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Portfolio Withdrawal in Retirement: How Much

If you have considered how much you might plan on withdrawing from your retirement portfolio, you may have heard of the 4% rule. This rule is the result of pioneering work done in the 1990's by Bill Bengen, a California planner, testing various withdrawal rates on historical portfolios. Bengen's work has been used and cited and leaned upon for years. While there are things about the work to quibble with, the work was seminal in the area of portfolio withdrawal rates. Bengen's premise is that the 4% starting withdrawal amount is adjusted for inflation each year thereafter as long as the retiree lives or as long as the portfolio lasts. We don't think that people really live that way. Peoples' lives change and people adjust over time. But we still like 4% as a starting place to talk about portfolio withdrawal rates in retirement.

More recently, work by Jon Guyton, a Minnesota planner, proposes a series of withdrawal rules that hold out the prospect of higher starting rates of withdrawal; possibly in the 5% range or above. These rules require exquisite fine-tuning of the withdrawals based on prior-year market performance with lock-down rules after down markets and limited inflation adjustments. We think these rules can be workable for those who desire highly structured and complex withdrawal rules.

A simple yet powerful approach is to withdraw a fixed percentage from the portfolio each year, say 4½% or 5% each year, based on the year end value. This will assure the retiree of not exhausting the funds. This method will result in occasional declines in spending money available. And this approach assures portfolio growth to the extent that the withdrawal rate is sufficiently below the expected return. (If the withdrawal rate is too high against the expected return, this method will lead to a loss of purchasing power and a continuous decline in spendable dollars.)

All of these analytical frameworks address the rate of withdrawal from the portfolio. They generally assume a growth rate in the portfolio sufficient to hold the line against inflation. Inflation, the great destroyer of purchasing power, is the biggest long term risk in a retirement portfolio.

The prospect of outpacing inflation in a retirement portfolio depends on three variables:

1) Expected Return of the portfolio. This is a direct function of the amount of equities in the portfolio, with higher equity percentages providing a greater prospect of outpacing inflation. 2) Withdrawal Rate. This is really a focus on spending: taxes, gifts, groceries, etc. Money withdrawn from an IRA and deposited to another account is a transfer and not a withdrawal from the portfolio for these purposes. 3) The Inflation Rate. We can guess and estimate, and we can personalize our inflation rate by making smart consumption choices, but for the most part, inflation will be a given. So ...

Expected Return – Withdrawal Rate = Growth Rate

Growth Rate – Inflation = Real Growth Rate

This is not rocket science; it is arithmetic.

Suffice it to say, a lower withdrawal rate presents a better likelihood of ending up with funds in the portfolio than does a higher withdrawal rate. Whether your personal goal is to expend all your funds in retirement, leaving nothing, or to continue to grow the portfolio to accumulate funds for your heirs, or something in between, the relationship of the three variables is important. And, of those three, the withdrawal rate is the only one that we can directly and affirmatively control. This is nothing less than the most basic tradeoff in personal finance: current consumption versus future consumption. Our advice is that this decision be made purposefully.

Portfolio Withdrawal in Retirement: Where From

Up to this point we've been addressing the pure withdrawal rate: the how much. The next question is how to harvest the liquidity from the portfolio for withdrawal. A consequence of holding more equities in the portfolio is the increased exposure to the "sequence of returns" risk. The risk that the retiree may be faced with selling devalued assets to fund cash flow.

In a recent article, Michael Kitces, a Maryland planner, addresses the sequence of returns issue that is widely held to be the big hazard to retirement security. Many strategies have been proposed to overcome this risk. He looked at exotic bucket strategies, and decision rules. What they have in common is the avoidance of selling risky/high growth assets during a downturn. The bucket strategy may include a hefty cash reserve held as a cushion against sale of equities in a down market.

Likewise, decision rules put off the use of risk assets for liquidity in down periods. These techniques work somewhat, but they are sub-optimal.

When compared with a simple total-return strategy using regular rebalancing, the exotic strategies come in second. The best strategy, according to Kitces, is the one we have used all along: simple rebalancing. When we are adding money to a portfolio, we buy the asset classes that are down. When we are withdrawing money from a portfolio, we sell the asset classes that are up. It is a rebalancing discipline applied to cash flow.

We like Kitces' description: "simple rebalancing already has an astonishingly powerful effect in helping to avoid unfavorable liquidations, as the process systematically ensures that the investments that are up (the most) are sold, and the ones that are down (the most) are held and, in fact, bought instead." This last point is key. Using the simple rebalance strategy we don't just hold the assets that are down, we buy more.

Two Final Points

Note that there has been no mention of "income" or "principal" in this discussion. Our opinion is that the focus on "income" generating assets in retirement is a distraction that can have devastating consequences, particularly in low interest rate environments like we now have. Modern portfolio management brings the focus to total return, with capital gains being at least as desirable, if not more so, than ordinary income.

It is easy and common to conflate the rate of Required Minimum Distributions (RMDs) from a retirement account with the rate of withdrawal from the portfolio as discussed above. They are not the same. RMDs are the Treasury's way of extracting income tax on the retirement plan. The Treasury has no particular interest in your goals for security, asset preservation, legacy, or consumption. You can adopt the Treasury's plan or you can create your own.

The table below shows the returns through March 31, 2015 for selected investment asset classes. In most cases, the results below are appropriate benchmarks for the related mutual funds in your investment portfolio.

Asset Class	Data Series	YTD	3 Yrs.	5 Yrs.
Ultrashort Bonds	BofA Merrill Lynch Three-Month US Treasury Bill Index	0.00	0.07	0.09
Short Term Municipal Bonds	Barclays Capital Municipal Bond Index 3 Years	0.41	1.35	1.96
Short Term Government Bonds	Barclays Capital Treasury Bond Index 1-5 Years	0.89	1.00	1.79
Short Term Corporate Bonds	BofA Merrill Lynch 1-5 Year US Corporate and Government Index	1.00	1.56	2.25
Short Term Global Bonds	Citigroup World Government Bond Index 1-3 Years (hedged)	0.41	1.04	1.14
Intermediate Term Municipal Bonds	Barclays Capital Municipal Bond Index 7 Years	1.09	3.35	4.73
Intermediate Government Bonds	Barclays Capital US Government Bond Index Intermediate	1.25	1.54	2.81
Intermediate Corporate Bonds	Barclays Capital Credit Bond Index Intermediate	1.77	3.73	4.88
Intermediate Global Bonds	Citigroup World Government Bond Index 1-5 Years (hedged)	0.62	1.57	1.75
US Marketwide Core 1 & 2	Russell 3000 Index	1.80	16.43	14.71
US Marketwide Vector	Russell 2500 Index	5.17	17.13	15.48
US Large Cap Market	S&P 500 Index	0.95	16.11	14.47
US Large Cap Value	Russell 1000 Value Index	-0.72	16.44	13.75
US Small Cap Market	S&P Small Cap 600 Index	3.96	17.30	16.25
US Small Cap Value	Russell 2000 Value Index	1.98	14.79	12.54
Real Estate Investment Trusts	Dow Jones US Select REIT Index	4.71	13.95	15.89
International Marketwide Core & Vector	MSCI World ex USA Index (net div.)	3.83	8.24	5.72
International Large Cap Market				
International Large Cap Value	MSCI World ex USA Value Index (net div.)	2.61	8.06	4.90
International Small Cap Market	MSCI World ex USA Small Cap Index (net div.)	4.03	8.52	7.63
International Small Cap Value				
Emerging Markets	MSCI Emerging Markets Index (net div.)	2.24	0.31	1.75

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