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A Sensible Accumulation and Withdrawal Plan for Retirement

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Ultimately the process of long-term investing and financial planning is aimed at achieving your financial goals, ranging from a secure retirement, leaving a legacy or putting children through college. The primary goal of a secure retirement is to make sure the money outlives you. At its core, this investing/financial planning process can be broken down into a few major components. This article discusses these components, as well as the practical, psychological, temperamental and financial impediments to your successful implementation of a sensible accumulation and withdrawal program to achieve your financial goals.

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, irresponsible withdrawals will deplete the nest egg prematurely. This is everyone's worst nightmare!

The hallmark of an appropriate 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 whatever source must exceed your regular, recurring expenses, with additional allowance for irregular, lump-sum expenses. I don't have to tell you that all

Thanks for your referrals!

As we conclude our twelfth year of publishing *Observations,* we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past twelve years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

Inside This Issue:

- A Sensible Accumulation and Withdrawal Plan for Retirement p.1

this is not easy to accomplish.

Saving regularly takes laudable 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 I find clients have 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. Like I said, 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 of 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, SIMPLE 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 etc. 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. Most of these vehicles offer the advantage of tax-deferred or tax-free accumulation of savings.

Once an appropriate savings program is established and followed, the investing part presents its own challenges. You might wonder why this is so if you can just delegate the design, creation and implementation of the program to a financial professional. Like any other 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. I see this all the time.

In contrast, I see people swinging for the fences, hoping to hit it big and fast. Exhibit A is the 1999-2000 tech bubble. People who would spend weeks researching where to buy a microwave so as to get good value would not think twice about sinking half their nest egg in one or two stocks with positive momentum. The human mind is not particularly good at calibrating risk and return, when emotions are high and issues of money are involved.

Even if you are fortunate enough to be working with a trustworthy and competent advisor who gets along with you, you might be surprised what could still derail you from reaching your goals. A relatively

new field of finance has emerged, known as behavioral finance/economics. In case you think this is a passing fad concocted by those who reside in ivory towers, consider that one of its most well-known proponents, Daniel Kahneman, won the Nobel Prize in Economics in 2002 for his work in this field. Before your eyes start glazing over, let's just say behavioral finance has in my mind finally put to bed all the academic theories about efficient markets.

Under behavioral finance theory, market participants are seen as irrational, prone to alternating bouts of panic and fear, at least over the short term. Anecdotally, you see this every day – you don't need some genius with a 200+ IQ to tell you. This is in sharp contrast to the view of the market advocated by the efficient market hypothesis (EMH) proponents, who say that market prices are always correct and efficient, because prices are determined by supply and demand decisions (true) made by thousands of market participants (also true) who are highly rational and who carefully deliberate all available market information when making decisions (the part about rationality should be making you laugh uncontrollably right about now).

What does any of this have to do with you, you might ask? Well, behavioral finance has isolated 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. You might be surprised to hear how 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. If you think you are above all this, then you are in the distinct minority and kudos to you.

For instance, there is ample evidence (courtesy of DALBAR and other research firms) showing that mutual fund investors do not come anywhere close to earning the returns produced by their mutual funds, because they tend to abandon the funds at low points and get back in at high points. It does not help that the media, your neighbors, friends, colleagues at work and your relatives are often throwing a lot of noise at you to do a little bit of this or that, or to change course because somehow they are just doing so much better than you. They are simply baiting you; unfortunately many fall for this sort of manipulation. If you are aware of these pitfalls and can come up with a coping system to avoid this type of harmful behavior, you will do yourself a big favor toward achieving your goal of satisfactory wealth accumulation over time.

Assuming your savings program is ongoing, and you have managed to work out a sensible, prudent investment program with the help of a trustworthy, competent financial advisor with whom you get along, and you have also developed the emotional and temperamental fortitude to stick with the program through thick and thin, then we turn our attention to the second phase of achieving your financial goals, namely how to develop an appropriate withdrawal plan to accomplish one or more of the following goals: 1) ensure your money outlives you, 2) leave a legacy to heirs, and 3) leave money to charitable causes.

Hundreds of articles and books have been written discussing what is a proper withdrawal plan. However, I have not come across any source more elucidative and sensible than the wonderful article by William P. Bengen, recently published in the Journal of Financial Planning. As I agree with many of Mr. Bengen's observations and suggestions, I spend the rest of this article discussing and summarizing his ideas.

One size most definitely does not fit all when it comes to developing an appropriate withdrawal program. Mr. Bengen correctly identifies the most important factors that govern the appropriate withdrawal rate in the distribution phase: the base-line withdrawal scheme (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; the 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 legacy; 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 (life-style scheme). The assumed returns used by Mr. Bengen are the long-term historical returns for the asset classes implementing the asset allocation.

From this baseline withdrawal rate, he advises that you can increase or decrease the 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 permissible 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 withdrawal rate by favoring more equities, accepting some risk that your money might run out, 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 permitted annual withdrawal amount.

While the concepts introduced by Mr. Bengen can 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 permissible 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 of your financial advisor.

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