Formulas help determine savings strategies

Steven Podnos *10:09 a.m. EDT September 29, 2016*

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QUESTION: **A friend told me that their financial planner told them that they should use a 4 percent distribution rate for their retirement portfolio. What does that mean?**

Answer: Advisers wrestle with telling people entering retirement just how much money they can spend each year without either the amount being too much (running out of money) or too little (losing the enjoyment of your savings efforts). We have studied “what works” to an amazing degree, as there is a large body of academic literature on this subject.

There are several parts to this question and answer. First, does it matter what the retirement funds are invested in? Second, does it matter how old you are when you start in retirement? Third, what is a reasonable rate at which to start withdrawals? Finally, should adjustments be made once you start?

Many advisers (including myself) start with the premise that the worst possible outcome is to run out of money at an advanced age. So, we look back historically at all types of investment markets to see how various mixes of investments (mostly stocks and bonds) would have fared over decades of a retirement distribution.

Although not exact, the results of these studies suggest that over the last 70 to 100 years, a portfolio with 50 percent to 70 percent in stocks and the remainder in fixed income would “last” at least 30 years if 4 percent of the starting amount were withdrawn every year. The vast majority of portfolios would not run out of money during that time (and many would grow), but the worst possible scenario is the start of planning.

This must then be adjusted by a number of factors. If the portfolio is flat to growing, then the following year’s distribution can be increased by the percentage of inflation. Another adjustment is for age at the time of retirement. The longer you have in retirement, the smaller the initial percentage for distributions. So, someone retiring in their 50s might want to start at 3 percent, conversely a retiree at 75 could start at a 6 percent to 7 percent rate.

Yet another adjustment has to do with the “luck factor.” If you are lucky in that your portfolio grows solidly during the first five years or so of retirement, you will generally be able to be more aggressive with withdrawals. Conversely, bad results in the first five years flashes caution. This is despite the fact that a good retirement portfolio should contain several years of assets that are not subject to market volatility.

There are some new studies that suggest that immediate annuities (where you give an insurance company a lump sum and they promise an income for life) may be good bond substitutes and increase the security of the portfolio. In any event, “hope” is not a solution, and one’s retirement portfolio should be carefully monitored, and distributions carefully thought out in most cases.

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