Chapter 4

THE KEDREC RESERVOIR™

"Only when the tide goes out do you discover who's been swimming naked."

– Warren Buffet

You've got three markets to plan for: up markets, down markets, and flat markets. In up markets, you can pull income anywhere without much of a problem. Flat markets are really a combination of mostly up markets and a few really bad down markets. Ultimately, the problem we are trying to solve is how to pull income from your accounts when markets go down without accentuating your losses while also maintaining enough flexibility to adjust your plan and income along the way.

The Rule of Income suggests that you should never draw income from an account that has experienced significant losses. Failing to do so may have negative effects on your income and assets and may ultimately compromise your retirement. Remember earlier in the book when I took you through the exercise of what would happen if your account went down by -30%? As a quick reminder, a -30% loss would take a 43% return just to break even. Now, assume you took 4% from your portfolio when you had already lost -30%. At that point, you would be down -34% overall, which would require a 50% return just to break even.

When you follow the Rule of Income, you address a major potential problem in retirement, sequence of returns risk. Basically, if you can avoid taking income from accounts that have lost money, you do yourself and your investments a huge favor. The problem is we don't know when the markets are going to crash. No one knows the future.

This is where the Kedrec Reservoir™ comes in. Imagine allocating a portion of your assets into investments or products that cannot lose any principal (money). When markets go down, you draw income from your reservoir. That's it. It is so simple, yet so important I'm going to say it again.

When markets are up, you can take income anywhere.

When markets go down, you pull income from your Kedrec Reservoir™.

By not accentuating your losses, you allow your accounts the potential to recover faster. By not accentuating your losses, you are protecting your cash value return on investment (remember the 6% vs. 8% return comparison). The Kedrec Reservoir™ helps you not dig holes so deep you can't climb out of them.

I cannot emphasize enough what a game changer it is to be able to support a plan designed to never require you to take income from accounts that have experienced significant losses.

You don't need to be a sophisticated investor who perfectly times the market. You just need to make sure your reservoir is full and liquid enough to keep your income coming in should things get ugly in the market.

You fill up your reservoir, based on what your plan would suggest. As you enjoy your retirement, you slowly and deliberately drain your reservoir. When you retire, you will probably need a bigger reservoir than when you are 10 to 15 years in. When implemented correctly, this simple strategy helps solve sequence of returns risk, the risk that makes the 4% Rule potentially risky.

The Kedrec Reservoir™ also allows you to be flexible in your plan and portfolio while maintaining an appropriate amount of protection from down markets. You could argue that the Kedrec Reservoir™ strategy makes the annuitized income stream obsolete.

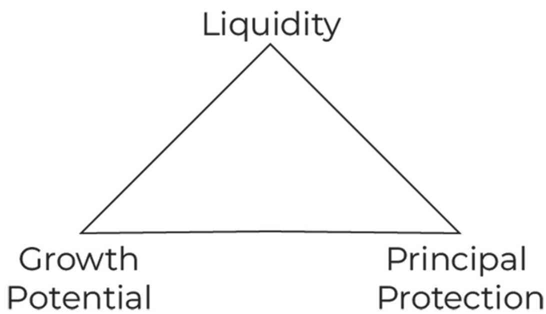
To keep going, you would have potentially less risk than your standard market-based portfolio, opening the door to consider the lump sum option instead of taking a pension. That would give you more control over your income and how you could prepare it to be passed to your heirs. Lastly, you can invest with more confidence in the market, putting yourself in charge of the "dividends" you want from your portfolio.

This strategy cannot be accomplished by any one carrier, custodian, or company. There is no single product that you can buy to make it all work. It is a self-sustaining financial ecosystem. Each investment or product plays a role in the overall portfolio.

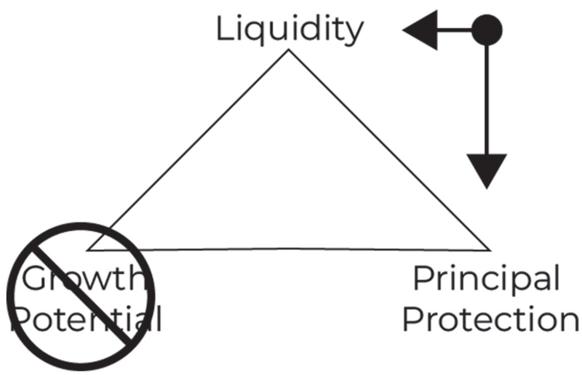
Now, you might have some questions. Let's get to some answers about the Kedrec Reservoir™.

Question #1: What Investments or Products Qualify For the Kedrec Reservoir™?

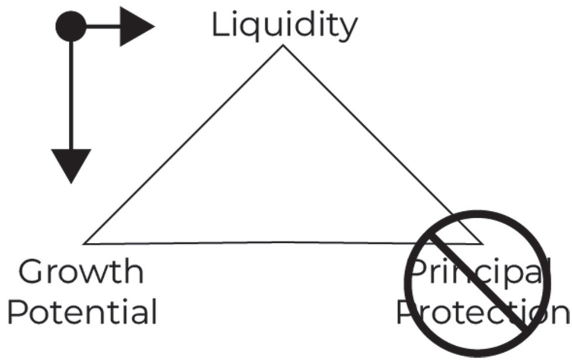
All investments can offer you reasonable growth potential, principal protection, and liquidity. The problem is *each investment can only offer you two of the three characteristics*. Here's a simple graphic to illustrate my point.



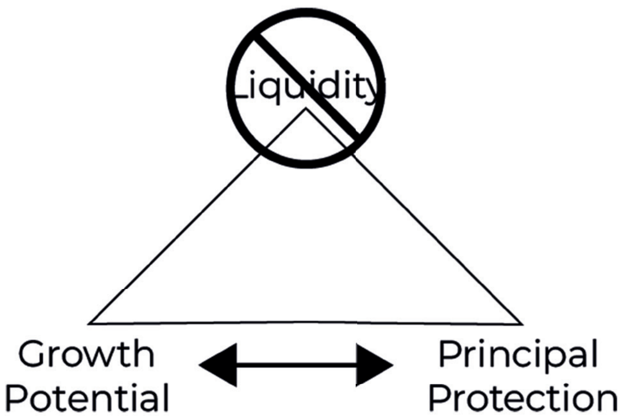
In the example below, principal protection and liquidity would characterize checking, savings, and money market accounts. At the risk of being redundant, you can't have liquidity, principal protection, *and* reasonable growth potential.



Growth potential with reasonable liquidity would characterize your stocks, mutual funds, and ETFs. It may take a couple of days to settle before you get your funds, but they are pretty liquid.



Both groups don't work for the reservoir. One lacks sufficient growth potential, which you need to be able to keep up with inflation. The other lacks sufficient protection, which you also need for this strategy to work.



The Kedrec Reservoir™ needs investments or products that offer reasonable growth potential to help keep up with inflation and principal protection so that when markets go down, they don't lose money. There are only four financial products that I believe qualify. They are:

- U.S. Treasuries, if held to maturity
- Certificates of Deposit
- Fixed or Fixed-Indexed annuities, if not annuitized
- Cash value life insurance

Each of these options has its own benefits and detriments. At this point, it is too early to tell which ones make sense because we have not made your plan, yet. Remember, you need a plan in place before you can discuss strategies. You need strategies in place before you can discuss investments and products.

Question #2: How much do I need to put into a Kedrec Reservoir™ for this to work?

It's too early to tell. It will all depend on your plan. For those who want to front load your plan and travel, there's a good chance you might lean heavier on U.S. Treasuries as you fund your reservoir. For those who are planning to retire in three to five years or so, you may consider a combination of CDs and annuities. For those who have assets they won't need for ten years, and they are anticipating a higher than desirable taxable situation, and are healthy, you may end up considering cash value life insurance. If you go down that path, please make sure you are in need of the death benefit you'll be paying for as well as the fees involved with the product. I'll explain more later.

Overall, it's too early to tell how much should go into your reservoir. But, I want to get the options out in the open so you can keep them in the back of your mind as you go through Part 2.

Question #3: Is it possible that I don't need a Kedrec Reservoir™?

Yes. If you are getting the income you need and want from income sources, such as rental income, DST income, pension income, and so on, then your assets would in theory be focused on building a legacy to pass. You probably only need the reservoir if you plan on taking income from your assets that are not already providing you with an income stream.

The purpose of the Kedrec Reservoir™ is to keep income coming in from your portfolio without accentuating losses in the down year. Everyone's plan is different. Therefore, how much you put into the reservoir, if anything at all, is entirely dependent on you and your plan.

The proper sequence is to build the plan first and then let the plan and universal rules help guide the implementation of the strategies, like the Kedrec Reservoir™.

In Part 2, we will build the plan, run the calculations and scenarios that will help guide what should go into your Kedrec Reservoir™, and decide how to structure it so liquidity is not a significant issue. **If you aren't yet absolutely clear on how**

a Kedrec Reservoir™ works, that's okay. We're going to be talking about it a lot in the coming chapters.

We've got one more chapter before Part 2. Though it is short, it is still very important.

I'll see you there.

Key Chapter Takeaways

- When markets go up, you can take income from anywhere. When markets go down, you take income from your Kedrec Reservoir™.
- Investments and products that qualify for the Kedrec Reservoir™ include U.S. Treasuries, if held to maturity, CDs, Fixed or Fixed-Indexed annuities, and cash value life insurance, like indexed universal life insurance.
- You cannot know how much should go into the Kedrec Reservoir™, if any at all, until you put your plan together. Plan before you talk about strategies, investments, and products.