimental tear to your eye.

The need for parental wisdom and perspective never really fades though, does it? And celebrating Mother's Day and Father's Day provides a nifty parallel to thinking about our portfolio's "financial parents," namely, the Investment Policy Statement and the Withdrawal Policy Statement. If your financial plan is missing these foundation documents, then the opportunity for a happy financial home may elude you, as well.

What exactly are these essential, responsible "financial parents" then?

An Investment Policy Statement

Financial planners and advisers often use an Investment Policy Statement (IPS) to establish clear parameters for how assets will be managed on a going-forward basis. Whether or not you work with a professional adviser, the discipline and communication that a written document brings provides a cornerstone to building your financial portfolio. Many times, the process is as enlightening as the end product; a bit like parenting, if you've had that experience!

Note that an IPS does not set your goals for retirement income or for investing; rather, it's descriptive. An IPS covers how investments will be managed in alignment with the long-term goals you have set in your financial plan.

Many online guides can assist you in creating an IPS. What do they have in common? In addition to the above, they span several pages and detail the types of investments that the planner, wealth manager or investor will use. In a professional advisory relationship, the IPS is drawn up after two other steps are complete:

- The initial discovery (discussions and sharing of documents that foster mutual understanding between the client and the planner), and
- Discussion and agreement (a clarification about what will happen between the adviser and the client).

The IPS, as a record of the investment issues agreed upon and the governing investment policies, is signed by both the client and the planner.

With the IPS in place, the investment plan is implemented. The IPS serves as a road map for the adviser to follow in the initial and ongoing trades of the client's wealth. This road map can be quite specific; it should be, if it logically guides portfolio monitoring and adjustment over time. The IPS should anticipate not only monitoring for poor performers, but also identifying good performers. It will include rebalancing, tax-loss harvesting and any other practices the investment manager will use in aligning the portfolio with the client's stated objectives.

A Withdrawal Policy Statement

One prompt for aging baby boomers to thinking about their own retirement income has been their own parents' aging and passing. They look at, perhaps, dad's pension and mom's Social Security benefit, then think, "But I don't have a pension, and I don't feel confident about a Social Security check, so how will I really fund my lifestyle?" In some ways, the Withdrawal Policy Statement (WPS) helps reassure retirees and aspiring retirees. It is a strategy for addressing the unknowns of retirement—spending, longevity, investment volatility and so on.

In the financial services industry, the thought leaders, bloggers, columnists, advisers and planners are increasingly focusing on the WPS. Retirement researcher and certified financial planner Jonathan Guyton is widely credited with crafting an industry-standard WPS. As a starting point, you might list the three main goals that a WPS includes, customizing it for your family.

First, you spell out the guidelines for withdrawals. This states how you will act in a normal market, a typical spending year. In other words, the baseline.

Second, you clarify how your withdrawals will respond (act) in the face of stock market volatility, high inflation or an atypical spending year (health-driven, for example). In other words, the crisis.

Finally, you state how you'll correct your withdrawals if and when the other rules push spending past your preset bumpers for high spending (withdrawals too high compared with portfolio value) or low spending (rules are forcing unnecessary spending cuts compared with household need). In other words, course corrections.

Michael Kitces, a certified financial planner, the practitioner editor of the Journal of Financial Planning and a thought leader in financial services, summarizes the five components of the WPS, with a special focus on the final two pieces. The five elements include:

1. Your income goals, expressed in dollars per year.
2. The assets to use in funding that income.

3. The initial withdrawal rate (expressed as a percentage of total assets to be used in retirement).
4. The rules for prioritizing your selection of withdrawal asset class (expressed as an if-then; for example, “if the stock market shows a loss, then make no adjustment for inflation. Instead, keep the same withdrawal rate that year.”)
5. The rules for setting the withdrawal percentage, after year one. (Set a maximum and minimum withdrawal rate.)

These last two components speak to funding withdrawals from your retirement money, and to implementing and adjusting that funding approach.

The WPS is as much philosophy as it is a policy. As you draft one, be sure to keep in mind that it is rules-based, but not rigid; responsive, but not reactive. The intent is to manage your behavior in a crisis, later, by thinking pre-emptively now. Rather than react, you will refer to this document and follow the plan for what action to will take, if any. Another way to think about the WPS is as the enduring guide of your family legacy; these true-for-you principles outlast temporary hiccups and unfortunate situations.

Flying the nest?

The apple doesn’t fall far from the tree, as the saying goes. This reference to our tendency to repeat our parents’ behaviors isn’t very flattering. You may have adopted your folks’ guidance and biases, or you may have rejected their counsel and views. Sometimes, you want to pursue a different path. So what does a financial home look like without the initial, “maternal” IPS and the planning ”paternal” guide of a WPS?

Without an IPS, an investor might be less disciplined in stock selection, in mutual fund or ETF research, in maintaining his or her allocation to bonds, or about rebalancing in general. The investor might end up with a portfolio that is in truth just a collection of individually well-reasoned investments.

As they do in anticipation of their adolescent’s unpleasant, unwise or just ill-timed behaviors around the Four Cs of curfew, car, cash and cellphone, wise parents set guidelines. With an IPS, some asset classes or strategies might be excluded, saving the investor from novel or complex instruments that aren’t appropriate to the family’s real goals and needs for retirement income. The IPS is a plan that brings wisdom to your investing behavior, reflecting and documenting ahead of a sharp market move.

Without a WPS, the investor may not have a concise, thorough way to communicate with his or her spouse or children regarding spending, budget or health-care/home-care choices. In the absence of setting a WPS, the household is more likely to use a spending-based withdrawal plan. In other words, an approach to cash flow driven by “it’s there when I need it.”

Put another way, aspiring retirees struggle with what some would call “the problem of no denominator.” If only you knew how long your money had to last, in years, you could simply divide your account balance by that number, right? All my money divided by all my remaining years. Simple! But in the context of “no denominator,” investors need some other equation. The WPS is it.

Adding a wrinkle

In addition to Kitces’s work, additional leadership can be found at J.P. Morgan Asset Management, which publishes an annual illustrated Guide To Retirement. The company’s chief retirement strategist, Katherine Roy, highlights the idea of flexibility, driven in part by retirees’ anticipation of “spending less, later.” The WPS described above might be too rigid for such a retiree, who expects his or her non-working years to reflect three activity-based spending stages, in order:

1. The go-go years of high spending;
2. The slow-go years of moderate spending; and
3. The no-go years of low spending.

If you prefer this definition, then your WPS would need to be more dynamic, with fewer triggers and rules. Bottom line: Your spending at home would not be closely related to your portfolio’s value in the stock market.

However, if you deny this view, then the WPS outlined by Guyton is a suitable starting point. The policy-based triggers or bumpers may prompt an increase or decrease in spending at home; perhaps it would include advance identification of what spending gets cut in down years.

Deciding between the two can be a personal decision, but be mindful of bias and denial. Health-care costs in the no-go years—expected to be low spending years—can push this plan into crisis, at the retiree’s most vulnerable life stage. Yes, it’s more fun to identify activities for the go-go years, such as a family Disney cruise, and to justify such an expense with a promise to “spend less, later.” But this fact does not mean that expenses in the later no-go years, such as long-term care, are irrelevant or immaterial.

So, what type of WPS will you write? One that is rules-based, with triggers and which requires spending adjustments when the withdrawal rate is moved up, down or sideways? Or one that is spending-based, ignores the market and potentially avoids the risk of under-spending?

To borrow a final idea from J.P. Morgan, the retiree can only control a few aspects of retirement. Completely outside your control are factors such as market returns and policy (tax, entitlements). You have some control over aspects like employment (earnings, duration) and longevity. But you have total control over two powerful elements of retirement: your portfolio’s risk and your saving versus spending decisions. The IPS and WPS can provide essential support for this potent component of retirement.

Whether or not your parents are still living, their role in your upbringing is undeniable. The values, lessons and guidance they shared when you were growing up contribute to your morals, ethics and decision making today. Similarly, adopting an IPS and WPS today can guide your decision making and spending for decades. Celebrate your real parents this spring by creating two financial parents, and complete your happy financial home.

About the author: Cameron Morgan, M.B.A., is a wealth manager who specializes in helping podiatrists and other medical specialists realize their financial goals. A&I Financial Services LLC is an Englewood-based Registered Investment Advisor. Securities provided through Geneos Wealth Management Inc., member Finra, SIPC. Investment advisory services offered through A & I Financial Services LLC, registered investment adviser.