

WITHDRAWAL RATE RISK

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The withdrawal rate, also known as the distribution rate – what is it? It is a measure of the percentage of your investment portfolio removed each year to maintain your lifestyle. Why is it important? Because there can be a significant impact on the longevity of your money depending on the level of this rate. In 1998, the Trinity Study, conducted by three professors from Trinity University in San Antonio, produced several conclusions on this issue, one of which was, “retirees who desire inflation-adjusted withdrawals must anticipate a substantially reduced withdrawal rate from the initial portfolio.” Consider the following example to help illustrate this point.

Assume you have accumulated \$2,000,000 and are ready to retire. Based on today’s conventional wisdom, you intend to take \$80,000 (a 4% distribution) each year from your investment portfolio to maintain your lifestyle. This could be fine the first year – but what about each successive year? Now, assume in the second year your investment portfolio declines by 5% due to a market downturn. Are you still able to maintain your lifestyle with a 4% distribution? Unfortunately no. If you needed \$80,000 the first year, you would need more money the next year after accounting for inflation. Assuming a 3% inflation rate, you would need to remove \$82,400 the second year, which equates to a 4 ½% distribution rate (remember, you began with a \$2,000,000 portfolio, removed \$80,000, then the portfolio declined by 5%, leaving \$1,824,000. Removing \$82,400 is equal to a 4 ½% distribution rate). This shows that the “rule” of removing no more than “X%” (4% in this example) each year to maintain your lifestyle, while good in theory, can prove to be inconsequential in application.

So what are some strategies to help reduce this risk? One is to create and invest your money in an income-producing portfolio. This type of portfolio could be constructed with investments that provide a large portion of their return in the form of income (compared to capital appreciation, or rising prices). Typical investments could range from dividend-paying stocks to interest-paying bonds to real estate rental properties with positive cash flow. You could construct your portfolio so the total amount of annual income produced would maintain your lifestyle. However, there are risks to this portfolio. First, you cannot consume all the income. The solution is that you will need to reinvest a portion of the income (after taxes) to combat inflation to maintain your buying power over time. Second, real estate is less liquid than stock and bond investments and it can be difficult to access cash, especially during periods where properties are vacant (and therefore, not generating income).

Another strategy is to construct a balanced portfolio. This type of portfolio could be constructed with investments that provide both capital appreciation and income. Typical investments could include the same as referenced above but also include non-dividend-paying stocks. You would construct your portfolio to target a specific, long-term annualized return with the objective of removing a portion each year from either appreciation, income, or both to maintain your lifestyle. However, this strategy also has

risks, such as what happens when the stock market is flat or negative in any given year? The solution is that you need to have a system to monitor and harvest gains during positive markets to build a buffer in your portfolio. These harvested gains can then be consumed in future years during periods of market underperformance.

These are just two of many strategies that can be used to help maintain your lifestyle during retirement. The effectiveness of these or any strategy will depend on measuring your distribution rate, executing your investment strategy, and making necessary adjustments along the way. Your distribution rate, however, can be the first line of defense to identify a faulty investment strategy that could result in outliving your money.

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