RBC Wealth Management
The Crescent Group

Carsten Frederiksen, CFP®
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6401
NMLS#: 1321563 City National Bank
The Crescent Group website

Paul Hendershot
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
NMLS # 1370978 City National Bank

Nick Weege
Financial Advisor
214-775-6408

Lindsey Vickers, MBA
Client Service Associate
214-775-6458

Andrew Ielmini
Client Service Associate
214-775-6448

October 2019 Commentary

How much money can you safely withdraw during retirement, without having to worry about running out of money? The financial media often tout a so-called “4% Rule” for retirement withdrawals, whereby a retiree withdraws 4% of their assets every year. Unfortunately, such an oversimplified rule fails to take into account each investor’s specific circumstances, leading to the possibility that an investor could overspend and run out of money, or not spend as much as they can afford to and potentially miss out on meaningful life experiences.

In reality, determining how much you can safely withdraw during retirement involves assessing and balancing three critical factors: risk tolerance, asset allocation, and time horizon. Let’s begin with asset allocation. In our August Commentary, we provided the long-term returns for major investment asset classes: 1% for gold, 4% for bonds, 3% for residential real estate, and 7% for U.S. stocks. On the basis of the long-term data, it’s clear that over a long time horizon, an investor will make the most money by buying and holdings stocks. However, this ignores the human element of investing, and this is where risk tolerance comes into play. Stocks will only hurt an investor who has a fear of market volatility, and who inclines towards selling their stocks when the market enters panic mode and declines substantially, as it does from time to time. Investors who fear volatility need to weight their portfolios more strongly towards bonds and other income-oriented investments in order to reduce the volatility of their portfolios. Prudent financial advisors will help their clients overcome the fear and stay invested when markets decline, in order to remain on track with their financial plan. This is one of our Group’s main focuses[1][2].

A second way that the human element comes into play with asset allocation is that we all need regular cash withdrawals for living expenses in retirement. Having to sell stocks at depressed prices in order to withdraw cash for living expenses could potentially cause an investor to permanently lock in losses. Since we cannot predict when market corrections will occur, but we do know they certainly will happen, it’s important for retirement investors to maintain several years worth of living expenses in cash and bonds. This way, when an investor withdraws cash during a market correction, they can take the cash from bonds and not have to sell stocks at depressed prices.

Obviously, reducing one's exposure to stocks will reduce one's expected investment returns and hence reduce how much money a person can safely withdraw every year. This explains why risk tolerance and asset allocation together determine how much an investor can safely withdraw in retirement.

The other way asset allocation comes into play is with expected returns. In the early 1980s, the ten-year Treasury bond yielded more than 10%. As of the end of last month, it yielded 1.7%. Not only is 1.7% a paltry number, but it's far less than the average historical inflation rate. So while an investor could have invested their entire portfolio in bonds in the early 1980s and could have withdrawn 10% or more of their assets every year, that is far from the case in today's investment market. Given where bond yields sit today, investors who don't want to substantially reduce their retirement withdrawal goals will likely need to increase the portion of their assets they invest in stocks. Investors whose risk tolerance prevents them from increasing their stock exposure will have to reduce the amount of money they can safely withdraw from their accounts, or risk running out of money in the future(3).

Time horizon represents the third critical factor that determines how much a retiree can withdraw from their investments without having to worry about running out of money. The longer one's time horizon, the more conservative one needs to be with withdrawals. For example, all other factors being equal, an investor with a ten-year time horizon can withdraw 10% of their original balance every year and the money will last. Obviously, no person can predict with certainty what their time horizon will be. The prudent approach is to use average longevity rates from actuarial tables, which is what our Group does with financial planning. As one's time horizon increases, so too do the number of potential risks that can impact one's financial plan. Such risks include inflation, the potential for higher tax rates, adverse reactions to market corrections, and various life events.

As one can tell from the above discussion, determining the best withdrawal rate for your retirement assets – a rate that balances enjoying one's life while not worrying about outliving one's assets – is part art and part science. It involves many complicated factors, which will likely evolve over time. Our Group is here to make sense of this process and integrate all of these details for you as your life unfolds and as your needs evolve.

Best Regards,

The Crescent Group
Carsten Frederiksen, CFP® | Paul Hendershot | Nick Weege | Andrew Ielmini | Lindsey Wood, MBA

Sources:

(1) Siegel, Jeremy, Stocks for The Long Run
(2) Shiller, Robert, Irrational Exuberance
(3) U.S. Department of The Treasury