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Income Withdrawals in Retirement: What's the Right Amount?

Determining the optimal amount to withdraw from retirement savings each year is a vexing question that every investor inevitably must face. This is one of the key elements in retirement planning: establishing a sustainable, long-term income withdrawal rate. Everyone's goal is to be comfortable in retirement. Part of that comfort comes from knowing future financial needs can be met without having to cut back on spending too much and without depleting retirement savings too early.

Vista typically recommends investors set annual income withdrawals at 4-5 percent of their portfolio's beginning balance, and adjust for inflation each year thereafter. This is a prudent withdrawal method that significantly reduces, but does not eliminate, the probability of a retiree outliving his or her money.

When we recommend withdrawals of 4-5 percent, we are referring to the percentage of the portfolio's initial value withdrawn during the first year of retirement. In subsequent years, withdrawals are increased to keep pace with inflation. For an investor with a \$1 million portfolio using a 4.5% withdrawal rate, assuming 3% annual inflation, the amount withdrawn in the first year would equal \$45,000; \$46,350 is withdrawn in year two, \$47,740 in year three, and so on. Not this entire amount is available for discretionary spending, as some will be used to pay taxes.

Not surprisingly, many investors interpret a 4-5 percent withdrawal rate as meaning five percent. Choosing the appropriate rate within this 4-5 percent range is an important decision and will depend on the flexibility of a retiree's spending needs. Retirees who have higher fixed expenses as a percentage of their total income may find it difficult to cut back if their portfolio falls in value. For these investors, Vista recommends the more conservative 4%. Investors willing and able to reduce spending when market returns are poor may be able to withstand a higher withdrawal rate.

Unfortunately, future returns are neither known in advance nor guaranteed. Portfolio returns can – and will – vary greatly year to year. The combination of a large withdrawal and poor performance in the same year, especially early in retirement, can significantly shorten the lifespan of a portfolio. Even if the market rebounds and investors enjoy above-average returns in later years, retirees may have to significantly cut back on withdrawals because their portfolios were so depleted in the first few years of retirement.

Maintaining the financial flexibility to make adjustments in retirement, if necessary, is critical. Flexibility enhances a portfolio's ability to meet long-term goals. The lower an investor's fixed expenses are, the easier it is to cut back withdrawals following a poor year of performance. If portfolio values decline suddenly due to market losses, it's probably much easier to delay that two-week vacation in Aspen than it is to put off the monthly mortgage payment. Financial flexibility may also allow retirees to take large one-time withdrawals, if they so choose. After all, nothing says withdrawals cannot be adjusted upward following periods of strong market returns.