The Wealth Counselor

A monthly newsletter for wealth planning professionals

The Bear Market's Impact on Safe Retirement Withdrawal Rates

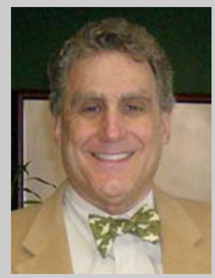
Volume 4, Issue 3

This issue of The Wealth Counselor examines "safe" retirement account withdrawal rates in light of the recent bear market and what adjustments clients should make, if any, to ensure that they do not run out of funds in retirement. These issues are critical to clients and can open the door to discussions of other topics, including the adequacy of funds for retirement, planning needs, and life insurance, among others. Therefore, these issues are equally important to all wealth planning professionals.

From Glenn D. Price

Price & Farrington, PLLC

Attorneys and Counselors at Law
12501 Bel-Red Road Suite 215
Bellevue, WA 98005
425-451-3583



At Price & Farrington, PLLC we work closely with our professional colleagues to help our clients plan, protect and pass their legacies to their loved ones through caring and confidential counseling.

The Impact of the Order of Returns
No one factor impacts whether clients will run out of money in retirement more than the order of their returns; i.e., when in their retirement deviations from an average rate occur. Here's an illustration.

Presume the following for Cindy Client:

- Retiree will live for 30 years
- Inflation during retirement on average will be 3% per year
- Initial portfolio of $1,000,000, being 60% stocks and 40% bonds (rebalanced annually)
- Stocks will earn, on average, 10% (real 7%) per year
- Bonds will earn, on average, 5% (real 2%) per year

Table 1

Year	*Initial Balance*	*Portfolio Growth*	*Portfolio Balance*	*Withdrawal*	*Year-End Balance*
1	$1,000,000	$80,000	$1,080,000	-$65,895	$1,014,105

2	$1,014,105	$81,128	$1,095,233	-$67,872	$1,027,362
5	$1,050,810	$84,065	$1,134,874	-$74,165	$1,060,709
10	$1,084,080	$86,726	$1,170,806	-$85,978	$1,084,828
15	$1,059,714	$84,777	$1,144,491	-$99,672	$1,044,819
20	$938,994	$75,120	$1,014,114	-$115,547	$898,567
25	$663,174	$53,054	$716,228	-$133,951	$582,278
29	$272,727	$21,818	$294,545	-$150,763	$143,782
30	$143,782	$11,503	$155,285	-$155,285	$0

As Table 1 reflects, assuming inflation and rate of return are constant, if Cindy withdraws $65,895 per year, adjusted for inflation, she will run out of money at the end of year 30.

Does this mean that the safe retirement rate is 6.6%? Not at all - this is the safe withdrawal rate only if Cindy's returns are 8% and inflation is 3% each and every year of her retirement.

If we change the returns in the above example for only four years - the first two and last two - and keep the 8% annual average, dramatically different results are obtained depending on which way the changes go. Change the year 1 and 2 returns to 0% and those in years 29 and 30 to 20% and Cindy runs out of money in year 23. Change the year 1 and 2 returns to 20% and those in years 29 and 30 to 0% and Cindy will have more than $1 million left at the end of year 30.

These extreme examples demonstrate the compounding impact of the returns in the initial years of retirement and illustrate why financial planning, like estate planning, is a relationship, not a transaction. With neither can the client can safely "set and forget it." Both are likely to require "mid-course corrections."

Planning Tip: Returns and withdrawals during the initial years of retirement can have a significant impact on whether the client will run out of funds during retirement.

Impact of Inflation and Client Health
Other critical factors are the inflation rate and the client's health. A 1% increase in inflation that is not offset by an increase in earned returns or a decrease in the rate of withdrawals results in Cindy running out of money in year 25 instead of year 30. If Cindy's health deteriorates, a 30-year planning horizon may no longer be realistic.

Planning Tip: Sitting down with the client annually to discuss rebalancing and what happened during the past year provides a good opportunity to assess whether changes need to be made in the plan to adjust for market or life events.

Are There "Safe" Withdrawal Rates?
William Bengen performed the seminal research in this area. In his 1994 article, *Determining Withdrawal Rates Using Historical Data* (Journal of Financial Planning, Jan. 1994), he concluded that a balanced portfolio produces a safe withdrawal rate for a 30-year retirement period of approximately 4.1%.

In their article, *Retirement Savings: Choosing a Withdrawal Rate that is Sustainable* (AAII Journal, Feb. 1998), Cooley, Hubbard, & Walz concluded that 4% is conservative, suggesting rates as high as 5 to 6%, depending on the assumptions. Similarly, in *Making Retirement Income Last a Lifetime* (Journal of Financial Planning, Dec. 2001), Ameriks, Veres, & Warshawsky concluded that a 4.5% withdrawal rate produces only modest failure rates. Based upon this and similar research, conventional wisdom is that the "safe" annual withdrawal rate is 4 to 5%.

Planning Tip: Current research suggests the safe annual withdrawal rate is in the 4% to 5% range.

Planning Tip: Research is only as good as the assumptions it uses. These research papers assume the past is indicative of the future - but the future could be quite different. Note that clients tend to adjust their spending favorably in light of current circumstances.

Total Return Trusts (Unitrusts)
In recent years, total return trusts, also called "unitrusts," have become more popular with financial and legal estate planning professionals. With a unitrust, rather than trust income, the current beneficiary receives an amount equal to a fixed percentage of the fair market value of the trust assets, valued as of the same date each year.

With a unitrust, the trustee invests for total return rather than trying to balance between the desires of the current beneficiaries (who desire income) and the future beneficiaries (who desire growth). Some have described that balancing between classes of beneficiaries as "striving to disappoint equally." As the trust value grows, so will both the unitrust payment to the current beneficiary and the amount left for the residuary beneficiary. (For an excellent discussion of unitrusts, see Wolf & Leimberg, *TRUs (Total Return UniTrusts)*, at www.Leimberg.com/freeResources/truArticles/truIntroduction.asp.)

Several states have adopted statutes that expressly permit unitrusts, and these states permit a unitrust payout percentage of 3 to 5% per year. While unitrusts are different from safe withdrawal rates in that unitrusts also ensure the availability of assets for the remainder beneficiaries, a unitrust amount of up to 5% ensures that with a reasonable return, some growth accrues to the remainder beneficiary as well as the current beneficiary.

Planning Tip: Total return trusts (unitrusts) give trustees the flexibility to invest for greatest total growth. Distributions from a unitrust should not exceed 5%.

Conclusion

Many clients are concerned about running out of money in retirement, especially now, with their retirement account values battered by the current bear market. Research suggests safe withdrawal annual rates are in the 4 to 5% range, but it is important for clients to adjust expenditures according to current conditions. This is particularly true if the client retires in a down market, given that net returns in the early retirement years will have a significant impact on what the client can withdraw later in retirement.

By raising these issues with clients, the planning team is addressing a significant client fear head on. At the same time, this discussion opens the door to further discussions, including the adequacy of funds for retirement, retirement and estate planning needs, long-term care planning, and life insurance, among others.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.

Price & Farrington, PLLC Attorneys and Counselors at Law 12501 Bel-Red Road Suite 215 Bellevue, WA 98005 Website