How Retirees Can Spend More Early (And Safely)

By Editor Test *Wed, Jun 9, 2010*

Bill Klinger's decumulation method involves techniques for moving payout rates up or down in response to market fluctuations. The New Jersey professor has also created the Retirement Quant planning tool.

"Most retirement income strategies assume a flat distribution in terms of real income," said William J. Klinger, a professor at Raritan Valley Community College in New Jersey. "But I kept hearing of people who want to spend more instead of less early in retirement."

So Klinger, a University of Chicago MBA, a computer scientist and creator of Retirement Quant, a planning, decided to tilt the traditional inflation-adjusted 4% decumulation rate so that real income was 10% higher at the beginning of retirement.

"I looked at Bureau of Labor Statistics results and saw that in all categories but medical expenses, spending goes down in retirement," he told RIJ. "If so, then people would rather spend more early than later. There was no magic to choosing 10%. It could have been 20% or 30%. I thought 10% was something people could reasonably accommodate."

There's more to Klinger's method than simply starting out with a higher income, however. As he explains in a recent article in the Journal of Financial Planning, "Creating Safe, Aggressive Retirement Income Profiles," the method also involves techniques for adapting payout rates up or down in response to market fluctuations.

In his article, Klinger describes the classic hypothetical retiree with $1 million in a balanced (60% large-cap equity/40% investment grade bonds) portfolio. He assumes an optimistic 12.4% average equity return and a 6.2% average bond return, and tests the probabilities of portfolio success with Monte Carlo analysis.

Klinger tests several initial annual retirement incomes, ranging from about $35,000 to $53,000, and shows the interaction between the choice of initial payout rate and the portfolio success rates, late-retirement income rates, and final portfolio balances (i.e., legacy amounts).

During retirement, Klinger's method requires the application of risk control rules that adjust income in response to market performance. He has two rules for adjusting income downward and one rule for adjusting income upward.

The Capital Preservation Rule dictates that if the withdrawal rate in any year exceeds 6%, the retiree must reduce real income in the following year by 10%. The Negative Return Rule states that if the portfolio has a negative nominal return in any year, real retirement income is reduced by 10%. The Prosperity Rule states that if the withdrawal rate in any year falls below 3.8%, the retiree can raise his income by 10% in the following year.

The Klinger technique accommodates either a small annual reduction in real income each year in

retirement-as little as a third of one percent-or a step-wise reduction in income that occurs once every five years. In one of several scenarios presented in the paper, a retiree with $1 million might begin with an income of $44,408, decrease it by $153 a year (in real dollars) and end up with a median income after 30 years of $39,860 and a median legacy of $1.984 million.

That scenario carries a 95% Monte Carlo success rate. Clients tolerant of a 90% success rate could take out $51,240 the first year, while clients requiring a 99% chance of success would cut their first year income to only $35,441.

Klinger's ideas about retirement income are also embedded in Retirement Quant, a proprietary planning tool that he sells online for $250 (professional edition) or $50 (personal edition) through his company, B-K-Ind LLC.

A graduate of the University of Chicago, Klinger ascribes to the school's famous free market philosophy, more or less. "Do I count Milton Friedman as one of the best economists ever, yes," he said. "It's great that there are a number of YouTube videos with him. He was a brilliant man and a nice person."