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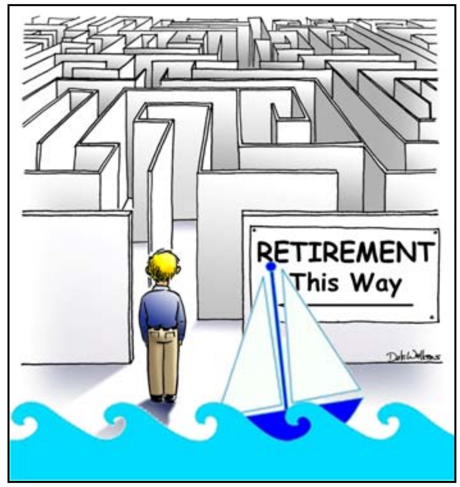
Optimizing Your Retirement Withdrawals

Navigating the Retirement Maze



If you're a healthy sexagenarian, then congratulations. You're likely to live well into your 90s. However, that's also the bad news: you'd better be financially prepared to handle a lengthy retirement. While modern medicine is extending our life expectancies, in many cases our finances are still playing catch-up. Thus, it is important that you don't overspend your lifetime savings and have them expire before you do.

The flip side of that situation is under-spending. Your heirs would most likely welcome dividing up a larger estate, but you might have really enjoyed taking that world cruise or climbing Kilimanjaro, had you known your assets could have safely supported those expenditures.

So what's the best rate at which to spend down your retirement savings? Much research has been done on this topic, and I'll summarize some of the key findings, plus what I consider to be the best approach.

The "4% Rule"

This is the classic "rule of thumb." Using historical U.S. market data going back to 1926, it's been shown that for a 50/50 stock/bond portfolio with a withdrawal rate of 4.5% of the starting balance in Year 1 of retirement and increased by the rate of inflation each subsequent year, a retiree would have a 95% chance of not running out of money after 30 years. Sounds like pretty good odds. The advantages of using this approach are that it is simple, and appears to be safe.

So what are the downsides of using this withdrawal rate?

- You might live longer than 30 years, coupled with escalating medical costs.
- Most of the time you would have ended up with large surpluses after 30 years. In fact, over 90% of the time you would have had *more* assets after 30 years than what you started with.
- To quote the ubiquitous disclaimer: *"Past performance is no guarantee of future results."*

Regarding the last point, a recent study showed that in 10 of the 17 developed countries, using this rule since 1926 would have failed retirees more than 25% of the time. In Spain and Italy, it would have resulted in running out of money 70% of the time.

The Market Valuation Approach

Not surprisingly, it turns out that whether the stock market is overvalued or undervalued – i.e., the degree to which price-earning ratios (P/E) are above or below historic averages – in your year of retirement is highly predictive of your "safe withdrawal rate". The Shiller PE10 Ratio, which is an inflation-adjusted average P/E of the prior 10 years worth of market data, has been reasonably accurate at forecasting longer term market returns.

Michael Kitces, a prominent financial writer, suggests the following modification to the "4% rule" using this additional information:

- PE10 <12 ("undervalued") – Increase withdrawal rate to 5.5%.
- Between 12 and 20 ("fairly valued") – Increase rate to 5.0%.
- PE10 >20 ("overvalued") – Use the "safe" 4.5% withdrawal rate.

As of this writing, the PE10 was 21.3, implying an overvalued market and thus a 4.5% withdrawal rate.

The "Mid-course Correction" Approach

A sailor doesn't set sail by pointing his boat towards his destination, locking the tiller, and then taking a nap. The journey is one of constant corrections for weather, tides, and unforeseen circumstances. Nor does it make sense to lock in to a fixed retirement withdrawal strategy for 30-plus years.

In their book "Yes, You Can Still Retire Comfortably," Ben Stein and Phil DeMuth introduced the concept of dynamically adjusting withdrawal amounts by recalculating your withdrawal percentage every five years as if it were your first day of retirement. This has the advantages of simplicity, allows for mid-course adjustments, and each subsequent recalculation will represent a retirement period that is five years shorter.

The Big Picture

Here we addressed "How much can I spend?" For those approaching retirement, the more pertinent question might be "How much do I need to save?" This is an equally important issue, and one which I'll cover in a future column.

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