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TSP Withdrawal Strategies
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Growth and Income

"Growth and income" is the mantra of wealth management advisors who are in the business of advising retirees on savings plan withdrawals throughout their retirement years. But the model for saving money throughout one's career and into retirement is to grow accounts early, then to become an increasingly more conservative investor closer to and into retirement. However, realizing that retirement savings will not last forever if invested only in super-safe, low-return accounts is the wake-up call that most people receive the first time they analyze their pre- or post-retirement budgets and balances. With lifespans becoming ever longer, it becomes more and more apparent that despite best efforts, many people just haven't saved enough for retirement, and of course no one wants to run out of money. But wait a minute. Why must we put all of our money into super- safe, low yield investments in retirement? Given that many of us will statistically live as long as or longer in retirement than we actually worked, the advantage of incurring short-term market risk for long-term higher rewards is obvious. That realization, however, often then morphs into, "But I don't know how to do that!" Back to wealth management advisors and their promises of growth and income. Often with fees as high as 3% of total annual balances plus the fees charged by money managers for invested funds, retirees pay dearly for this so-called "expertise." To put it in perspective, 3% of a one million dollar balance equals $30,000 per year in expenses. That is roughly equivalent to the cost of a new car every year!

Federal retirees do not have to fall into this trap. There are simple ways of achieving the same growth versus income plan as well as or better than entrusting your money with wealth management advisors - and without incurring their fees. In fact, many wealth management advisors wish that they, too, could use the same strategy as I will outline in this article since it is far easier and provides a much higher average rate of return without the risk. But, alas, they do not have access to the Thrift Savings Plan. As a federal employee, you do.

G Fund: A Key Strength of the TSP

One of the key strengths of the TSP is the G Fund, which is an index of special issue government securities. This fund is as safe as any savings account because it is backed by the full faith and credit of the United States. The interest rate is roughly the same as that of a 4- or 5-year certificate of deposit, with the difference that there is no penalty for early withdrawal. Indeed the G fund has only slightly lower long-term rates of return than a bond fund, without the worry of an inverse price-to-yield relationship. This is a fancy way of saying that when interest rates rise, bond prices fall. In fact, the G Fund travels in the same direction as interest rates. You won't find that in the F Fund or in any other bond index fund.

The G Fund works well for income, but it doesn't provide good long-term growth rates. What about growth then? Well, the stocks funds (C, S, and I) provide decent long term (10 year plus) growth rates. So can you spread your assets across these funds as well as draw on the G Fund for income? In a word, No! The TSP uses a prorated distribution method for withdrawals. This means that every dollar is distributed at exactly the same percentages as the funds are allocated within the TSP account. For example, if you have allocated your funds as 40% in the G Fund and 20% each in the C, S, and I Funds, then the breakdown of each dollar distributed will be 40 cents from the G Fund and 20 cents each from the C, S, and I Funds. This is a good scenario only if the stock market goes up every month. And how likely is that?

So the strength of the TSP is the G Fund for income purposes. But the TSP is weak compared with "on-demand" withdrawals. On-demand withdrawals, as allowed by Individual Retirement Accounts (IRAs), permit you to withdraw any amount you want, whenever you want, from any of your funds or assets. While fees and fund expenses at brokerage firms that manage IRAs are usually much higher than those at the TSP, with some shopping around, it is possible to invest in funds that are nearly identical to those at the TSP with only moderately higher expenses. For example, Admiral shares in the S&P 500 Index at Vanguard (essentially equivalent to the C Fund at the TSP) currently have an expense ratio of 0.05%. By comparison, the C Fund has an expense ratio of 0.028%. On a $500,000 balance, this amounts to an annual difference of about $110.

The TSP has a myriad of Withdrawal Capabilities

Let me point out one final concern before I discuss the action plan for TSP withdrawals. The TSP has a myriad withdrawal capabilities, including the option of a one-time partial lump sum withdrawal where the proceeds can be transferred directly into a traditional IRA. You can move a substantial portion of your TSP funds into a low-cost, passively-managed index fund, such as the S&P 500, leaving enough money in the G Fund to finance approximately 10 years of income. The S&P 500 inexpensively allows for mostly successful long-term growth. Keep in mind that IRAs and TSP accounts generally become subject to IRS Required Minimum Distributions (RMD) at age 70.5 and beyond. A great way to hedge against the subsequent tax hit as well as significantly improving your long-term tax planning strategy is to convert a portion of your traditional IRA into a Roth IRA *before* age 70.5. IRA funds converted to a Roth IRA are taxed as income within that tax year, so be sure to calculate the amount of tax you will owe. Keeping the conversion to 10% or less of the total balance is a good rule of thumb. If you invest the Roth IRA in the same fund in which the traditional IRA was invested (for example the S&P 500 index), brokerage firms typically do not charge a fee for the conversion. Also, note that Roth balances provide tax-free growth when held for 5 years or more, although you should anticipate that your Roth balances will be invested and growing for many more years beyond 5. Roth IRA balances are exempt from IRS RMD (but Roth TSP is not!). In addition, Roth IRAs are not taxed as income to beneficiaries so they become extremely useful tools in estate planning.

The TSP has a little-known rule that will be your friend in retirement years. As long as a TSP account has $200 or more in the account, you may transfer money back into the TSP. Remember your traditional IRA? As the balances in your G Fund at the TSP get lower, consider transferring some of your IRA funds back into the TSP. This will replenish the pool of money you are using for income. Statistically speaking, real growth will have occurred in your IRA funds and you will be able to transfer some of that growth back into your income stream. Remember: this can continue as long as you maintain at least $200 in the TSP account and you still have traditional IRA balances. Roth balances are NOT allowed to be transferred to the TSP at this time.

10-Step Plan for Formulating an Optimal TSP Withdrawal Strategy
Download available at: www.nitpinc.com/10-Step-Plan.pdf

Step 1: Determine your income needs. Keep it simple by using 70% of your current gross salary. The difference between expenses and income from FERS and Social Security benefits is the "shortfall." Calculate what approximately 10 years of this shortfall equals in total dollars.

Step 2: Take a "One-Time Partial Lump Sum" (using TSP Form 77) - all of the TSP balance except the 10 years of shortfall from step 1 - and transfer it to a mostly stock-based traditional IRA. Invest most of the money in low-cost index fund(s) such as the S&P 500 index (which is equivalent to the C Fund at the TSP). However, keep some money (maybe $30,000 or so) in a cash account in the IRA for emergencies and for covering occasional tax liabilities.

Step 3: Perform an "Interfund Transfer" on the TSP website of the remaining TSP balance (the shortfall) into the G Fund. Then submit a request for a series of equal monthly payments from the TSP (using TSP Form 70) to cover income requirements determined in step 1.

Step 4: Each year, convert a portion of the stock-based IRA into a Roth IRA keeping the same fund at the same brokerage company. Do not convert more than you can afford to pay in taxes in any one year. The IRAs constitute your growth component so it's important NOT to react to short-term market fluctuations. Resist the urge to buy and sell.

Step 5: As your TSP balance grows smaller, transfer some of the traditional IRA funds back to the TSP G Fund (using TSP Form 60). This amount should cover approximately 3 to 5 years of additional income needs.

Step 6: Continue to convert small amounts from the traditional IRA into the Roth IRA. The smaller the balance of the traditional IRA, then the smaller will be the amount of Required Minimum Distribution (RMD) at and beyond age 70.5. There are NO RMDs from Roth IRAs…ever!

Step 7: Make one more transfer of any remaining traditional IRA balances to the TSP. This could fund anywhere from 2 to 10 years more of income from the G fund depending on the balance, your age, and your income requirements.

Step 8: At this point, the Roth accounts should be large so it's time to begin selling some of the Roth S&P 500 index fund shares. Place the proceeds in a money account at the brokerage firm. Generating enough cash for 3 to 5 years of income plus emergency funds is usually more than adequate.

Step 9: As you grow older, the RMDs are most likely getting large enough to begin wiping out the TSP and traditional IRA balances. The distributions may even exceed actual income needs. Adjust the RMD by selling fewer shares of Roth IRA and placing [what?] into a cash account.

Step 10: In advanced old age, the rate of return on your investments is not as important anymore, however, income needs can still vary based on long-term health care requirements. In addition, you should have finalized estate planning by this time. Remember, there is no income tax on Roth IRA funds inherited by your beneficiaries.

Mr. Redden has been a presenter with NITP for over 25 years.He specializes in providing counseling and lectures to individuals on planning for retirement. He has been providing these types of training and counseling services since early 1987 under contract to the U.S. Office of Personnel Management as a Master Trainer for the FERS General Open Season, as well as many other Federal Agencies

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