

Key decisions for your retirement withdrawal strategy

You’ve accumulated what seems like a sufficiently sized nest egg coming into retirement. The next step is to figure out how to get your money out of it.

At first blush, the answer seems simple: Buy income-producing securities — bonds and dividend-paying stocks — and call it a day. When yields are higher, so is your payday; when they’re lower, you have to get by on less. If you have a lot of money and yields are good, you may be able to get away with never touching your principal during your lifetime; the money then can pass to kids, grandkids or charity.

That’s certainly one way to do it, but it’s not the only retirement spending strategy out there. To home in on the right one, retirees need to consider two sets of questions: first, the extent to which they’re comfortable with a fluctuating payday and, second, whether they want their paycheck to come from income alone or other sources, as well.

Investors often conflate these two questions — for example, they assume that if they’re focusing on income production, they’ll need to put up with some variability in their payday as prevailing market yields ebb and flow. In reality, it’s possible to employ an income-centered strategy that delivers a steady dollar paycheck. Meanwhile, the opposite strategy also is viable: building a total-return-centered portfolio that delivers a variable, market-sensitive payday. Retirement researchers generally consider variable distribution methods as more sustainable than withdrawing a fixed dollar amount because they’re more market-sensitive.

To arrive at the best decision for you, consider the following:

Will your withdrawal amount be fixed, variable or a blend?

Do you want a paycheck in retirement that is more or less static, save for an inflation adjustment to help preserve the purchasing power of what you withdraw? Or are you OK with varying paychecks, depending on how your portfolio is performing? Let’s walk through the pros and cons of each of those approaches and also consider a hybrid strategy that blends these two approaches.

The fixed-dollar amount: Using this strategy, the retiree takes a specific percentage of his or her portfolio in year one of retirement, then inflation-adjusts that dollar amount in subsequent years. That’s the spending approach embedded in the 4 percent “rule” for retirement spending. For example, say a retiree has an \$800,000 portfolio and is using a starting withdrawal of 4 percent. Year one spending is \$32,000; year two spending is \$32,960 (the initial \$32,000 plus a 3 percent inflation adjustment).

Pros: A reliable income stream; comes closest to simulating the paycheck that many retirees earned while they were working; is the strategy embedded in much of the academic literature on withdrawal rates.

Cons: Not sensitive to market fluctuations; taking too much in down years could leave less in place to bounce back when the market recovers.

The fixed percentage method: Using this method, the retiree takes a preset percentage of the portfolio per year. Assuming an \$800,000 portfolio, the retiree taking a 4 percent fixed percentage of the portfolio would have \$32,000 in year one. But if the portfolio increased in value to \$900,000, the payday would also increase to \$36,000.

Pros: Ties in with portfolio values and market performance; market-sensitive spending strategies generally considered more sustainable than those that don’t consider market performance; virtually guarantees retiree won’t run out of money.

Cons: Translates into a fluctuating paycheck, which may not suit retiree’s lifestyle considerations; taking a fixed percentage from a shrinking pool may not be enough to live on in some years.

The hybrid method: Such strategies — and there are a few variations — attempt to deliver a fairly steady paycheck while also baking in some market sensitivity. One of the simplest strategies to implement, one that T. Rowe Price has advanced, would be to spend a relatively static dollar amount while foregoing the inflation adjustment in down-market years. Another strategy, discussed in research by Jonathan Guyton and William Klinger, assumes a fixed-percentage withdrawal method with “guardrails” to ensure that spending never goes above a given ceiling or floor.

Pros: Attempts to deliver a fairly stable cash flow while also staying sensitive to portfolio fluctuations.

Cons: Can be more complicated to understand and implement; simple methods, like the T. Rowe Price strategy, help improve the odds that a retiree won’t run out of money, but they don’t guarantee it.

Morningstar

BIG ASSUMPTIONS CAN MESS UP YOUR PLAN

BY CHRISTINE BENZ

As inveterate watchers of sitcom reruns (and a real-life Felix/Oscar combination), my sister and I loved “The Odd Couple” (with Tony Randall, left, as Felix Unger) while we were growing up. One of our favorite episodes featured a courtroom sequence in which Felix berates a witness to “never assume,” and proceeds to use the chalkboard to demonstrate what happens when you do. More years later than I care to admit, the mere mention of the word “assume” makes me smile.

But assumptions aren’t always a laughing matter, and that’s certainly true when it comes to retirement planning, where “hope for the best, plan for the worst” is a reasonable motto. Incorrect — and usually too rosy — retirement-planning assumptions are particularly problematic because by the time a retiree or pre-retiree realizes her plan is in trouble, she may have few ways to correct it; spending less or working longer may be the only viable options.

What follows are some common — and dangerous — assumptions that individuals make when planning for retirement, as well as some steps they can take to avoid them.

DANGEROUS ASSUMPTION 1: That stock and bond market returns will be rosy

Most retirement calculators ask you to estimate what your portfolio will return over your holding period. It may be tempting to give those numbers an upward nudge to help avoid hard choices like deferring retirement or spending less, but think twice.

To be sure, stocks’ long-term gains have been pretty robust. The S&P 500 generated annualized returns of about 10 percent in the 100-year period from 1915 through the end of last year, and returns over the past 20 years have been in that same ballpark. But there have been certain stretches in market history when returns have been much less than that; in the decade ended in 2009, for example — the so-called “lost decade” — the S&P 500 actually lost money on an annualized basis.

The reason for stocks’ weak showing during that period is that they

were pricey in 2000, at the outset of the period. Stock prices aren’t in Armageddon territory now, yet neither are they cheap.

What to do instead: Prudent investors may want to ratchet down their market-return projections somewhat just to be safe. Morningstar equity strategist Matt Coffina has said that long-term, inflation-adjusted returns in the 4.5 percent to 6 percent range are realistic for stocks. Vanguard founder Jack Bogle’s forecast for inflation-adjusted stock returns is in that same ballpark.

Investors will want to be even more conservative when it comes to forecasting returns from their bond portfolios. Starting yields have historically been a good predictor of what bonds

7 FINANCIAL CHALLENGES FOR RETIREES

Withdrawals

A too-high withdrawal rate can force a retiree to make do with less later in life. The right withdrawal rate depends on portfolio mix, market performance.

Longevity

Long retirement horizon — a couple aged 65 has 25 percent chance of one partner living to age 96.

Solvency

Shrinking percentage of workers covered by pension plans as Social Security and Medicare under strain.

Savings

Under-funded 401(k) accounts. Most Americans have an enormous savings gap.

Inflation

Erodes the value of savings and reduces returns. Health care inflation historically is higher than the Consumer Price Index.

Market volatility

Uncertain returns and income.

Market performance early in retirement determines portfolio’s long-term viability.

Retiree spending

Spending on food and health care often increase in retirement. Long-term care expenses are impossible to predict.

might earn over the next decade, and right now they’re pretty meager — roughly 2 percent or 3 percent for most high-quality bond funds. That translates into a barely positive real (inflation-adjusted) return.

DANGEROUS ASSUMPTION 2: That inflation will be mild or nonexistent

In a related vein, currently benign inflation figures may make it tempting to ignore, or at least downplay, the role of inflation in your retirement planning. Like robust return assumptions, modest inflation assumptions can help put a happy face on a retirement plan. But should inflation run hotter than you anticipated in the years leading up to and during your retirement, you’ll need to have set aside more money and/or invested more aggressively in order to preserve your purchasing power when you begin spending from your portfolio.

What to do instead: Rather than assuming that inflation will stay good and low in the years leading up to and during retirement, conservative investors should use longer-term inflation numbers to help guide their planning decisions; 3 percent is a reasonable starting point. And to the extent that they can, investors should customize their inflation forecasts based on their actual consumption baskets. For example, food costs often are a bigger slice of many retirees’ expenditures than they are for the general population, while housing costs may be a lower component of retirees’ total outlay, especially if they own their own homes.

The possibility that inflation could run higher than it is today also argues for owning investments that help you preserve purchasing power once you begin spending your retirement assets. That means stocks, which historically have had a better shot of outgaining inflation than any other asset class, as well as Treasury Inflation-Protected Securities and I-Bonds, commodities, precious-metals equities and real estate.

DANGEROUS ASSUMPTION 3: That you’ll be able to work past age 65

Never mind how you feel about working longer: Continued portfolio contributions, delayed withdrawals and delayed Social Security filing

A NEW VOCABULARY FOR

When it comes to their finances in retirement, most people want the same things. They want to be able to enjoy a lifestyle on par with, if not better than, the one they had when they were working. They want to have the money to pay for travel and hobbies that give them joy without having to skimp in other areas. They want their assets to last for their lifetimes, with possibly some left over for loved ones or favorite charities. Most of all, retirees and pre-retirees want to put their money in its place: With busy lives to lead, they just don’t want to worry about it.

Yet, despite all of those commonalities, there’s a tremendous range of opinion about specific strategies for achieving the above-mentioned goals. Certainly, there’s more than one way to get it done, and the fact that retirees and pre-retirees debate various strategies can signal that they have a healthy conviction in their approaches. But if you read between the lines, some of these disagreements are more semantic than they are real. And Morningstar can’t help but wonder if that’s because a lot of the terms we use to discuss retirement are outmoded — a vestige of the days when CDs had double-digit yields and pensions were plentiful.

The new world of retirement

planning calls for more flexible and inclusive terms. Herewith are some retirement terms that Morningstar would like to see retirees and pre-retirees swap into their vocabularies, along with terms we’d like to see on the chopping block because they fan the flames of confusion.

In: Spending rate

Out: Withdrawal rate

“Spending rate” gets at the notion that there’s more than one way to get the money you need from your portfolio in retirement. Yes, you can extract your money through outright withdrawals of principal, as the term “withdrawal rate” suggests, but you also can get it from spending your income and dividend distributions rather than reinvesting them back into the portfolio. Many retirees sensibly take a variety of tacks to generate the money they need from their portfolios, using income and dividend distributions to provide them with a baseline of living expenses and tapping principal to generate any excess income required.

The term “spending rate” also telegraphs the concept that total-return investors withdrawing principal from their portfolios aren’t the only ones who need to concern themselves with the safety and the sustainability of their spending. Income-minded investors might automatically tune out any discussion of withdrawal rates, assuming that the term refers

to withdrawal of principal. (In fact, we recently heard an income-minded investor say that her withdrawal rate was 0 percent because she can subsist on her portfolio’s income alone.) But most of the research surrounding safe withdrawal rates — including the 4 percent rule — doesn’t differentiate about whether the retiree gets his or her money from bond and dividend income or withdrawals of principal. The effect of 4 percent taken from a portfolio is the same regardless of whether it comes in the form of dividend and income distributions that are spent rather than reinvested or whether it comes from withdrawals of principal after reinvesting income, dividends and capital gains distributions.

In: Retirement cash flow

Out: Retirement income

Retirees often obsess about generating income from their portfolios, conflating their need to replace the income they once earned from their salaries with a need to invest their whole portfolios in income-producing securities. This phenomenon probably has its roots in a more favorable yield environment: When bond yields were higher, many retirees could readily generate the cash they needed from their portfolios using money markets and bonds.

It generally makes sense to increase stakes in income-producing securities like bonds and divi-