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A Better Way to Tap Your Retirement Savings

'Dynamic' withdrawal strategies give retirees more flexibility than the venerable 4% rule. But they come with a catch.

PHOTO: GETTY IMAGES

By **ANNE TERGESEN**
May 31, 2015

Want to spend more than 4% of your retirement savings annually without putting yourself at great risk?

It might be possible with a "dynamic withdrawal strategy." This method of tapping one's nest egg allows retirees at times to exceed the 4% annual withdrawal rate long considered a safe level of spending in later life.

But while a dynamic approach offers the flexibility to spend more—especially at the start of retirement—such strategies also come with a downside: In any year in which

your portfolio loses value, you may need to tighten your belt.

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"There is no free lunch," says Jonathan Guyton, a financial adviser in Minneapolis and co-creator of one such strategy.

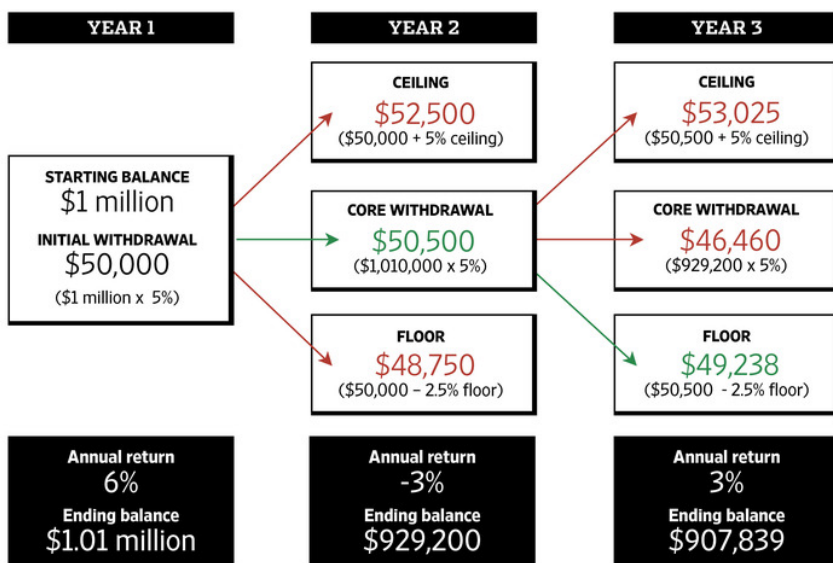
Dynamic withdrawal strategies have attracted attention as financial advisers have sought to refine and move beyond the so-called 4% rule. Widely used since now-retired financial planner Bill Bengen published groundbreaking research on safe withdrawal rates in 1994, the 4% rule calls for retirees to spend no more than 4% from their portfolios in the first year of retirement—and then adjust that amount annually to keep up with inflation.

For someone with a $1 million portfolio, the formula produces an initial income of $40,000 and—assuming inflation of 2.5%—an increase to $41,000 in year two.

In contrast with that relatively rigid approach, a dynamic strategy takes into account how financial markets—and, as a consequence, retirees' nest eggs—perform from year to year. Annual withdrawals may be adjusted accordingly.

Those adjustments, according to financial advisers, give dynamic withdrawal strategies two advantages over the 4% rule. First they allow for a larger withdrawal rate at the start of retirement, when people generally are most active, says Michael Finke, a professor of personal financial planning at Texas Tech University.

Of course, spending more at the outset of retirement can be risky. But many dynamic strategies set their initial withdrawal at about 5%. That's well below 6.5%, the median 30-year withdrawal rate retirees could have used without going bust since the late 19th century, says Michael Kitces, director of planning research at Pinnacle Advisory Group Inc. in Columbia, Md. ("Median," meaning a withdrawal rate of 6.5% would have been successful half the time.)



Since 4% is the withdrawal rate that "would have worked if you had retired during a historic catastrophe" such as the Great Depression, "if you start at 5%, there's a decent chance you won't ever have to make spending cuts," Mr. Kitces adds.

The second advantage: Dynamic approaches, say a growing number of advisers and academics, can help retirees better manage the risks associated with an extended bear market.

"We have an unusual situation where stock prices are almost double their historic average valuations and bond yields after inflation are basically nothing. There's almost no way returns on portfolios in the future are going to be what they were in the past," Prof Finke says. In contrast to the 4% rule, strategies that call for reduced spending when times get tough "can significantly increase the sustainability of a retirement portfolio."

What follows are three dynamic withdrawal strategies. Which works best for you will depend on factors such as your tolerance for risk and complexity, your desire to leave something for heirs and your willingness to cut spending if need be.

The 4% rule, adjusted

Worried about withdrawing an inflation-adjusted 4% from your portfolio amid a market

crash? Baltimore-based mutual-fund company T. Rowe Price Group Inc. recommends forgoing inflation adjustments following any year in which your portfolio loses value. Assuming you hold 60% in stocks and 40% in bonds, that means you can withdraw 5% to start and still have a 90% chance—based on historical experience—of not running out of money over 30 years.

Pros: Relatively easy to administer, this approach produces a more predictable income stream than many other dynamic strategies.

Cons: While your nominal income may remain steady, your inflation-adjusted income is likely to decline over time. Moreover, if your portfolio generates average to above-average returns over your retirement, your heirs will pocket much of the upside, says Wade Pfau, a professor at the American College of Financial Services and a principal at McLean Asset Management Corp.

Floor-and-ceiling rule

Many financial advisers, including Mr. Bengen, have devised variations of this approach.

If your portfolio rises in value during the year, your withdrawal in the following year will rise, too—but no higher than a well-defined "ceiling." Conversely, if your portfolio falls in value, your withdrawal will also decline, but no lower than a set "floor." (See the example in the accompanying chart.)

The goal, says Colleen Jaconetti, a Vanguard Group senior investment analyst, is to "use good years to give yourself a little bit of a raise but reinvest any excess" so you'll have a cushion for down years.

Pros: Changes in income may be frequent, but relatively small.

Cons: The math requires a few steps—and your inflation-adjusted spending may decline over time.

The guardrail rule

In contrast to the floor-and-ceiling approach, this strategy is likely to produce fewer adjustments to income. But, when adjustments are needed, the income swings are typically larger.

Let's say that you retire with $1 million and withdraw 5%, or $50,000, in year one. If your balance changes by year-end, you must recalculate your withdrawal rate. Assuming your portfolio declines 20% to $800,000, your $50,000 withdrawal—plus an annual

adjustment for inflation—now represents more than 6% of your new $800,000 balance.

Any time your withdrawal rate rises above 6%, the rule imposes a 10% pay cut for the next year, says Mr. Guyton, co-architect of the method along with William Klinger, a software developer and educator in New Jersey. As a result, after adjusting the $50,000 initial withdrawal for inflation—to $51,000, assuming a 2% inflation rate—the method imposes a 10% pay cut, of $5,100, to produce a $45,900 withdrawal in year two.

The good news: You can give yourself a 10% raise following years in which your withdrawal rate falls below 4%—as would happen when withdrawing $50,000 from a $1 million portfolio that appreciates by more than 25% to over $1.25 million.

In years in which your withdrawal rate is between 4% and 6%, simply adjust your most recent withdrawal—$50,000 in this example—to keep up with inflation. (Skip the inflation adjustment following a year in which your portfolio sustains a loss.)

Pros: Mr. Guyton puts the odds of running out of money using such an approach at close to zero. And if your portfolio does well, your income is likely to grow considerably, says Mr. Pfau.

Cons: In a prolonged bear market, you might face consecutive 10% annual cuts.

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Corrections & Amplifications

Jonathan Guyton and William Klinger are co-architects of the guardrail strategy to tap retirement savings. An earlier version of this article incorrectly described Mr. Guyton as the sole architect of the strategy. (June 26, 2015)

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