Safe Withdrawal Rates

A problem with a solution.

There are lots of articles and programs that offer "safe withdrawal rates." The amount a retiree should withdraw would be equal to the withdrawal rate multiplied by last year's ending retirement investment balance. Then that withdrawal amount would be increased each year by whatever was the last year's inflation rate. Theoretically and in a perfect world, those amounts would not exhaust your retirement savings for about 20 or 25 years. That rate was usually about 4%, but now many authors are suggesting a rate closer to 3.5%. In a pretense of sophistication, a planner might say that with such-and-such allocation of stocks and bonds, then you would have a 90% chance that your investments would last for 25 years." They derive values from retirement programs based on Monte Carlo methods where they assign a set of statistics to your portfolio based on historical price variations in stocks and bonds.

The Problem:

What they most often do NOT say is that those numbers only apply to what happened in the past and that they may NOT apply in the future—particularly the future you will face. Your future includes coping with the fallout from incredibly large unfunded state and national future obligations and the high taxes and inflation that likely will follow. Our population is aging so that there will be fewer young people to help fund the entitlements that the elderly depend on. A large part of the baby boomer generation will have to work much longer because their savings are so low. Of course their skills, knowledge and health must still be adequate to compete with younger workers.

When is it safe to use a "safe" withdrawal rate? There are some cases where retirees can use this simple approach for retirement planning. They are confined to the following limitations.

(1) The retiree has no fixed income pension or annuity. If so, then the retiree has to save approximately one third of the fixed income pension or annuity which means that the net withdrawal will be less than the "safe" withdrawal amount.

(2) The retiree has already started taking Social Security or a pension that has a full cost-of-living adjustment. (Taking Social Security early may not be in the retiree's best interest.)

(3) After-tax returns for taxable investments and before-tax returns for qualified investments like IRAs exceed 1% over inflation for each year. We suggest that you check your actual return either with the Return Calculator on www.analyzenow.com, or use the following two formulas:

> Before-Tax Return = (End of year investments plus annual withdrawals minus beginning of year investments minus annual deposits) divided by (Beginning of year investments minus ½ annual withdrawals plus ½ annual deposits). Note, contrary to what you think or what you may read, even if withdrawals include payments for income tax, this is still a before-tax return!
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> After-Tax Return for taxable investments = Before-Tax Return of taxable investments times (100% – Tax Rate%).

(4) Investments in the equations above should not include an emergency reserve as well as a reserve for replacements of large value items that will wear out.

Even in these very limited cases, there is no guarantee safe withdrawals will be "safe," because they may turn out to be excessive in light of future events and economic problems.

Uncertainty makes "safe" withdrawal rates uncertain, not safe:

There is lots of uncertainty in your future financial life. Perhaps the greatest uncertainty is your health care cost. You don't know either the amount of care you will need or the unit costs of that care. You don't know what Medicare and Medigap premiums will be nor what care will be covered. Some professionals have estimated the average total health-care cost for a retiree will be over two-hundred thousand dollars during retirement. Further, you don't know what long-term-care may cost you. Nor do you know how long you will live and therefore how long your withdrawals must last. You certainly should not base a plan on "life expectancy," because that is only the average life span. You have a 50% chance of living longer than that. You still need money, perhaps even more, if you are in the half of the population that lives those extra years.

Another group of financial uncertainties include tax rates, inflation and especially the return you will get on your investments. Right now interest rates are really low. That has proved to be a problem for older retirees who have been relying on interest for much of their retirement income. Returns from the stock market have also been particularly poor for the past decade. Further, the actual returns people get from investments are often far below the reported security returns not only because the finance industry takes large cuts from personal investments with their fees, but also because most people buy stocks when they are high and sell when they are low—just the opposite of what they should do.

One of the largest uncertainties can be what you may feel obliged to spend to help relatives. Maybe your aging parents run out of money, and you don't want to see them get inferior care. Or perhaps an adult daughter with children gets divorced and suddenly is without income. Almost every retiree I know has experienced such events and diverted part of scarce retirement resources to relatives—something that was not covered in the "safe withdrawal rate."

There is confusion about what is included in "safe withdrawal rates."

Most retirement planning programs do not clarify what the safe withdrawal rate covers. For example, they may not tell you whether it includes income tax or mortgage payments or what you will pay from Social Security, pensions, etc.

Safe withdrawal rates are terribly misleading for those retirees who have fixed pension or annuity payments or plan to delay Social Security.

If you plan to (wisely) delay the start of Social Security or a pension, then you likely will have to take out more from savings than a safe withdrawal rate. Yet such delays most often may make your long term future much better.

If you are getting a fixed pension or annuity payments, a safe withdrawal rate will shortchange your future inflation protection. Consider someone who has little savings but a large fixed pension. That person will have most of her income fixed for life without much compensation for inflation. The fact is that retirees with little savings should only spend an amount of their fixed pension about equal to the after-tax payment multiplied by a fraction equal to their age divided by 100. Save the remainder!

The Easy Solution:

There is a way to cope with all of these uncertainties and ensure you will have some, though small, investments left on the day you die. This requires some discipline and willingness to do an analysis once every year that may take up to a couple of hours, but probably less time than going to a movie.

I can simply tell you that it's better to ignore the concept of a safe withdrawal rate and use a retirement program like the Pre and Post Retirement Planner from www.analyzenow.com that makes provisions for

all of the things that follow without confusing the user. This is not an advertisement for the program because I do not make any money from it, but I have not found another program that accounts for the many practical and theoretical shortcomings of the many other programs I have tried.

The solution for users of other retirement programs:

The first thing to do is to calculate a "Replacement Reserve." This is simply an amount of money that will permit you to pay for significant known future purchases using money from your savings instead of having to buy things on credit. The difference between buying something on credit compared to saving for it before hand is huge. These are items such as a new automobile or large household maintenance costs such as what might be a long-term need to replace carpets, a hot water heater, furnace or roof as well as the need to paint the exterior of a home. There is a free replacement budgeting program on www.analyzenow.com that makes this easy, or you can find articles on that site that tell you how to do it with a hand calculator. It's the same method that's used by large home owners' associations to develop a reserve for maintenance or replacement of everything from community roads to common area furnishings. The calculations will show how much you should already have in a savings reserve and the additional amount you will have to save this year.

An alternative to calculating a replacement reserve is to use a retirement planning program that lets you insert an estimate of the cost for each item in about the year you think the money might be required. The Pre and Post Retirement Planner from www.analyzenow.com is such a program. It has a special events tab that lets you put in such costs in each year of your future life. If you do this, you do not need a separate replacement reserve.

The next thing to do is to set aside some amount of your total savings as an emergency reserve for unknown financial needs. There is no magic formula for this and no perfect answer. If you know that an adult child or an elderly parent will require some support from you, you could include an amount that you think might be something you can live with. A reserve for unknown needs should not be less than 10% of your investments when you start retirement in my experience.

If your program does not ask you to input debts AND you are already retired, then reduce your investment balance by the amount of your debt including your current mortgage balance. A debt is a negative investment. If you don't subtract the debt from investments, the resulting budget from a retirement planning program will have to provide for the debt payments. If you subtract debt from investments, then the budget you get from a retirement program should not make provision for the debt payments. To determine your cash needs, you will need to add debt payments to the budget you get from the retirement program. When you subtract debts from investments, the retirement program assumes that the debt payments will be deducted from your investments. Of course this isn't true if the debts are a large part of the investments and the debts have much higher interest rates than the returns on investments. In cases like this, it's important to use a more comprehensive program that asks for interest rates on debts.

After subtracting debts, replacement reserves and emergency reserves you will have the amount of investments that can be used to support your normal everyday living expenses and income taxes. Many of the simple retirement programs on the Web lead you to believe that you can spend more than you should and lead retirees to borrow money for large replacements or emergencies as they occur.

The amount you can draw each month or year depends on many assumptions about the future, so you will be faced with estimating economic and other inputs. These may include returns, inflation, tax rates and, with some programs, death ages. There likely will be a default value for returns and inflation, and almost always, these will be optimistic for several reasons. Retirees suffer from REVERSE dollar-cost-averaging (RDCA) because they make regular withdrawals from investments instead of regular

deposits.   Further, firms which offer these programs don't want you to think that they will give poorer results than their competitors. They usually offer default returns based on a very select set of security indexes (without any client fees) and fixed allocations that fail to account for the fact that retirees get more conservative with age and most often buy and sell securities at the wrong time. Few retirees earn much more than 1% above inflation. Check the return you really got for any year using the return calculator on www.analyzenow.com. Compare that with the return your financial firm reports. There often is a large difference because the firm's returns may not include their fees and costs.

Now calculate your retirement affordable spending using a good retirement planner on the internet but with conservative values for returns, inflation and tax rates. Insert your retirement income sources such as Social Security, pensions, annuities, and the remainder of your investments. You will get an output representing the amount you can spend in the coming year. This is equivalent to a budget for normal living expenses, and, if you didn't use a program with special event inputs such as the Pre and Post Retirement Planner, this budget will have to cover the annual contributions you must make to your replacement reserves. If your program did not ask for tax information, then this budget will have to include income taxes.

What should or should not be included in a budget from a retirement program is often unsaid and can be confusing—all factors that make "safe" withdrawals suspect. If you entered your debts in your retirement program, then the program's affordable spending is in addition to the debt payments. Here is a table to help illustrate the development of the amount of cash you will need for the forthcoming retirement year from savings, Social Security, pensions and annuities:

$ amount your retirement program says you can afford to spend.
+ $ amount of your income tax IF you entered tax rates in your retirement program.
+ $ amount of your debt payments IF retired AND you made debt entries in your calculations.
+ $ amount for replacement items IF you subtracted a replacement reserve.
+ $ amount for replacement items IF you entered specific replacement costs in future years.
= $ Total of items above for the cash you will need from Social Security, pension, and savings.

Note: When the time comes for you to actually replace something, the cash will come from the replacement reserve. If the reserve is not large enough to cover all replacement items, then the "$ amount your retirement program says you can afford to spend" above has to cover the annual contributions to the replacement reserve.

Good retirement programs automatically do all the retired bookkeeping above automatically and explain what is included and what is excluded from the result. The Pre and Post Retirement Planner from www.analyzenow.com does an excellent job of this.

Repeat this whole process again at about the same time each year. I do it at income tax time when I have all of my numbers already assembled. Do NOT rely on increasing last year's budget by the amount of last year's inflation as implied by "safe withdrawal rates." In some years you may be able to spend more, but realistically there will be years when you must reduce your spending. Sometimes these reductions may be heartbreaking, but those are challenges almost all retirees face.   By keeping reserves, you will alleviate much of the pain.

Systems analysts would say an annual calculation means you are using "feedback" instead of an "open loop" calculation. You are feeding back not only your actual investment performance but also the effects from surprise events that were previously unknown. This is analogous to a pilot controlling an airplane. He can't fly the airplane open loop, that is, set the controls at the beginning of flight and expect not to have to put his hands on the controls again. He must use feedback by adjusting the controls continually to adjust to the conditions he actually encounters throughout the flight.

This is the real way to have “safe” withdrawals and stretch your investments until you die.

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