

Conserving Client Portfolios

The questions are more than academic. “How much can an investor afford to withdraw from their portfolio during retirement, while minimizing the risk of exhausting that portfolio prematurely?” and “How should a person’s portfolio be invested such that he or she can withdraw the maximum amount possible?” are very real questions that investors must address if they want to maintain the same standard of living in retirement as in their working years.

Indeed, with the decline of traditional pension plans and increases in longevity and health care cost, millions of Americans must now consider not only how to save for retirement but how to preserve their portfolios during retirement. According to William Bengen, CFP®, author of “Conserving Client Portfolios During Retirement,” the highest withdrawal rate that produces 30 years of longevity is somewhere between 3 percent and 6 percent, what he refers to as SAFEMAX – the “Maximum Safe Withdrawal Rate.”

To be sure, each person may have their own SAFEMAX, depending on such factors as asset allocation and rebalancing, but Bengen notes that 4.15 percent -- assuming a 30-year time horizon – is perhaps the ideal withdrawal rate when using a portfolio made up of two asset classes with 64 percent invested in large-company stocks and 37 percent invested in intermediate-term Government bonds, and which is rebalanced at the end of each calendar year.

By way of background, this maximum withdrawal rate is based on a study of “50 retirees” using actual historical investment returns and rates of inflation to test assumptions about withdrawal rates, asset allocation, and portfolio longevity, according to Bengen. This approach contrasts with approaches that use probability models, such as Monte Carlo simulation, which use mathematical models of investment performance and inflation to produce maximum withdrawal rates. Both approaches, historical returns and probability models, have their strengths and limitations.

The SAFEMAX can change, however, depending on the number of asset classes used in a portfolio. For instance, a portfolio made up of three asset classes with 17.5 percent invested in small-company stocks, 42.5 percent invested in large-company stocks and 40 percent in intermediate-term Government bonds will produce SAFEMAX of 4.4 percent. For his part, Bengen notes that planners and investors with a high tolerance for volatility and a desire to maximize their withdrawals could increase the percentage invested in stocks.

Of note, Bengen reports that investors need not include long-term bonds in their retirement portfolios given the limited impact on increasing the SAFEMAX, but investors can replace intermediate-term government bond funds with money market funds without any adverse effect on withdrawal rates.

To be fair, the maximum withdrawal rate can also change if an investor uses a time horizon other than 30 years. Not surprisingly, the peak SAFEMAX increases as the time

horizon shortens. For instance, the peak SAFEMAX for a person with a 10-year time horizon is 8.9 percent, about twice that for a person with a 30-year time horizon. In addition, the percentage that a person invests or allocates to large-company stocks declines as the time horizon shortens, until about 10 years is reached, after which it increases with decreasing time horizons. For instance, individuals with time horizons of about 15 to 20 years will optimize their withdrawal rate with a total equity allocation of 30 percent.

Individuals with a time horizon of more than 30 years, meanwhile, can use an initial withdrawal rate of 4 percent for their tax-deferred portfolio, 65 percent of which would be invested in large-company and small-company stocks.

What is the risk of higher withdrawal rates? According to Bengen, increases in withdrawal rates reduced the odds of an investor's portfolio lasting 30 years. For tax-deferred accounts, an increase of 1 percentage point above the SAFEMAX in the initial withdrawal rate reduces the probability that a portfolio will last 30 years by 15 to 20 percent. An initial withdrawal rate increase of 2 percentage points above the SAFEMAX results in just a 55 to 60 percent success rate. For taxable accounts, the results are slightly different. An increase of 1 percentage point above the SAFEMAX in the initial withdrawal rate produces a success rate of roughly 85 to 90 percent and an increase of 2 percentage points results in a 70 percent success rate. The bottom line is that some individuals may want to trade off a higher initial withdrawal rate for the near certainty of their portfolio lasting as long as their time horizon goal.

Investors and financial planners can use other techniques for increasing the initial withdrawal rates without increasing risk. For instance, retirees can modify their withdrawals using such approaches as the fixed-percentage approach or the floor-and-ceiling withdrawal approach.

In addition, Bengen reports that investors can marginally increase their initial withdrawal rates by changing the frequency with which they rebalance their portfolios during retirement. For instance, many investors are told to rebalance their portfolios at least every 12 months. But according to Bengen's research, investors could rebalance every 75 months, or once every 6 and one-quarter years, and actually improve the initial withdrawal rate to 4.65 percent.