

Key to Making Retirement Savings Last: The Withdrawal Rate

What Does This Article Cover?

- What is a withdrawal rate, and how can it affect my retirement?
- How can I be certain my retirement portfolio will last throughout my retirement years?
- How can annuities help smooth out my retirement income?

"How much can I afford to withdraw from my retirement savings annually without eating away at my principal? How do I make it last as long as I need it to?" Both are key questions for anyone who is retired or contemplating retirement.

Even people who have accumulated \$1 million, long considered a "safe harbor" amount for retirees, are concerned. If they withdraw too much, they may exhaust their savings; too little and they can unnecessarily lower their standard of living. These concerns have been exacerbated by the recent bear market that reduced the earnings of, or in many cases depleted, millions of portfolios.

A More Conservative Approach

According to a March 10, 2004 Wall Street Journal article, today many retirement planners are advising a conservative 3.5 percent withdrawal rate. This means that someone who has painstakingly built a \$1 million retirement nest egg should withdraw only \$35,000 a year and live the lifestyle this would permit—clearly not the dream retirement they envisioned. This in turn is leading people who are still working and saving for retirement to ask, "Will I ever be able to retire?"

Every retiree's goal is to live off a retirement portfolio comfortably, without drawing down the principal balance to a dangerously low level. Fortunately, there have been studies that can help you figure out a sustainable withdrawal rate, that is, how much of your total portfolio you can spend each year and still enable your portfolio to generate adequate annual income. In addition, certain financial products, primarily annuities, can help ensure that you don't outlive your resources and that you have an even flow of money during retirement, while also providing adjustments for inflation.

According to the Journal article, during the bull market years financial experts would say that a retiree could safely withdraw five to six percent a year without eating into principal. For a retiree starting with a \$1 million portfolio that means an income of \$50,000 to \$60,000. That may have been a little optimistic. Indeed, for a \$1 million portfolio that earns 3.7 percent a year, withdrawals of 6 percent or \$60,000 can be maintained for approximately 26 years before exhausting the entire portfolio. These days many people enjoy retirements that last 30 or even 40 years, which underscores the need for both a solid accumulation and wealth-building strategy and a sustainable withdrawal rate.

Everyone's situation is different; no single withdrawal rate is right for everyone. People without heirs may wish to withdraw more aggressively than those looking to pass assets on to future generations. Moreover, the more a portfolio is responsible for retirement income, that is, the less a retiree receives from Social Security and pensions, the more conservative the withdrawal rate must be to ensure that retirement savings last 30 years or longer.

The Trinity Study

In what has become known as the Trinity Study, three professors from Trinity University in San Antonio, Texas, studied actual historical stock and bond returns to determine sustainable withdrawal rates. The study, first published in 1998 in the Association of American Individual Investors Journal, has gained renewed significance in light of recent turbulent economy.

Using data from 1926 to 1995, the professors looked at five possible portfolio compositions, from 100 percent stocks to 100 percent bonds - the three other portfolios were: 75 percent stocks/25 percent bonds, 50/50 stocks and bonds, and 25/75 stocks and bonds - and evaluated the impact of fixed annual withdrawals ranging from three percent to 12 percent. Stocks were represented by the S&P 500, while long-term high grade domestic bonds were used for the bond portfolios.

Payout periods were in five-year intervals, from 15 to 30 years. In the study, the professors considered a portfolio successful if it ended a particular withdrawal period with a positive value.

The study produced a number of conclusions, including:

- Withdrawal periods longer than 15 years dramatically reduced the probability of success at withdrawal rates exceeding five percent.
- Bonds increase the success rate for lower to midlevel withdrawal rates, but most retirees would benefit with at least a 50 percent allocation to stocks.
- Retirees who desire inflation-adjusted withdrawals must anticipate a substantially reduced withdrawal rate from the initial portfolio.
- Stock-dominated portfolios using a 3 to 4 percent withdrawal rate may create rich heirs at the expense of the retiree's current standard of living.
- For a payout of 15 years or less, a withdrawal rate of 8 to 9 percent from a stock-dominated portfolio appears sustainable.

Another site, RetireEarly.com, recently conducted a similar study using a database that spans all the way from 1871 to 1998 and basically confirms the conclusions of the Trinity Study.

Both studies concluded that four to six percent of a retiree's starting portfolio is a safe withdrawal rate range. Withdrawal rates above five percent increase the probability that a portfolio will be exhausted during the retiree's lifetime.

Even if a portfolio can sustain a five or six percent withdrawal rate, retirees can benefit by giving themselves as much financial flexibility as possible. This way, if a withdrawal rate reduction is necessary, the retiree's standard of living is not compromised significantly. To give yourself financial flexibility, experts agree, first and foremost remain as debt-free as possible. Without a large overhead each month, it's easier to cut back when necessary. Some retirees may want to consider moving to a smaller home to reduce both mortgage and maintenance costs.