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# Make Your Retirement Savings Last a Lifetime

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To boost a nest egg's longevity, advisers and academics are increasingly turning to 'dynamic' drawdown strategies that adapt to changing circumstances.

When driving on a winding mountain road, you probably don't flip on the cruise control and sit back grooving to the radio. So why would you put your retirement spending on autopilot?

Like a Rocky Mountain road trip, retirement requires constant course corrections. To keep retirement-spending plans on track, a growing number of financial advisers and academics are developing drawdown strategies that adapt to changing circumstances, such as age and account balance, rather than withdrawing a set amount annually throughout retirement. Retirees using these "dynamic" strategies adjust withdrawals from year to year as their age, spending goals, portfolio performance and other conditions change.

Because they respond to changing market conditions and investment returns, dynamic spending strategies can help address one of the biggest risks retirees face: poor returns in the early years of retirement that blow their spending goals off course. Dynamic strategies also allow for larger withdrawals in early retirement year when people tend to spend more on travel and hobbies. "The more flexibility you have to cut spending if necessary, then the higher the withdrawal rate you can start with," says Wade Pfau, professor of retirement income at The American College, in Bryn Mawr, Pa.

The new spending strategies are a departure from the "4% rule," which in the past 20 years has become the basis for many retirees' drawdowns. With the 4% rule, a retiree spends 4% from a balanced portfolio in the first year of retirement, adjusting that dollar amount each year to keep pace with inflation. A retiree using this strategy, according to proponents, has a 90% chance that his money will last for 30 years.

Though easy to follow, the rule ignores portfolio performance. A retiree who follows it blindly will keep spending the same inflation-adjusted dollar amount even if his nest egg falls off a cliff.

It also ignores personal spending goals and the fact that many retirees are willing to trim spending later in retirement so that they have more cash to cover their bucket list while they're younger. A retiree who forgoes a cruise in his first year of retirement because his 4% withdrawal won't cover it may not be healthy enough to take that trip later on even if he has plenty of money remaining. "I don't want people ending their lives with that regret," says Katherine Roy, chief retirement strategist for J.P. Morgan Asset Management.

What's more, recent research raises doubts about whether the 4% rule holds up under current market conditions. Given today's low yields, using the 4% rule for a 40% stock and 60% bond portfolio produces just a 48% chance of success over a 30-year period, according to research from Morningstar, Texas Tech University and The American College.

While most advisers now agree that variable spending strategies are best, they don't agree on what these strategies should look like. Some strategies allow spending levels to fluctuate widely from year to year, while others put "guardrails" around withdrawals to keep them within a moderate range. Some aim for near certainty that a portfolio will last for 30 years, while others say that a success rate of 80% or even lower is appropriate for many retirees.

So how can you choose the approach that’s right for you? "It's a trade-off decision," says Judith Ward, senior financial planner at T. Rowe Price. "Do you want to take more now and adjust later on, or be more conservative and give yourself a raise later on?"

To help answer that question, size up your guaranteed income sources, such as Social Security and pensions, to determine how much of your essential expenses they'll cover. The more guaranteed income you have, "the more risk you can take when it comes to pulling money from your portfolio," says David Blanchett, head of retirement research at Morningstar Investment Management. That may mean taking larger withdrawals for spending on hobbies in early retirement, recognizing that you may need to cut back later on. Retirees who depend on their portfolio to cover essential expenses, however, may not be able to tolerate much yearly fluctuation in spending levels.

**Let annual spending vary.** People entering retirement with the flexibility to allow portfolio withdrawals to vary annually can take advantage of the dynamic spending strategies that respond to changes in investment performance, life expectancy and other factors.

Blanchett has created an online calculator that helps retirees determine an appropriate withdrawal in each year of retirement based on their time horizon, stock allocation, desired probability of success and portfolio fees. Go to [www.davidmblanchett.com/tools](www.davidmblanchett.com/tools) and click "simple calculator."

Consider a 65-year-old female in average health with a 40% stock allocation who is paying 1% in money-management fees and has a desired probability of success of 80%. Under "estimate a retirement period," she would find that she has a 25% chance of living another 30 years. After plugging these numbers into the calculator, the retiree finds that her withdrawal rate should be 3.6%. If she comes back five years later in poor health, and finds that she has a 25% chance of living another 22 years, the shorter time horizon boosts her withdrawal rate to 4.75%.

Particularly for younger retirees with longer time horizons, Blanchett's research has concluded that this dynamic spending formula is more efficient than static spending approaches such as the 4% rule. In other words, it's a closer approximation of what a retiree would spend if he had perfect information about his life span and future market returns.

For older retirees, who may have time horizons of 15 years or less, Blanchett says a simpler dynamic spending approach can work well. This strategy is based on the IRS's required minimum distribution rules, which require you to start drawing money from traditional IRAs and 401(k)s after age 70 1/2. To use this approach, divide your total year-end portfolio balance by the life expectancy factor listed for your age in IRS Publication 590. A 75-year-old retiree, for example, could use the publication's uniform lifetime table to find that he should withdraw 4.37% of his balance this year.

With the RMD approach, annual withdrawals fluctuate with your portfolio balance, and the withdrawal percentage increases with age. It doesn't factor in your stock allocation or fees, as Blanchett's dynamic formula does, but with time horizons under 15 years, "it doesn't really matter if you fill in all these extra variables," Blanchett says. A study from the Center for Retirement Research at Boston College and China's Renmin University has also found that the RMD approach beat simpler strategies such as the 4% rule or spending only the interest and dividends from a portfolio.

Younger retirees should note that the RMD approach may lead to overly conservative withdrawal rates in early retirement... And retirees of all ages should recognize that this strategy will allow annual spending to fluctuate significantly, which "makes it very hard to budget how much you can spend each year," Pfau says.

Robo-advisory firm Betterment's retirement income service offers another simple approach for dynamic retirement spending. The algorithms that calculate annual portfolio withdrawals are designed to maximize income while keeping spending relatively consistent from year to year. But retirees should note that the service aims for a 99% chance of success, meaning that they'll likely be forgoing some spending during their lifetimes in exchange for the virtual certainty that they'll have money left over when they die. For more details, go to www.betterment.com/retirement-income.

**Place guardrails around spending.** Retirees who can't tolerate much fluctuation in annual portfolio withdrawals have a number of options for improving on the 4% rule without adding too much complexity.

One approach suggested by T. Rowe Price: Take steady inflation-adjusted dollar amounts, as with the 4% rule, but forgo the inflation adjustments in the year following any year when your portfolio has dropped. Retirees following this approach can safely start retirement with a higher withdrawal rate than those who insist on taking inflation adjustments each year, the firm says.

For a 60% stock and 40% bond portfolio, for example, a retiree who occasionally forgoes inflation adjustments can start with a 5.1% withdrawal rate and have a 90% chance that his portfolio will last 30 years, according to T. Rowe Price.

Another strategy suggested by Vanguard lets retirees choose how much spending can fluctuate from year to year. This approach starts with allowing retirees to spend a set percentage of their portfolio each year. Unlike the 4% rule, this strategy makes spending responsive to market performance and makes it virtually impossible to run out of money. But it can lead to unsettling swings in spending from year to year.

Say you start out with a plan to spend 5% each year from your $1 million portfolio. In the first year, you spend $50,000. But if a market crash reduces your portfolio to $850,000 in the second year, your spending drops by 15% -- to $42,500.

To make this approach more palatable, Vanguard suggests adding a ceiling and floor to make annual spending more consistent. A 5% ceiling, for example, would mean that spending can't rise more than 5% from one year to the next, while a 2.5% floor would mean that spending can't fall more than 2.5% from the previous year. Given the scenario above, your spending would be $48,750 in the second year -- just 2.5% less than the $50,000 you spent in year one.

Assuming a balanced stock and bond portfolio, Vanguard found that a 5% ceiling and 2.5% floor approach produced a 92% success rate over 35 years.

A bit of mental accounting can help retirees accept modest fluctuations in annual withdrawals. Jorge Padilla, a financial adviser in Miami, is working on a dynamic spending policy that he'll introduce to clients early this year. He'll continue to use the 4% rule as a baseline, but he will reassess spending every year and allow for adjustments based on factors such as a client working during retirement. To help clients manage the fluctuations, he says, they should consider budgeting so that all essential expenses are covered by the basic 4%, with any additional withdrawal above that considered "fun money" for travel or gifts.

Yet another alternative for reducing the risk of spending steady dollar amounts from volatile stock-and-bond portfolios is to trim back stock allocations in early retirement. Pfau and Michael Kitces, director of planning research at Pinnacle Advisory Group, in Columbia, Md., found that portfolios starting with 20% to 30% in stocks and increasing to 60% or 80% in stocks during the retirement years lasted longer than those that had a declining stock allocation.

That's an about-face from the standard advice to trim stock allocations as you age. But it can help address the risk that a market slide in early retirement will devastate your spending plan. Returns during the first 15 years of retirement really drive the results over the entire retirement time horizon, Pfau says. "You're the most vulnerable in the early part of retirement," he says, and if stocks crash in those early years, "you can dig a hole" that's very hard to get out of.

Some financial advisers are already embracing this unconventional approach. Kevin Meehan, a financial planner in Itasca, Ill., has had to tell some clients that they need to trim spending after a stock-market slide -- and "that's a tough conversation," he says. "Not everyone can absorb that." But when he talks about keeping stock allocations low in early retirement and shifting to a more growth-oriented portfolio later when a market downturn presents less risk, that "gets a quick 'aha' from a certain group" of clients, he says.

**Cut the tax and fee bite.** You can't predict how long you'll live and how markets will perform -- or make essential expenses disappear. But you can control how tax-efficiently you spend your money and the fees you pay for money management. And minimizing those costs can greatly boost the longevity of your savings.

To minimize the tax bite, consider these general guidelines from Colleen Jaconetti, senior investment analyst at Vanguard. "The first money to spend from the portfolio is an RMD," Jaconetti says. After all, you're required to take these distributions after age 70 1/2, and you'll be taxed on the money whether you spend it or not. Next, spend the taxable flows from your portfolio -- any interest, dividends and capital gains from taxable accounts. Once you add these taxable flows to your RMDs, Social Security and pensions, "a lot of times it covers people's spending," Jaconetti says, and you may not even need to pull additional money from your portfolio.

If you do need additional cash from your portfolio, draw next from taxable accounts, spending first from assets that are held at a loss, then those that have gains. After that, turn to tax-advantaged accounts. If you expect to be in a lower tax bracket in the future, you might want to spend first from tax-free Roth IRAs, saving tax-deferred 401(k)s and traditional IRAs for last. If you expect to be in a higher tax bracket in the future, reverse the order, saving Roth accounts for last.

As for portfolio fees, Blanchett's calculator can offer a powerful illustration of the importance of minimizing these costs. Consider a retiree with a 40% stock allocation who is paying 1% to his financial adviser and another 1% in fund fees. Using a withdrawal rate of just 3.1%, he has an 80% chance that his money will last 30 years. But if he can slash his fees to 0.5%, he can boost his withdrawal rate to nearly 4% and have the same 80% chance of success.