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The Sound Investor Series #78

Retirement Savings and Spending Ideas

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December 13, 2006

One of the most difficult issues for retirees is figuring out how much of their savings they can safely spend each year. This is obviously a critical issue because you don't want to run out of money before you die. On the other hand, you don't want to be too conservative and just scrap by; and die leaving a large bank account. You really can't take it with you.

We know people are living longer these days and that is one of the big issues. If a couple is in good health at age 65, there is about a 50 percent chance that one of them will live into their 90s. For a typical retired couple, the financial planning horizon has to be set at least 30 years.

The December 11th issue of The Wall Street Journal (WSJ) included a special section on Retirement. One article dealt with how retirees might spend their nest-eggs and reviewed the work of William Bengen. Mr. Bengen is a financial planner and some of his articles can be found by searching www.fpanet.org. He recommends that clients, who want a good chance that their portfolios will last at least 30 years, withdraw only 4 percent of savings in the first year of retirement. This dollar amount should then be adjusted for inflation and deflation to determine subsequent yearly withdrawals.

If a couple has \$200,000 saved, the 4 percent withdrawal would come to \$8,000 in the first year. If inflation was 3 percent, the second year's withdrawal would increase by that amount (\$240) and be \$8,240. A period of deflation would cause the withdrawal amount to decline. It is important to note a few things. First, the withdrawal rate percentage is only used in the first year. After that, withdrawals are based on the previous year's dollar amount adjusted for inflation. In other words, withdrawals do not go up and down with swings in your portfolio. The second point is that all these numbers are on a pre-tax basis. If you have to pay taxes on the \$8,000 withdrawn, your actual spending power will be much less.

Is there anything magical about 4 percent? No. It just happens to be the best number, based on historical data, for retirees to be relatively confident their money lasts for 30 years. If a couple assumes they will die earlier or wants to take a bigger risk of running out of money, the initial rate might be increased to 5 or 6 percent. Also, as we all know, the markets are unpredictable and using 4 percent is not a guarantee of success.

The point of this discussion is to get savers to understand how little money they can realistically spend. We might argue until “blue in the face” whether 4 or 5 percent is the “correct” withdrawal rate, but the 800-pound gorilla in the room is the size of your nest-egg. With a nest-egg of \$200,000, going from a 4 to a 5 percent withdrawal rate, only increases your income by \$2,000, pre-tax.

Americans need to increase the size of their nest-eggs. Data shows we have saved very little. In fact, the median savings of families, excluding their homes, is only around \$50,000. (The median means half have more saved and half have less saved.)

Most Baby Boomers plan on solving this problem by working longer. However, the experience of recent retirees suggests this is a pipe-dream. Not only do retirees work less in retirement than they expect, but 40 percent of workers are forced to retire earlier than they planned due to layoffs or health issues.

For the most part, these problems are simmering just under the surface as the first Baby Boomers now turn 60 and the security of pension plans starts to recede. But over the next 10 to 20 years these problems will bubble to the surface and become a national and possibly an international problem.

While the country is falling further and further into debt it is hard to see how we are going to bail ourselves out of this problem. When a growing number of retirees are forced to exist on Social Security and handouts from their children, our economy is bound to be affected and with it the financial markets.

I am not willing throw in the towel on the stock market at this early date, but I am also less inclined to advise clients that the stock market is definitely the best place to be invested for the next 30 years.

The danger of retirees running out of money should also affect how fixed income savers split investments between regular bonds and Treasury inflation-protected securities (TIPS). Like most Baby Boomers, I tend to worry about inflation, not deflation and therefore believe TIPS are a great investment. But, never put all your (nest) eggs in one basket. Investors would be well advised to purchase both regular bonds and TIPS.

In summary, most of us have trouble saving for retirement. But, if you live to an old age like many of us will, you will have a long time to be grateful if you plan ahead.

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