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Getting Going / *By Jonathan Clements*

Retirees Don't Have to Be So Frugal: A Case for Withdrawing Up to 6% a Year

MAYBE YOU DON'T have to order the early-bird special after all.

Many retirees have trimmed their spending during recent years, and it isn't just because of plunging bond yields and tumbling stock prices. Instead, they have been reacting to dire warnings from Wall Street, cautioning them that their portfolios can't sustain the sort of withdrawal rates that used to be considered safe.

Feeling pinched? Don't resign yourself to a lifetime of scrimping and saving just yet.

Boosting income. When advising seniors about their spending, financial experts have grown increasingly conservative. For instance, one influential study found that, if retirees want to be confident their savings will last 30 years, they need to limit their initial withdrawal rate to 4.1%, or $4,100 for every $100,000 saved.

But a new study by Minneapolis certified financial planner Jonathan Guyton, which appeared in October's Journal of Financial Planning, suggests retirees don't have to be nearly so frugal. He analyzed how to generate 40 years of income while surviving brutal market conditions, such as high inflation and a steep market decline early in retirement.

His finding: Retirees may be able to withdraw as much as 6.2% initially, provided they follow three rules. "There's nothing radical to this," Mr. Guyton says. "It's just a matter of being street smart. These are things you would sensibly think about doing after a tough year."

Before we get to the rules, you will need a little background. When experts talk about withdrawal rates, they are typically referring to the percentage of a portfolio's value withdrawn during the first year of retirement.

Thereafter, retirees are assumed to increase their withdrawals along with inflation. Let's say you retired with $600,000, inflation ran at 3% and you used a 6% withdrawal rate. In that scenario, you would withdraw $36,000 in the first year of retirement, $37,080 in year two, $38,192 in year three and so on.

Keep two things in mind. First, you will owe taxes, so not all this money can be spent. Second, if you spend your dividends and interest, these sums count toward the amount withdrawn.

Following rules. The strategy of increasing withdrawals along with inflation works fine, provided the markets and inflation are moderately well behaved. But if you get hit with either rapid inflation or a devastating market crash, you can rapidly run out of money, as you make larger and larger withdrawals from an ever-shrinking portfolio.

To figure out how to combat that risk while maximizing income, Mr. Guyton analyzed two portfolios, one with 80% stocks and the other with 65%. Both portfolios had the sort of well-diversified mix you could get by buying large-stock funds, small-company funds, foreign shares, real-estate investment trusts, bonds and money-market instruments.

He found that the 80% stock portfolio could support a 6.2% initial withdrawal rate, while the 65% stock portfolio could start at 5.8%. But if you adopt those lofty withdrawal rates and you want to be sure your money lasts 40 years, Mr. Guyton says you need to follow three rules.

- If your portfolio loses money during the year, you can't give yourself a raise the following year. In other words, if you add up your portfolio's year-end value and the money withdrawn during the prior 12 months and this sum is less than your portfolio's beginning-of-year value, you can't increase your next year's withdrawal to compensate for inflation.
- No matter how high inflation gets, your maximum annual increase is 6%.
- You have to avoid selling hard-hit stock funds. Instead, each year, start by lightening up on winning stock funds.

Suppose you had targeted 6% of your portfolio for real-estate investment trusts and REITs have a good year. You would pare back your REITs to 6%, funneling the excess into a money-market fund. This money fund, says Mr. Guyton, should initially account for 10% of your total portfolio.

Next, "rebalance" your bond funds back to their target percentages, again sweeping the gains into your money fund. The proceeds from rebalancing, plus the cash already in your money fund, should cover your spending needs.

What if it doesn't? Mr. Guyton says you should draw down your bonds even further. As a last resort, sell more of your stock funds, starting with the prior year's best performers.

All this, of course, is based on an analysis of historical returns. If we get wacky markets, miserably low long-run returns or you incur hefty investment costs, you may have to withdraw less than Mr. Guyton suggests.

Moreover, because the first and second rules will occasionally limit spending increases, there's a chance that retirees who use Mr. Guyton's strategy will receive less total income over 40 years than if they had started with a lower initial withdrawal rate but got inflation increases every year.

Still, Mr. Guyton's rules make a ton of sense to me—and I suspect many retirees will find his approach appealing. After all, they get a decent amount of income initially and they may never see the downside, either because they don't live long enough or because the markets prove relatively benign.

As Mr. Guyton puts it, "I wouldn't want to be the financial planner who has to look an 85-year-old client in the eye and explain why he has so much money and why he's had so little fun."

Making It Last

Here's how to reduce the risk of outliving your retirement savings:

- Clamp down on spending if your portfolio suffers a calendar-year loss or rapid inflation returns.
- Avoid selling hard-hit stock mutual funds.
- Invest part of your bond money in an immediate annuity that pays lifetime income.
- Favor low-cost funds, so you keep more of what you make.