Withdrawal Risk

When you reach retirement, you face a lot of changes, from your daily routine to your financial situation. Perhaps the biggest financial challenge is the transition from earning money and accumulating assets to spending down your hard-earned assets. Developing a plan for spending down your assets can be extremely challenging, especially since you don't know how long you'll live.

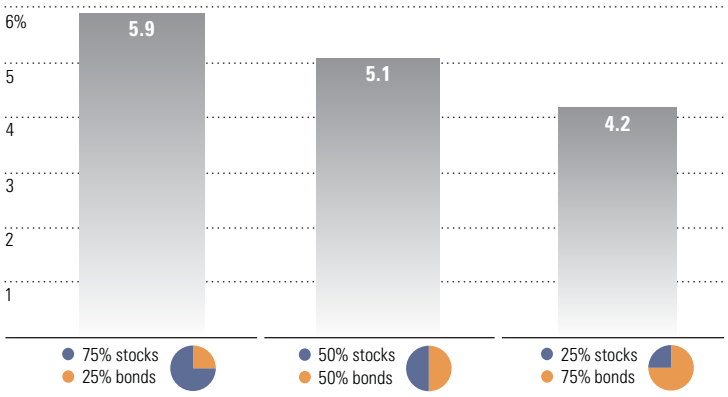
Withdrawal risk is the risk of drawing down your assets too aggressively to meet your spending needs, with the possibility of depleting your assets before you die. It's a risk that keeps many retirees up at night.

What is a reasonable withdrawal rate?

When approaching retirement, the first question many investors ask is how much money they can safely extract from their portfolio each year. A simplistic way of looking at this is a withdrawal rate, expressed as a percentage of your investment assets.

The withdrawal rate you can sustain may be lower than you think[1]

Average: 1926–2006



Historically, as shown above, withdrawal rates that could support an investor over a typical 30-year retirement, varied from 4.2% to 5.9%, depending on the asset allocation of the portfolio. Of course, if you lived longer than 30 years, these withdrawal rates would need to be lower.

Many investors are too optimistic and hope to withdraw 10% or more of their portfolio annually to support their desired retirement lifestyles, which is sure to rapidly deplete their portfolio. Other investors are too pessimistic; they construct a portfolio of CDs, bonds, and dividend-paying stocks and only withdraw interest and dividends from their portfolio, vowing never to touch principal.

Unfortunately, there is no magical formula or simple solution. The optimal withdrawal rate will vary from investor to investor, and may vary over time.

Many financial planners consider a withdrawal rate of 4%–5% as being reasonable and sustainable over a long retirement horizon. This withdrawal rate will have a profound impact on how much money you need to accumulate before retiring and when you can retire. It's likely to shock anyone who is a bad saver.

For example, a $1 million portfolio with a 4% withdrawal rate would produce only $40,000 in income in the first year. If you're trying to replace $100,000 in income and estimate $20,000 will come from Social Security, you'll probably need to save $2 million before retiring.

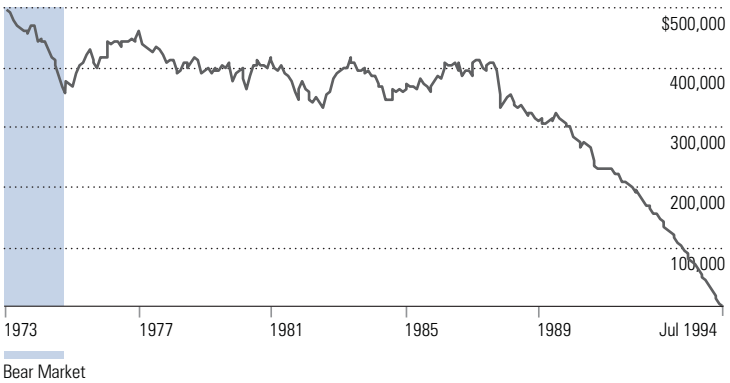
Determining the appropriate withdrawal rate will be based on many factors such as longevity, spending, inflation, asset allocation, and annuitization. Some financial planners may be more comfortable with withdrawal rates as high as 5%–7%, but even then, they would want to adjust the plan each year based on spending, portfolio performance, and other life events.

How does the timing of portfolio returns affect planned withdrawals?

The sequence of market returns affects how long your retirement portfolio can sustain your desired withdrawals. When poor returns occur early in your retirement, as you begin taking distributions from your portfolio, the risk that your portfolio will run out of money dramatically increases. Financial planners call this "point in time" risk.

Let's assume a worker retired on Dec. 31, 1972, with a $500,000 retirement portfolio composed of 50% stocks and 50% bonds. Beginning in 1973, he withdrew $25,000 per year. The first two years of his retirement were the bear market years of 1973 and 1974 in which the stock market fell by 14.7% and 26.5%, respectively. The dual strains of market losses and withdrawals proved too much for the portfolio and rapidly depleted his savings. His timing was unfortunate.

Retiring at the beginning of a bear market can significantly impact your retirement wealth
Actual historical return sequence beginning with a bear market



Now, let's take the same retiree, with the same portfolio and withdrawal rate, but reverse the sequence of his portfolio's returns. Let's say the returns from 1994 occurred before the returns from 1993, etc., with the returns from 1973 occurring last. Instead of retiring at the beginning of a bear market, he retired in the midst of a bull market. As you can see in the illustration below, our retiree's portfolio performed well early in his retirement. By the time the portfolio encountered a bear market, it had grown so much that the poor returns had only a small effect on his portfolio balance, and he was able to maintain his desired withdrawals.

Retiring in the midst of a bull market can have a positive impact on your retirement wealth

Reversed historical return sequence ending with a bear market

The recent bear market of 2002–2004 further illustrates point in time risk. Many of your peers who were approaching retirement or who recently retired probably saw big drops in the value of their retirement savings, causing many people to delay retirement or return back to work.

We're not suggesting that you should try to time your retirement to coincide with a bull market as that would be impossible. The main point here is that yearly withdrawals over a long period of time can reduce your asset base to levels that can't sustain your retirement goals. Many financial planners would suggest that you adjust your withdrawal rate and spending each year based on the returns you earned in the previous year. If you face poor returns early in retirement, you might want to lower your withdrawal amounts and spending for a while. Conversely, in years when you earn good returns, you can maintain, or perhaps increase your withdrawal amounts and spending.

What tax considerations might affect my withdrawal strategy?

For each of your tax-deferred accounts, once you reach age 70½, you'll need to pay careful attention to any Required Minimum Distributions (RMDs) mandated by the IRS. RMDs are designed to force you to take money out of your tax-deferred accounts and pay the taxes you've deferred over the years. Your RMDs are calculated by dividing your account balance by your life expectancy. For example, a 70-year-old man with a $100,000 traditional IRA and a life expectancy of 85 would be required to make an RMD of roughly $6,667. The following year, your RMD will change based on your revised life expectancy and portfolio value.

Questions to ask your advisor:

- What is a reasonable withdrawal rate and how much income might that generate each year?
- Given my spending goals in retirement and my withdrawal rate, how much do I need to save before I retire?
- How should I adjust my withdrawal rates in years when my portfolio performs poorly or exceptionally well?
- What are my RMD requirements for the coming year?
- Once I've made my RMD withdrawals, which accounts should I tap first to meet my additional withdrawal needs?

If you fail to make withdrawals that meet RMD requirements, you'll be subject to fines and penalties from the IRS. RMDs can be complicated to manage and easy to overlook, so you may want to consult a financial planner or tax advisor.

Once you've figured out your RMDs, there's a good chance you'll need to make additional withdrawals above and beyond your RMD withdrawals to meet your income needs. A critical issue you'll need to consider at this point is the tax-efficient sequencing of withdrawals from various accounts. For example, studies have shown that in general, it is best to begin withdrawals from taxable accounts first, tax-deferred accounts second and tax-free accounts last. Why? The longer you defer paying taxes by sheltering assets in tax-advantaged accounts, the more your money can grow by compounding over time. Proper planning on the sequencing of accounts from which you withdraw assets can save you taxes and preserve your assets over time.

Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The data assumes reinvestment of all income and does not account for taxes or transaction costs. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. Each portfolio is rebalanced monthly.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Bonds—5-year U.S. Government Bond; Inflation—Consumer Price Index.

[1]All withdrawal rates are represented by an inflation-adjusted percentage of the initial portfolio balance that, if withdrawn in each of the 30 years of the hypothetical retirement horizon, would have resulted in an ending portfolio balance of $0. Annual fees of 0.94% for stocks and 0.82% for bonds were assumed.