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Individual Retirement Accounts

YOUR MONEY

How Retirees Can Spend Enough, but Not Too Much

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When you retire, you'll probably want to visit your grandchildren more than once each year. Perhaps you'll aim to give money each month to charity or your religious congregation.

Craig Lassig for The New York Times

Jonathan Guyton, a financial adviser, found a rule of thumb too conservative, leading to missed opportunities early in retirement.

The amount you have saved will clearly matter a great deal in whether you can do these things. But so will your portfolio withdrawal rate — the percentage of your assets that you take out each year to pay your expenses. You want it to be high enough to afford fun and generosity but low enough that you have little risk of running out of money.

Until a few years ago, the standard advice was that 4 percent or 4.5 percent was about the best you could do. So if you had $500,000 in savings, 4 percent would give you about $20,000 in your first year of retirement to augment Social Security and any other income. Then, you could give yourself a raise each year based on inflation. At 3 percent inflation, you'd end up with $20,600 in the second year of retirement and so on from there.

More recently, however, several studies have suggested that withdrawing 5 percent or even 6 percent was possible — and still prudent.

Retirees rejoiced.

And then the stock market fell to pieces.

In the wake of the carnage, people who hope to retire anytime soon will probably be starting with a kitty smaller than they had expected just a few years ago. So an extra percentage point on the withdrawal rate matters even more than it might have in 2007. It could be the difference between traveling to see family or not, or it could determine when you get to retire in the first place.

But could it also lead you on a path toward ruin? This week, I went back to two of the researchers who had come up with the more generous formulas to see whether they're sticking by them. Not only are they staying the course, but one is telling his clients that they can take out as much as 6 percent of their money during the next year.
How can they justify something like this after the year we've just had?

Setting a Rate

Here's one big reason to be suspicious about applying that same 4.5 percent withdrawal rate to all people, no matter when they retire: Should a person who had the bad luck to retire in March 2009, at the stock market's recent bottom, spend 4.5 percent of, say, $350,000, or could they spend a bit more? After all, people who retired a year or two earlier with the same portfolio, before the bulk of the stock market's decline, might have started with 4.5 percent of $550,000 (and taken inflation-adjusted raises each year from that initial amount until they died).

It didn't seem right to Michael E. Kitces, a financial planner and director of research at Pinnacle Advisory Group in Columbia, Md. He said he was uncomfortable with all the decisions made based on "the day you happen to come into my office and the balance on that day."

In fact, he started looking into this before the market collapsed, and his research ended up suiting the conditions of the last year perfectly. He tried to figure out whether one could estimate how much better or worse stock market returns might be in the years after big declines — and whether the answer might allow for a more generous initial withdrawal rate.

What he concluded was that the overall market's price-earnings ratio — taking the current price for the Standard & Poor's 500-stock index divided by the average inflation-adjusted earnings for the past 10 years before the date of withdrawal — was predictive enough to produce guidelines. Then he came up with the following suggestions for a portfolio of 60 percent stocks and 40 percent bonds meant to last through 30 years of retirement.
If the ratio was above 20, indicating that stocks were overvalued, then a 4.5 percent withdrawal rate was prudent given that the stock market was likely to fall. But if it was between 12 and 20 (the historical median is roughly 15.5), a 5 percent rate was safe, tested against every historical period for which data was available. And if it was under 12 — a level it almost got to earlier this year — a rate of 5.5 percent would work.

The most recent figure was 17.67, which suggests a 5 percent withdrawal rate for current retirees. It had been above 20 until October 2008.

Mr. Kitces gets his ratios from a set of data that the Yale professor Robert Shiller creates and stores on Yale's Web site , at http://bit.ly/3gexz. I've provided a link to that data (Mr. Kitces uses column K in the Excel spreadsheet there) and to all of the other research in this column in the online version of this story.

Making Adjustments

Jonathan Guyton, a financial planner with Cornerstone Wealth Advisors in Edina, Minn., looked at the 4.5 percent baseline and asked a different question: Couldn't it be a whole lot higher if a client was willing to forgo the annual inflation raise when conditions called for a bit of thrift?

And if so, under what conditions would that happen — and would people be willing to, in effect, cut their own retirement paycheck?

It didn't take Mr. Guyton long to find out. Two studies he worked on in 2004 and 2006 led him to the following conclusions about a portfolio meant to last 40 years: Using Mr. Kitces's research to establish a baseline initial withdrawal rate of up to 5.5 percent (or 5 percent given valuations at the moment), the initial withdrawal rate could rise another whole percentage point, to 6.5 percent, if at least 65 percent of the money was in a variety of stocks, as long as the owner followed a few rules.

First, if the portfolio lost money in any given year, there would be no raise at all for inflation. And if the size of the withdrawal, in dollars, in any year amounted to an actual percentage rate of the remaining portfolio that was at least 20 percent more than the initial withdrawal rate, retirees would have to take a 10 percent cut in their annual allowance that year. Then, the increase for inflation would build on that new base the following year. While Mr. Guyton also put a "prosperity" rule into place that allowed for a 10 percent increase in particularly good years, 2008 tested his "capital preservation" rule first. So he cut his clients' withdrawals by 10 percent.

How did they take it? "Many of them said, 'Really, that's all?' " he recalled. "Keep in mind how dire things seemed."

Others blanched, noting that they had played by the rules and didn't cause the financial crisis. But they came around when Mr. Guyton gave them a good talking to. "For us to maintain the same degree of long-term financial security for you that you said you wanted, this is what you need to do," he told them. "It's a system. And the great thing about a policy is that it leaves no doubt about what you are supposed to do."

Another cut of 10 percent might severely hurt their purchasing power, but the stock market's performance since March suggests that it won't be necessary in the coming months.

The Real World

The actual execution of these strategies requires a bit more work. You need to figure out what stocks and bonds should make up your investments in the first place, for instance, and how best to minimize taxes when you sell each year.

All this together seems complicated enough to suggest to a cynic that it's just a ruse to keep a client coming back each year for costly checkups. That said, surviving retirement without a big pension that never runs out isn't easy, and paying a bit of money each year in exchange for help in prudently raising your withdrawal rate by 20 percent does not strike me as completely insane.

Retirees also have to wonder whether the market will behave in the future as it has in the past. Or whether retirees can realistically stick to a strict budget. "Even if you tell me that spending fluctuates a bit here and there, we still have to start somewhere," said Mr. Kitces. "What on earth is your alternative? Are you not going to give any spending recommendations whatsoever?"

Mr. Guyton solves this issue for clients who can afford it by carving out a separate discretionary fund. Retirees can spend that money on anything, but once it's gone, it's gone, unless they manage to replenish it out of their regular annual withdrawal.
There are still plenty of retirees and advisers who will balk at what appears to be outsize aggressiveness, whatever the studies indicate. To them, Mr. Guyton suggests an entirely different consideration.

"The only problem is you run out of money? I don't buy that," he said. "For a lot of people who lock in on a 4 percent figure, it's a formula for regret. They get 15 years in and look back at all of the things they didn't do. And now their health is gone."