Turning a Pot of Money into a Lifetime Paycheck

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An estimated 10,000 people are retiring every day, and this unprecedented surge of new retirees is expected to last for the next 17 years. Many, perhaps most, will roll their retirement plan assets into an IRA, and that money Ъ plus Social Security and any non-retirement accounts they may have Ъ must provide their living expenses for the rest of their lives. Lacking the pension that provided the equivalent of a retirement paycheck to retirees of a generation ago, todayŝ retirees face the difficult task of figuring out how to turn their lump sum retirement account into sustainable income throughout their retirement.

For example, suppose a 65-year-old couple retires and finds that they can start receiving $1,750 a month from Social Security, and that when their retirement plan assets are rolled into an IRA that they have a total of $3,000,000 between the IRA and their other accounts. With so much money in the bank, the couple feels comfortable joining an expensive country club, traveling around the globe, buying a large recreational vehicle, and remodeling their home. By age 68, they have $2,500,000 in the bank and are spending $170,000 a year. Should this couple still feel comfortable?

Trying to answer that question requires calculation financial planners who serve retirees wrestle with all day long; even when the calculations have been made, there are no definitive answers. Some of the pioneering research into safe spending in retirement, most notably by Bill Bengen, takes into account what is called ñsequence riskò ï meaning some unlucky retirees will experience a severe market drop in their early years that will make it more likely they will run out of money before they die. The research assumes the retired couple wants to increase spending each year at exactly the inflation rate so that they maintain spending power. The research then looks at historical market returns and identifies the spending level that would have survived even the worst sequence risk scenarios. The answer is a withdrawal of between 4% and 4.5% of the portfolio in the first year, with the dollar amount rising with the inflation rate each year.

In our illustration, Social Security covers $21,000 of the coupleôs annual living expenses, meaning the portfolio has to come up with an additional $149,000, indexed to inflation, for the next 30 years or so. That $149,000 withdrawal comes to almost 6% of the coupleôs $2,500,000 portfolio, a rate 1 ½ - 2 percentage points more than Bill Bengenôs suggested safe rate. The couple feels financially solvent, but they are really highly at risk if the market turns down in the next few years.

Further research, notably by Jon Guyton, has factored in the possibility that a retired couple will be willing to forgo inflation increases in years when their retirement portfolio has lost money. This so called ñadaptive withdrawalò strategy allows a retired couple to withdraw 4.8% of the portfolio in the first year. However, even under this more conservative scenario our hypothetical couple with an initial withdrawal of nearly 6% of their portfolio is still in the spending danger zone. And this only covers a 30-year period. People who live longer would need to live on somewhat less ï but how do you know how long you will live?

Other researchers, including Jim Shambo, have looked at the Bureau of Labor Statistics research on actual spending in retirement and found data that questions the assumption people in retirement only increase their yearly spending by the inflation rate. Shambo discovered that the government-calculated consumer price index (CPI) appears to understate by as much as 1 ½ percentage points actual yearly increases of retirement spending. Thus, if the CPI goes up by 3%, actual spending may rise by anywhere from 3.25% to 4.5%. Using a more complex calculation, Shambo found that people age 75 and older were spending between 13.2% and 22.01% more than the inflation statistics would suggest.

Of course, all this research focuses on surviving the worst-case scenario ï the times when the markets are least favorable to a comfortable retirement. If the investment market climate is, instead, sunny during the early years of retirement, and if our hypothetical couple happen to retire in the early years of a bull market, then their current spending will not be a problem and they may actually be able to increase their lifestyle expenditures.

The only way for you to try to stay in the safety zone and chart a course through the retirement income maze is to have a professional run the numbers every year (or at least every couple of years) in light of recent market activity and long-term guidelines. Converting a portfolio into a paycheck is a surprisingly complex exercise. Ten years down the road, when a few million baby boomers are well into retirement, you may be reading about some of the simple, innocent, and tragic mistakes they made with their spending decisions when they felt flush with cash.