How to Expect the Unexpected (in a Retirement Income Plan)

By Editor Test *Wed, Nov 17, 2010*

If you incorporated the risk of expensive emergencies, the sustainable withdrawal rate would sink to 3%, writes Gordon B. Pye, Ph.D., in the current issue of the Journal of Financial Planning.

The traditional "4% rule" regarding sustainable lifelong withdrawals from retirement savings works only if you neglect to anticipate the cost of emergencies, says a noted financial consultant.

If you incorporated the risk of emergencies, the sustainable withdrawal rate would sink to 3%, writes Gordon B. Pye, Ph.D., in the current issue of the *Journal of Financial Planning*. To put it another way, you'd have to arrive at retirement with 33% more savings than you thought you needed.

Emergencies can be worse than bear markets because they don't correct themselves, Pye says; they don't obey the principle of reversion-to-the-mean. Like bear markets, however, they pose timing risks. Their effect is worse if they occur near the beginning of retirement instead of near the end.

The retirement planning software that exists today is flawed to the extent that it doesn't help advisors incorporate the risk of emergencies into their spend-down rates, either before or after an expensive emergency, he says.

There's a one in 20 chance of an emergency occurring every year during retirement and, on average, one expensive emergency will occur during a 20-year retirement, Pye says. He projects a 38% chance of one emergency during retirement, a 36% chance of no emergencies, a 19% chance of two, a 6% chance of three and a one percent chance of more than three.

In the past, Pye has written about the Retrenchment Rule, a discounting technique that adjusts withdrawal rates downward during retirement. This rule accommodates the tendency for retirees to spend more money early in retirement (during the Go-go years) than later (during the Slow-go and No-go years). He uses an annual Retrenchment Discount Rate of 8% to deflate future projected withdrawals during retirement.

"A more active and expensive standard of living gradually becomes less desirable as lifestyles necessarily slow with age even for those who remain in relatively good health," he mordantly observes.

If a large unexpected emergency expense takes a chunk out of savings, he recommends sticking to the prescribed withdrawal rate, even if doing so entails a reduction in standard of living. To protect against insufficient income later in life, Pye has in the past recommended either buying a life annuity or allocating a "sizable portion of the portfolio each year to fixed-income issues."

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