How to Personalize Withdrawal Rates

By Kerry Pechter *Tue, Sep 15, 2015*

Safe spending rates range from 2% to 10%, writes researcher Luke Delorme in the Journal of Financial Planning. It all depends on when people retire, how much guaranteed income they have, whether they want to leave a legacy, etc. One size never fits all.

Whole forests have been pulped and supertanker-loads of ink spilled to produce articles about the various spending strategies that financial advisors can recommend. Some strategies emphasize safety, others emphasize “optimization.” Some roll Monte Carlo simulations to make the future seem less unknowable. Others rely on historical back-testing.

But experienced financial advisors know that there is no single, sure-fire spending formula. Or rather, the right strategy is the one that satisfies their clients’ fluctuating needs, keeps them solvent until they die, and achieves their legacy goals, if any. “What arrow flies forever?” asked Vladimir Nabokov. “The one that hits its mark.”

So how does the wise advisor, armed with six or seven different peer-reviewed spending formulas, match the right spending formula with the right client at the right time? How does he or she customize the research to each client’s reality?

Luke Delorme, a researcher at the American Institute for Economic Research in Great Barrington, MA, has come up with a “blueprint” that advisors can use to tackle this almost universal problem—a problem complicated by the fact that many people don’t know or can’t describe what they want.

In his article, “A Blueprint for Retirement Spending,” in the September issue of the *Journal of Financial Planning*, Delorme takes several of the withdrawal rates recommended by retirement specialists like David Blanchett, Michael Finke, Jonathan Guyton, Michael Kitces, and Wade Pfau, and shows how each can be fine-tuned depending on the preferences of each client.

“There are some big withdrawal rules out there,” Delorme told RIJ recently. “I’m trying to break the problem down into something more prescriptive—based on household preferences—and to come up with a structure that you can use to prepare for retirement. It’s a starting point.”

Four spending preferences

The first step toward determining a client-specific withdrawal strategy, Delorme writes, is to locate the client's position on two continuums. Listening to a client's comments during an interview, the adviser should be able to estimate how afraid they are (or aren't) of running out of money and how tolerant they are (or aren't) of a fluctuating cash flow. Overlaying the locations of two continuums, he arrives at four difference preferences:

- **Safe and constant income.** "I absolutely must not run out of money under any circumstances. I need to know what I can spend every year."
- **Safe and flexible income.** "I'm moderately concerned about running out of money, but I have a safety net if anything happens."
- **Optimal and constant income.** "I'm as concerned about not spending enough as I am about spending too much."
- **Optimal and flexible income.** "I want to maximize lifetime spending. I have a preference for spending while I can. I am willing to adjust spending based on market fluctuations.

Then he assigns a baseline withdrawal rate to each of these preferences, using the work of previous research about withdrawal rates as a guide. Thus he puts the safe and constant spending rate at 3.8%, the optimal and constant rate at 5.4%, the safe but flexible rate as the RMD (required minimum withdrawal rate, according to IRS rules), and the optimal and flexible strategy as the RMD plus the inflation rate.

Period of adjustments

Having established the baseline rate, Delorme fine-tunes it according to the combination of factors that is unique to each case. These factors, and their impact on withdrawal rates) include:

- **Age of retirement.** Later retirement means higher spending rate.
- **Marital status.** Surviving spouses tend to live longer than single people.
- **Health status.** Healthy people tend to live longer.
- **Guaranteed income** (Social Security, pension, private annuity). More guaranteed income means higher spending rate from savings.
- **Bequest motive.** Higher bequest motive means lower spending rate.
- **Exposure to equities.** Exposure between 30% and 60% has little effect on spending rate.
- **Fee load.** The spending rate is directly reduced by the amount of the expense ratio.
- **Desire to optimize "utility".** Utility maximizers are those who place a lot of importance on traveling or being active as much as possible while they are physically able.

Delorme gives examples of the spending rate changes associated with these variables. For instance, "For optimal and constant spenders, married couples could increase spending by 0.1 percentage points for each year that the couple delays retirement beyond age 65 (based on the younger spouse's age)." Another example: "As ratio of pension to savings increases, optimal strategies will spend a higher percentage of savings."

Two hypothetical clients

Along with tables, charts, equations and a respectful rehash of the academic literature, Delorme provides a couple of hypothetical cases that make his thesis easy to understand and apply in the real world. They represent the extremes of withdrawal rates; most clients would probably fall somewhere in between.

The first hypothetical clients are a very healthy couple who want to retire at age 62, are very conservative about money and have no guaranteed income besides Social Security. Their baseline withdrawal rate is an inflation-adjusted 3.8% a year. It drops 0.3% because of early retirement, 1.0% for risk aversion, 0.5% for fees and 0.5% for "relatively strong" bequest motive. Recommended initial spending rate: 1.5% to 3% constant dollars.

The second hypothetical couple, in average health, intended to delay retirement to age 75. They "love travel" and "want to live it up" in retirement. Their baseline withdrawal rate is an inflation-adjusted 5.6%. It goes up 2% because of late retirement, 0.4% because they have a defined benefit pension in addition to Social Security, and 0.2% because of their 60% equity allocation. It drops 0.8% because of fees. Recommended initial spending rate: RMD+2% or 3%, or between 6.4% and 7.4%.

Equities don't matter much

Except at the extremes, spending rates aren't sensitive to changes in equity allocations, Delorme believes. "As long as you're in that range [30% to 60%] there's not a huge difference in spending rate," he told *RIJ*. "I've found that how much you're spending each year is much more critical than your equity allocation. If your big concern is whether the portfolio will run out of money or not, lower spending is more important than a rising equity strategy.

"At the end of the day, it comes down to finding an asset allocation that you think people can stomach. I could tell recommend a 70% equity allocation, but if that makes them want to sell off in a downturn, it's not right for them. Reality doesn't always align with the model. For people in their 60s or 70s, I think 30% is reasonable."

Delorme's blueprint doesn't necessarily preclude the use of annuities during all or part of retirement as supplemental "flooring" to Social Security. In his calculations, there's a slot for pension income; that spot could be just as easily filled by a private annuity as by a pension. His rule of thumb: the higher the ratio of pension income to savings, the higher the safe spending rate from savings.

The AIER

The American Institute for Economic Research was founded in 1933 by Colonel Edward C. Harwood (1900-1980), an American engineer, businessman and economist who is said to have predicted the Great Depression. The non-profit AEIR, which also has a for-profit investment division, is best known for its research on the business cycles.

"Between the 1930s and 1950s, it was one of the few sources of that type of research," Delorme, who previously worked at the Center for Retirement Research at Boston College, told *RIJ*. "I've come in to start a new retirement planning, investing and personal finance division. The mission is to provide economic and financial research for average Americans."