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Retirement Planning – Revisited

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"Am I going to outlive my money?" This is one of the most important financial questions that we ask ourselves. Given the poor stock market returns over the past decade and our natural tendency to extrapolate market trends, many have confronted this question with increasing alarm and urgency.

This question is very difficult to answer definitively, because you need to make certain correct assumptions about the future: a) timing and amount of your expenses; b) sequencing and amount of any investment returns/losses; c) timing and amount of your withdrawals from your retirement assets; d) your life expectancy; and e) timing and amount of future savings, if any, that you can put away.

To offer some perspective on this topical question of what is a "safe" annual withdrawal rate from your retirement assets and, more generally, how to plan for retirement during these challenging economic times, we reprint below the **Fall 2010** article from **PDV *Observations*** on this subject (with some portions omitted).

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Planning for retirement is one of our most important financial responsibilities. Unfortunately, the terrible market over the past decade along with the collapse of the housing market have greatly complicated retirement planning. The retired are reassessing their plans, while those near retirement are confronting the unpleasant prospect of working longer. Younger workers are also affected, increasingly uncertain about the best way to save and invest for retirement. With persistently high unemployment, widespread salary cuts or freezes, a "lost decade" for equities and lower house values, coming up with a plan for secure retirement is hugely challenging.

The future is not as grim as a linear extrapolation of the past decade would suggest. Regression to the mean is a powerful force influencing financial markets. While many have abandoned stocks since the 2008-09 financial meltdown, historical data strongly suggest that the coming decade will likely produce much higher stock returns. This evidence shows that, ***without exception***, each decade of poor stock returns since 1926 was followed by a decade of substantially higher cumulative returns.

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The primary goal of a secure retirement is to make

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sure your money outlives you. The key components of a successful financial planning/investing program should accomplish the twin related goals of adequate capital accumulation on the front end during working years and reasonable distribution or withdrawal on the back end post-retirement. Obviously, both phases have to dovetail and work in sync. The accumulation phase encompasses the earning/saving years to build up a nest egg for retirement and beyond, while the distribution phase covers the tapping of the nest egg to sustain a desired lifestyle following retirement. With inadequate accumulation, money is going to run out regardless of how sensible the withdrawal rate is. As a corollary, even with a sizable nest egg, excessive withdrawals will deplete the nest egg prematurely.

The hallmark of an effective accumulation program must contain several critical elements: 1) regular and adequate savings, and 2) an investing plan for growing the savings which will more than offset the eroding effects of inflation and taxes over time. Of course, regular savings means that your income from all sources must exceed your regular, recurring expenses, with additional allowance for irregular, lump-sum expenses.

Saving regularly takes discipline and living within your means. Systematic budgeting and having a good handle on where the outgoing cash flow is being spent are critical. The main difficulty is being willing and able to allocate a chunk of focused time upfront to set up a plan of action and then stick to it. This is quite a burdensome and distasteful process for many people. Even with the help and advice of financial professionals, you have to do part of the hard work yourself. None of this is easy. If you go to the doctor, and she advises you to eat more fruits and vegetables and get plenty of exercise to promote better health, the fact that you continue to smoke, eat red meat and sit on the sofa all day watching television does not mean you disagree with the doctor's advice. It's just that often it's so difficult to come up with the discipline to follow the advice. It's the same thing with saving and investing.

One of the most effective and relatively painless ways of putting away regular savings is to automatically deduct money from your payroll. The adage "what you don't see, you won't miss" really does work quite well. In addition to the simplicity and effectiveness of this strategy, there are of course other significant reasons for implementing your savings plan via regular payroll deductions. Over the past 10 years or so, we have seen a proliferation of the types of allowable tax-advantaged retirement accounts as well as substantially increased contribution limits for such accounts.

Depending on your employer, you are likely now to have one or more of the following retirement accounts available to you: 401(k), Keogh, 403(b)(7), 457(b), Roth 401(k), SEP-IRA etc. In addition, depending on your income level and tax filing and marital status, you also have at your disposal one or more of the following non-company sponsored retirement plans: traditional IRA, Roth IRA, Rollover IRA and Spousal IRA. These vehicles offer the advantage of tax-deferred or tax-free accumulation of savings. Further, some of you may be vested under traditional defined benefit pension plans that will pay you income after retirement based on years of service and salary level. Of course, you will also receive social security benefits, notwithstanding that such payments are likely to be much lower in the future for those whose retirement is still some years away.

Once an appropriate savings program is established and followed, the investing part presents its own challenges. If you want to work with a financial advisor, you will have to do a lot of due dil-

igence. Like any profession, you will find that only a portion of all financial advisors are trustworthy, competent and with whom you are comfortable working.

Even if you find the right advisor, many natural behavioral instincts exist to throw you off course. For instance, some people are so conservative that they match long-term liabilities with short-term investment options. Even though they won't need to tap their nest egg for 30 years, they will put all their money in CD's to avoid interim fluctuation. This feeling of "safety" is totally illusory. After taxes and inflation, they might actually be losing purchasing power with CD's. This situation is exacerbated by the fact that taxes are levied on nominal returns (as opposed to real returns), leaving less after-tax dollars to keep up with inflation. Currently, the paltry yields on short-term CD's leave you *worse off* after inflation.

In contrast, some people swing for the fences, hoping to hit it big and fast. They don't diversify or they buy on a whim. The human mind is not particularly good at calibrating risk and return, when emotions are high and issues of money are involved. Others try to do the impossible of timing the market, jumping in and out and giving in to natural feelings of greed and fear.

Even if you are working with a trustworthy and competent advisor who gets along with you, you might be surprised by what could still derail you from reaching your goals. There is a long list of psychological factors or predispositions which make all of us prone to making investment mistakes. You might have heard of some of them: loss aversion, social validation, herding instinct, myopia, anchoring, confirmation bias, selective memory, over-confidence, and so on. If this sounds more like Psychology 101 than finance, the truth is that you cannot separate the two, since they are intricately tied together, as mass psychology has a disproportionate short-term effect in dictating how market participants react to business, political and economic developments.

Another huge stumbling block is the fact that investors generally have unrealistic expectations for their investments. They often expect them to do well all the time, and are tempted to change course when their programs "stop working temporarily." While we all would like to see our investments progress like a super-charged CD, producing stable, outsized and predictable returns, it is a pipe dream. In reality, even good investment programs produce progress that fluctuates and is at times frustrating. Many people bail on their investment programs during these inevitable, slow or frustrating periods to go after something else that is working, typically in time for their existing program to take off again, while the new program suffers. It's sort of like changing lanes on a busy freeway and finding the new lane slows down just as your old lane clears up.

An appropriate withdrawal plan forms the second component of a good retirement plan. William Bengen has developed some very useful ideas on what is an appropriate withdrawal plan that can be adapted to each individual's situation. Mr. Bengen correctly identifies the most important factors that govern the appropriate withdrawal rate in the distribution phase: the base-line withdrawal scheme (which directs how the withdrawal amount is to be computed); asset allocation between stocks, bonds and cash; desired success rate of program; account rebalancing interval; assumed excess investment return; desire to leave a legacy; and time horizon for withdrawal.

The most important of all the above factors is the base-line withdrawal scheme. Mr. Bengen uses a baseline scheme that assumes the following: 30-year time horizon; tax-advantaged account holding the nest egg; an asset allocation of 60% large-cap stocks and 40% intermediate-term government bonds; annual rebalancing of the nest egg to the desired asset allocation; no desire to leave a lega-

cy; 100% success rate that the nest egg will last for at least 30 years; and the same withdrawal amount each year, adjusted annually for inflation (a.k.a. life-style scheme). The assumed returns used by Mr. Bengen are the long-term historical returns for the asset classes implementing the asset allocation. Based on these assumptions, Mr. Bengen considers the safe withdrawal rate for the first year of retirement to be about 4% of the portfolio value at the beginning of retirement, which withdrawal amount is adjusted up annually for inflation.

Using this baseline withdrawal scheme as a starting point of reference, he advises that you can increase or decrease the initial withdrawal rate, depending on the choices you make to change the assumptions. The initial choice you have to make is to either stay with the life-style scheme or select one of the following alternative withdrawal schemes: larger withdrawals upfront, and then declining thereafter (life-phase scheme); withdrawal amounts that depend on performance of the nest egg, possibly augmented with floors and caps on the range of annual fluctuations (performance-based scheme); and same dollar withdrawal amount per year (annuity-like scheme).

After you choose one of these schemes, you can further adjust the initial withdrawal amount by changing any one of the following: asset allocation; the level of acceptable risk that your money might run out prematurely; rebalancing interval; assumed excess investment returns; the decision whether to leave a legacy; and the time horizon over which your money is to last.

You can choose to increase your initial withdrawal rate by favoring more equities, accepting some risk that your money might run out earlier than 30 years, lengthening the rebalancing interval, assuming a higher excess return, and/or shortening your time horizon. A desire to leave a legacy, on the other hand, would reduce the safe annual withdrawal amount.

Since initially introducing his ideas, Mr. Bengen has further suggested adjusting the initial withdrawal rate according to the market valuation at the beginning of retirement. When the market is undervalued, as it might be after a bear market or after a long period of stagnation, the initial withdrawal rate can be increased to take into account the probability of above-average market returns going forward. This is a particularly helpful suggestion in light of the terrible market returns in the past decade and the strong tendency for markets to regress to the mean. On the other hand, you should consider decreasing your initial withdrawal rate if you start your retirement during a period of market overvaluation. Results from more recent research completed separately by Michael Kitces and John Harris also support incorporating market valuation into determining the appropriate initial withdrawal rate.

While Mr. Bengen's concepts might seem overwhelmingly complex at first glance, he has done a tremendous service to the financial planning community by articulating a framework for rationally arriving at appropriate withdrawal rates, while at the same time empowering you to adjust withdrawal rates based on a series of choices that you can make, depending on your risk tolerance, time horizon and specific lifestyle, and with the guidance and input from your financial advisor.

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