

The Most Important Factor in Retirement Withdrawal Plans

When I first started this blog, I thought I would be doing lots of posts about [asset protection](#). I thought it was a really important part of personal finance. However, after learning a few things about it, I realized it isn't very important at all compared to other personal finance topics. The reason why is because the likelihood of a physician being successfully sued for more than their [malpractice policy](#) limits is so incredibly small. I calculate it at 1/10,000 per year in my specialty of emergency medicine. And a significant chunk of my assets ([retirement accounts](#) etc) aren't accessible to the creditor in that sort of a scenario anyway. So not only did I quit spending any time worrying about it, but I don't write about it very often either.



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I feel similarly about [retirement withdrawal](#) topics. Let me explain why.

There are blogs, books, forums, and commercial products out there designed to help you decide [how much you need to retire](#), how much you can withdraw from a portfolio in any given year, and what sort of an [asset allocation you should have in retirement](#). The arguments on this topic are endless. Engineer

types seem to particularly revel in them. There are academics such as [Wade Pfau](#) who have made an entire career mostly out of the topic. A good example of these sorts of discussions is found on the very comprehensive Early Retirement Now blog, [Ultimate Guide to Safe Withdrawal Rates](#), a source that is often cited in discussions in the comments section of this blog or on the [WCI Forum](#).

I think it is actually really important to know a little bit about this topic. But it is NOT important to know a ton about it. And the reason why is because there are lots of people who think knowing a lot about this topic will somehow allow them to come up with a scheme that will allow them to maximize their happiness and spending while minimizing their risk of running out of money should they live a long time. Which is pretty much nonsense.

So today, I'd like to discuss seven simple principles you need to know about withdrawing from your portfolio in retirement, the last of which is the very most important factor.

7 Principles for Retirement Withdrawal Plans (#7 is *the* Most Important)

1 You Are Mortal

I know. It seems so obvious. But too many people have designed a retirement withdrawal plan that, if you look at it carefully, assumes they are immortal. The most common problem in this department is best illustrated by the phrase "Never spend principal." Well, I've got news for you. While never spending principal does ensure you will never run out of money, it also ensures you will die with at least as much money as you retired with. [Because you will die.](#) Any retirement spending plan that doesn't acknowledge that fact

will result in you spending less than you otherwise could. And if that spending could have made your life happier, that's a real tragedy. The goal of a retirement withdrawal/spending plan is not to make you the richest guy in the graveyard.

2 Start in the Right Neighborhood



The second principle is to make sure that your withdrawal plan is in the right neighborhood. That neighborhood is four percent. The [4% rule](#) of thumb was best publicized by the [Trinity Study](#). The Trinity Study was designed to answer this question:

In the past, how much money could someone spend each year, adjusted upward for inflation each year, and not run out of money during a 30 year retirement?

That's it. That's the question. And it is a very important question. Because prior to this time, the general consensus was that if your portfolio averaged 8-10% a year, you could spend 8-10% a year. Seems logical, right? The problem with that is what is called Sequence of Returns (SOR) risk. That is, the risk that even though you average 8% (or whatever) returns over your retirement, if the crummy returns show up early, the combination of bad returns and portfolio withdrawals will cause you to run out of money early. So the amount you can safely take out each year must be low enough

that if SOR risk shows up, you still don't run out of money. It turns out that number is [somewhere around 4%](#).

People love to argue about this. Sometimes the arguments become insane. Like when people start arguing for a [2% safe withdrawal rate](#), which is basically the same thing as "Never Spend Principal" since the stock market yield and the 10 year treasury yield are both around 2%. But the point of the Trinity Study wasn't to rigidly define whether a 3.62% withdrawal rate was safe or a 4.22% withdrawal rate was safe. I mean, it just looked at round numbers, and those round numbers started at 3%. The point was that you can't withdraw 8% a year. The lesson to take from the Trinity Study (and pretty much every other one like it) is that the right neighborhood is somewhere around 4%. So start there. If you need much more than that, then you'll need a different plan to fund your retirement than portfolio withdrawals- like [SPIAs](#) and [Reverse Mortgages](#).

The other thing to realize with withdrawal rate studies, is that most of the time at 4% you die with way more than you retired with. On average, after 30 years, a 4% withdrawal rate leaves you with [2.7 times what you retired with](#). The 4% rule of thumb is set low to cover the worst-case scenarios. If your scenario doesn't look like that, you can likely get away with spending a little more.

3 The Importance of Growth

Another key principle to understand about withdrawal rates is that the longer the time period, the more important it is for your portfolio to continue to grow. Inflation is one of the greatest enemies of the investor, and it is a particularly lethal enemy to a retiree. Unless your retirement is very short, it is important that your portfolio contains at least some risky assets such as stocks and/or real estate to boost the portfolio returns sufficiently to survive a lengthy retirement where your spending is increased each year with

inflation. This is easily illustrated with the data from the Trinity Study:

Table 2: Retirement Portfolio Success Rates by Withdrawal Rate, Portfolio Composition, and Payout Period in Which Withdrawals Are Adjusted for Inflation

Annualized Withdrawal Rate as a Percentage of Initial Portfolio Value										
Payout Period	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%
100% Stocks										
15 Years	100%	100%	100%	94%	86%	76%	71%	64%	51%	46%
20 Years	100%	100%	92%	80%	72%	65%	52%	45%	38%	25%
25 Years	100%	100%	88%	75%	63%	50%	42%	33%	27%	17%
30 Years	100%	98%	80%	62%	55%	44%	33%	27%	15%	5%
75% Stocks/25% Bonds										
15 Years	100%	100%	100%	97%	87%	77%	70%	56%	47%	30%
20 Years	100%	100%	95%	80%	72%	60%	49%	31%	25%	11%
25 Years	100%	100%	87%	70%	58%	42%	32%	20%	10%	3%
30 Years	100%	100%	82%	60%	45%	35%	13%	5%	0%	0%
50% Stocks/50% Bonds										
15 Years	100%	100%	100%	99%	84%	71%	61%	44%	34%	21%
20 Years	100%	100%	94%	80%	63%	43%	31%	23%	8%	6%
25 Years	100%	100%	83%	60%	42%	23%	13%	8%	7%	2%
30 Years	100%	96%	67%	51%	22%	9%	0%	0%	0%	0%
25% Stocks/75% Bonds										
15 Years	100%	100%	100%	99%	77%	59%	43%	34%	26%	13%
20 Years	100%	100%	82%	52%	26%	14%	9%	3%	0%	0%
25 Years	100%	95%	58%	32%	25%	15%	8%	7%	2%	2%
30 Years	100%	80%	31%	22%	7%	0%	0%	0%	0%	0%
100% Bonds										
15 Years	100%	100%	100%	81%	54%	37%	34%	27%	19%	10%
20 Years	100%	97%	65%	37%	29%	28%	17%	8%	2%	2%
25 Years	100%	62%	33%	23%	18%	8%	8%	2%	2%	0%
30 Years	84%	35%	22%	11%	2%	0%	0%	0%	0%	0%

Note: Data for stock returns are monthly total returns to the Standard & Poor's 500 Index, and bond returns are total monthly returns to high-grade corporate bonds. Both sets of returns data are from January 1926 through December 2009 as published in the 2010 *Ibbotson S&P Classic Yearbook* by Morningstar. Inflation adjustments were calculated using annual values of the CPI-U as published by the U.S. Bureau of Labor Statistics at www.bls.gov.

As you can see, 4% worked pretty darn well in the past, except for when the retirement period was very long and the asset allocation was not very aggressive. Very early retirees looking to hedge their bets not only lean toward an initial withdrawal rate less than 4%, but also toward a more [aggressive asset allocation](#) (i.e. more stocks.)

4 The Data Sucks

Here's another thing people don't seem to get about this. The data that all of these studies are based on is terrible. At most, it's based on about 90 years worth of data. That's really only three completely independent 30 year periods. And

most of the studies look only at US based stock and bond returns. Few of them look at [real estate](#). Few of them look at the data from other countries, or if they do, it's based on an even shorter time period. In medicine, meta-analyses not only look at the data, but also consider the quality of the data. If retirement withdrawal rate studies were a meta-analysis, this data is not only retrospective, but it is also very limited. It is barely better than expert opinion. Keep that in mind as you draw any sort of conclusions from it. It doesn't matter how much the academics manipulate and massage it, there just isn't much data there to work with. The good news? Every year there's one more year of it!



There was a lot of uncertainty that occurred in Canyonlands National Park over Memorial Day. This is me dealing with it.

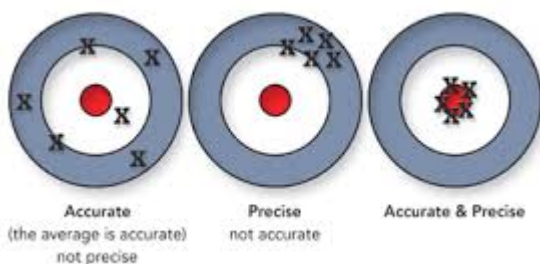
5 Be Comfortable with Uncertainty

Some people don't deal with uncertainty very well. There is a lot of uncertainty in life. I specialize in it. I'll bet a majority of my patients leave the emergency department without a definitive diagnosis for the complaint that brought them in.

We rule out some bad stuff, give them some precautions, treat their symptoms, and disposition them to primary care, a specialist, or an inpatient unit for additional observation or evaluation. When I go skiing in the backcountry, I check the avalanche forecast. The risk of avalanche is rated low, moderate, considerable, high, or extreme. When the danger is high, you stay out of avalanche terrain and ski low angle slopes in the trees. But there really is no guarantee of anything. Life is uncertain. Retirement is uncertain too. You don't know how long you'll live. You don't know how many big expenses will come up. You don't know what kind of market returns your portfolio will see nor in what sequence. Deal with it. If you are not willing to, it will cost you a lot of money either in foregone returns (from less aggressive asset allocations) or insurance premiums (SPIAs, longevity insurance etc.)

6 Don't Believe Precision

The funniest part about some studies and the things some people say in this regard is the false precision they use. I've seen withdrawal plans where the withdrawal rate went to three decimal points. Give me a break. You're doing well if you can get the first digit right (i.e. 3%, 4%, 5% etc.) Don't kid yourself. Just because someone (or some Monte Carlo simulator) spits out some incredibly precise answer doesn't mean the answer is accurate.



7 Adjust As You Go

Finally, we get to the topic of this blog post. The most important factor in your retirement withdrawal plan is not your asset allocation, nor your longevity, nor your initial withdrawal rate. It is your flexibility. The ability to adjust spending as you go was the key to being financially successful during the accumulation phase. It is also the key to being financially successful in the distribution phase. Start in the right neighborhood and adjust as you go. If you end up with two bull markets and a very minor bear in your first decade of retirement, you can probably adjust spending up or give more of your assets away. If sequence of returns risk rears its ugly head on you, cut your spending a little. Vacation in Mexico instead of Switzerland. Hold on to that car for a couple more years. Give \$50 to the grandkids for birthdays instead of \$100. Eat out once a week instead of twice.

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Of course, this all assumes you have the ability to cut back on spending. Just like in the accumulation phase, set up your financial life in the distribution phase so that the ratio of fixed expenses to variable expenses to truly discretionary expenses is as low as possible. Fixed expenses might be property taxes, utilities, and insurance. Variable expenses

are food and gasoline. Discretionary expenses are charitable contributions, gifts, and vacations. If only 20% of what you spend is truly fixed and only 30% is variable, you can relatively easily cut your spending by 50-60% if sequence of returns risk shows up. And if it doesn't? Great! You keep living "the good life." In fact, some people even go a step further and make sure they have enough guaranteed income ([Social Security](#), Pensions, SPIAs etc) to cover their fixed and a portion of their variable expenses. So in the event of a market downturn, they can literally eliminate portfolio withdrawals completely. This sort of flexibility is invaluable in making sure you don't run out of money.

So I'm not going to spend a lot of time on this blog analyzing 3.75% and 4.2% withdrawal rates and go over a dozen different systems for withdrawal. Like advanced asset protection techniques, it just doesn't matter much in the grand scheme of things. What does matter? Well, your asset allocation and starting withdrawal percentage matter a little, but what really matters is maximizing your flexibility. Put your effort there and you can afford to ignore an awful lot of the withdrawal rate chatter out there on blogs and internet forums.

What do you think? Do you agree that flexibility is the most important factor? Why or why not? Comment below!