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How long will my retirement savings last?

A number of research studies I've reviewed over the past few years state quite emphatically that most people fear running out of money during their lifetime more than they fear dying. Consequently, one of the most frequently asked questions people have when they contemplate retirement, centers around the issue of "How long will my retirement savings last?" If we knew the exact year that we would depart from this earth, the solution would be a relatively easy one to figure out. Simply divide your remaining years by your retirement savings and that is what you have to spend each year. Unfortunately, we usually do not know how many years we have left to live. However, no matter how old we are, we hope it will be a very long time before we pass on. Thus, back to square one and trying to figure out retirement savings longevity and asking the question, "How long will my retirement savings last?"

Trying to figure out this portfolio longevity question became a very "hot" topic in the financial planning profession about twenty years ago and continues today. In October 1994, a Certified Financial Planner practitioner named William Bengen began doing research in this area and published an article in the Journal of Financial Planning entitled, *"Determining Withdrawal Rates Using Historical Data."* Bengen was a 1973 graduate of the Massachusetts Institute of Technology with a Bachelor of Science degree in aeronautics and astronautics. After spending seventeen years in a family owned business, he moved to Southern California and started Bengen Financial Services earning his CFP™ designation in 1990. His ground breaking work laid the foundation for the studies that continue today in this area.

Based upon his review of thirty year rolling periods in the stock and bond markets dating back to 1926, Bengen came to the following conclusion. If an individual wanted their retirement savings to last 30 years through all types of changing market conditions, they could safely withdraw 4.1% from a taxable account and 4.2% from a non-taxable account (IRA or 401K). The initial withdrawal would always remain the same but an inflationary increase would be added to this non-changing balance every year. The underlying assumption of the Bengen research was an investment portfolio that consisted of 50% large company stocks and 50% intermediate-term government bonds that averaged an 8% rate of return over the thirty year period. Bengen later decided to add small-cap stocks to the mix and revised his initial recommendation to 4.5% as the safe withdrawal amount. As an example, if your retirement nest egg was $100,000 you could safely withdraw $4,500 in year one. If inflation was 2% in year two, you could safely withdraw $4,500 plus $90 totaling $4,590. If inflation was 3% in year three, you could safely withdraw $4,500 plus $135 totaling $4,635 etc. These conclusions were not without their shortcomings but provided a rule of thumb to follow.

If we look at the Bengen research today, twenty years later, it appears one of the problems in his safe withdrawal rule can occur because of either low yields in bonds or less than an average 8% stock market return. Another flaw of his initial research is that a strict application of the 4% withdrawal rule does not factor in how important returns are in the early years of retirement. This is referred to as the sequence of returns. The first five years of investment returns after retirement have been shown to have a great impact on retirement savings longevity. As an example, two retirees with an identical starting nest egg can have entirely different financial outcomes, depending on portfolio returns in the first five years of making withdrawals. A retiree starting with gains in the first five years will have better portfolio longevity than a retiree with investment losses in the first five years, even if their long-term investment averages end up being the same. The longevity of the nest egg can be reduced by years if those losses occur in the first five years.

So how can we make the Bengen 4.5% withdrawal rule better or are there alternatives? One small tweak to the Bengen rule is to forgo inflation adjustments in the years that the investment portfolio does not achieve a positive rate of return. In our example above, if the investment returns in any given year are negative or zero, the withdrawal would only be $4,500 for that year. This adjustment alone will help to stretch out portfolio longevity.

A totally different strategy that has emerged in recent years is one based upon the Internal Revenue Service (IRS) Required Minimum Distribution (RMD) tables from IRS Publication 590. This table is normally only used for required minimum distributions. Using the tables as a retirement drawdown strategy, however, you divide your total portfolio balances (IRA and non-IRA) by the life expectancy factor listed for your age in the table. As an example, a 75 year-old should withdraw 8.00% of his/her total nest egg this year and 8.4% next year at age 76. The IRS table is set up so that the withdrawal percentage increases every year that you live. This strategy probably works best for retirees age 70 and over since it may lead to overly conservative withdrawal rates if used before age 70.

There are other more complicated withdrawal strategies that have been developed by modern day researchers. These strategies add a degree of sophistication the Bengen 4.5% rule and the Required Minimum Distribution (RMD) strategy lack. However, I find the simplicity of these two approaches very appealing as a starting point in determining, "How long will my retirement savings last?" The discussion starts but certainly does not end with either the 4% rule or the RMD strategy. Since individual goals may differ, it would be a good idea to come in and discuss your personal objectives.

In my January Look-Back article I noted the significant differences between the S&P 500 returns in 2014 and the returns of many other investment categories for the year. After my newsletter was written, I came across an article by Jeff Benjamin in the February 2-6 issue of the Investment News. The Investment News is a weekly financial industry trade journal and Jeff is an ongoing contributor to the publication. Jeff writes that any advisor who gained returns close to the S&P in 2014 should be fired because they did not diversify and took too much risk. I was given permission to reprint this article and think that it provides a perspective you rarely see in this business since many clients do compare their returns only to the S&P 500. Please take a moment to read it. Take good care!!!

When underperforming the S&P 500 is a good thing

Matching the index last year would have involved too much risk.

As financial advisers roll through annual client reviews, many will be experiencing a similar task of having to explain how their portfolio strategies so badly lagged the 13.7% gain by the S&P 500 Index last year. Fact is, a truly diversified investment portfolio should have returned less than 5% in 2014. It was that kind of year. Any adviser who generated returns close to the S&P was taking on way too much risk, and should probably be fired. Blame the ever-expanding financial media or the increased awareness among investors, but there is no getting around the reality that clients have become programmed to dwell on the performance of a few high-profile benchmarks. "Sure, the S&P 500 had a good 2014, and if you had all or most of your money invested in (that index), you did too," said Ed Butowsky, managing partner at Chapwood Capital Investment Management. "But what were you doing with most of your money in a single index?"

Most years, a globally diversified portfolio that spans multiple asset classes can hold its own relative to something like the S&P. But when a year like 2014 happens and the S&P essentially laps the field, financial advisers who have done their job right might suddenly feel as if they have to make excuses for doing the right thing. "Periods like 2014 are why people think they should just go buy the index." said David Schneider, founder of Schneider Wealth Strategies. Investors tend to fixate on the S&P because it's the most famous index out there, and when it outperforms everything, it just makes the case for passive investing for all the wrong reasons," he added. "People think they can just get rid of foreign stocks.

While long-dated U.S. Treasuries emerged as a surprise outperformer last year with a 27.4% gain, most risk assets around the world didn't even show up for the game. Developed markets, as represented by the MSCI EAFE Index, fell 4.9% last year, and the MSCI Emerging Markets Index fell 2.2%.

When outperformance is a bad thing

SMALL CAP LAGGED **-** Midsize companies, as tracked by the Russell Midcap Index, generated a 13.2% gain last year and almost kept pace with the larger companies that make up the S&P 500. But the 4.9% gain by the Russell 2000 small-cap index shows that smaller companies were not really participating. With everything packaged into a diversified portfolio, it should have been near impossible to generate anything eye-popping last year. Applying allocations based on Morningstar Inc.'s five main target risk indexes, ranging from conservative to aggressive, the best performance last year would have been 5.23%, which includes a 1.51% decline during the second half of the year. To get that full-year return would have required a 91% allocation to stocks, divided between 59% in U.S stocks and 32%, in foreign stocks. That portfolio, Morningstar's most aggressive, also included 4% in domestic bonds, 1% in foreign bonds and 4% in commodities, as an inflation hedge.

On the other end of the spectrum, the most conservative Morningstar portfolio had just an 18% allocation to stocks, including 13% domestic and 5% foreign. The 61% fixed-income weighting had 50.5% in domestic bonds and 10.5% in foreign bonds. The 10.5% inflation hedge included 2% in commodities and 8.5% in Treasury inflation-protected securities

HISTORY LESSON --That portfolio gained just 3.38% last year but fell 0.73% during the second half of the year. "History has taught us that at the beginning of any 12-month period, stocks have as good a chance of gaining 44% as they do of losing 25%, "Mr. Butowsky said. The onus is always on advisers to turn years like 2014 into teachable moments with clients, and a lot of advisers are doing exactly that. Thomas Balcom, founder of 1650 Wealth Management, took a proactive approach in December by addressing the issue in his holiday greeting card message, which focused on "not putting all your eggs in one basket." "My clients were definitely surprised they weren't up as much as the S&P, because everyone uses the S&P as their personal benchmark," he said. "But we had things like commodity exposure and international stocks that were both down last year and that doesn't help when clients see the S&P reaching record highs."

Veteran advisers recognize 2014 as truly unique year for the global financial markets. In 2013, for example, when the S&P gained 32.4%, developed international stocks gained 22.8%. But domestically, the S&P was outpaced by both mid-and small cap indexes, meaning a diversified portfolio was riding on more than just the S&P's positive numbers. Prior to 2013, the S&P had outperformed international developed-and emerging-market stocks on only three other occasions since 2000. Domestically, the S&P has out-performed mid-cap and small-cap stocks only one other time since 2000, in 2011, with a 2.1% gain. "It's tough dealing with clients, because the S&P is the benchmark you can turn on the TV and hear about, and everybody wants to know why they aren't experiencing the same returns as the S&P," said Michael Baker, a partner at Vertex Capital Advisors. "The S&P 500 really just represents one asset class —large-cap stocks," he added. "And most investors only have about 15% allocated to large-cap stocks.

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