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How Much Annual Income Can Your Retirement Portfolio Provide?

Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio. The annual percentage that you take out of your portfolio, whether from returns or the principal itself, is known as your withdrawal rate. Figuring out an appropriate initial withdrawal rate is a key issue in retirement planning and presents many challenges.

Why is your withdrawal rate important?

Take out too much too soon, and you might run out of money in your later years. Take out too little, and you might not enjoy your retirement years as much as you could. Your withdrawal rate is especially important in the early years of your retirement; how your portfolio is structured then and how much you take out can have a significant impact on how long your savings will last.

Gains in life expectancy have been dramatic. According to the National Center for Health Statistics, people today can expect to live more than 30 years longer than they did a century ago. Individuals who reached age 65 in 1950 could anticipate living an average of 14 years more, to age 79; now a 65-year-old might expect to live for roughly an additional 19 years. Assuming rising inflation, your projected annual income in retirement will need to factor in those cost-of-living increases. That means you'll need to think carefully about how to structure your portfolio to provide an appropriate withdrawal rate, especially in the early years of retirement.

Current Life Expectancy Estimates

	Men	Women
At birth	75.2	80.4
At age 65	82.2	85

Source: National Vital Statistics Report, Volume 56, No. 10

Conventional wisdom

So what withdrawal rate should you expect from your retirement savings? The answer: it all depends. A seminal study on withdrawal rates for tax-deferred retirement accounts (William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning*, October 1994) looked at the annual performance of hypothetical portfolios that are continually rebalanced to achieve a 50-50 mix of large-cap (S&P 500 Index) common stocks and intermediate-term Treasury notes. The study took into account the potential impact of major financial events such as the early Depression years, the stock decline of 1937-1941, and the 1973-1974 recession. It found that a withdrawal rate of slightly more than 4% would have provided inflation-adjusted income for at least 30 years. More recently, Bengen used similar assumptions to show that a higher initial withdrawal rate--closer to 5%--might be possible during the early, active years of retirement if withdrawals in later years grow more slowly than inflation.

Other recent studies have shown that broader portfolio diversification and rebalancing strategies also can have a significant impact on initial withdrawal rates. In an October 2004 study ("Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?," *Journal of Financial Planning*), Jonathan Guyton found that adding asset classes such as international stocks and real estate helped increase portfolio longevity (although these may entail special risks). Another strategy that Guyton used in modeling initial withdrawal rates was to freeze the withdrawal amount during years of poor portfolio performance. By applying so-called decision rules that take into account portfolio performance from year to year, Guyton found it was possible to have "safe" initial withdrawal rates above 5%.

A still more flexible approach to withdrawal rates builds on Guyton's methodology ("Using Decision Rules to

More ways to help stretch your savings

- *Don't overspend early in your retirement*
- *Plan IRA distributions so you can preserve tax-deferred growth as long as possible*
- *Postpone taking Social Security benefits to increase payments*
- *Adjust your asset allocation*
- *Adjust your annual budget during years when returns are low*

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Create Retirement Withdrawal Profiles," *Journal of Financial Planning*, August 2007). William J. Klinger suggests that a withdrawal rate can be fine-tuned from year to year, using Guyton's methods but basing the initial rate on one of three retirement profiles. For example, one person might withdraw uniform inflation-adjusted amounts throughout his or her retirement. Another might choose to spend more money early in retirement and less later; still another might plan to increase withdrawals as he or she ages. This model also requires estimating the odds that the portfolio will last throughout retirement. One retiree might be comfortable with a 95% chance that his or her strategy will permit the portfolio to last throughout retirement; another might need assurance that the portfolio has a 99% chance of lifetime success. The study suggests that this more complex model might permit a higher initial withdrawal rate, but also means the annual income provided is likely to vary more over the years.

Don't forget that all these studies were based on historical data about the performance of various types of investments, and that past results don't guarantee future performance.

Inflation is a major consideration

For many people, even a 5% withdrawal rate seems low. To better understand why suggested initial withdrawal rates aren't higher, it's essential to think about how inflation can affect your retirement income.

Here's a hypothetical illustration; to keep it simple, it does not account for the impact of any taxes. If a $1 million portfolio is invested in a money market account yielding 5%, it provides $50,000 of annual income. But if annual inflation pushes prices up by 3%, more income--$51,500--would be needed next year to preserve purchasing power. Since the account provides only $50,000 income, an additional $1,500 must be withdrawn from the principal to meet expenses. That principal reduction, in turn, reduces the portfolio's ability to produce income the following year. In a straight linear model, principal reductions accelerate, ultimately resulting in a zero portfolio balance after 25 to 27 years, depending on the timing of the withdrawals.

Market volatility and portfolio longevity

When setting an initial withdrawal rate, it's important to take a portfolio's ups and downs into account--and the need for a relatively predictable income stream in retirement isn't the only reason. According to several studies in the late 1990s by Philip L. Cooley, Carl M. Hubbard, and Daniel T. Walz, the more dramatic a portfolio's fluctuations, the greater the odds that the portfolio might not last as long as needed. If it becomes necessary during market downturns to sell some securities in order to continue to meet a fixed withdrawal rate, selling at an inopportune time could affect a portfolio's ability to generate future income.

Making your portfolio either more aggressive or more conservative will affect its lifespan. A more aggressive portfolio may produce higher returns but might also be subject to a higher degree of loss. A more conservative portfolio might produce steadier returns at a lower rate, but could lose purchasing power to inflation.

Tax considerations

Prolonging your savings may require attention to tax issues. For example, how will higher withdrawal rates affect your tax bracket? And does your withdrawal rate take into account whether you will owe taxes on that money?

Also, if you must sell investments to maintain a uniform withdrawal rate, consider the order in which you sell them. Minimizing the long-term tax consequences of withdrawals or the sale of securities could also help your portfolio last longer.

Calculating an appropriate withdrawal rate

Your withdrawal rate needs to take into account many factors, including (but not limited to) your asset allocation, projected inflation rate, expected rate of return, annual income targets, investment horizon, and comfort with uncertainty. The higher your withdrawal rate, the more you'll have to consider whether it is sustainable over the long term.

Ultimately, however, there is no standard rule of thumb; every individual has unique retirement goals, means, and circumstances that come into play.

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