

With a combined 50+ years of experience, 2X Wealth Group is committed to educating and empowering investors. We firmly believe financial literacy helps people make better decisions.

Safe Withdrawal Rates During Retirement

There is no such thing as a free lunch. This popular adage, suggesting it is impossible to get something for nothing, comes from a common practice in the 1930s where American bars would offer a free lunch to entice drinking customers. Since the 1970s, it has been used in economic literature to describe opportunity costs, or trade-offs, in financial decision making. For retirees, we think the concept applies quite well to decisions about withdrawal strategies from their investment portfolios.

As the time for retirement approaches, our clients become more focused on how they are going to live off their portfolios for the rest of their lives. The change from *earning* money and saving to no longer working and *spending* those savings can be anxiety producing and sometimes leads to poor decisions. In this blog, we discuss the various options, pitfalls, and benefits of various strategies.

Safe Withdrawal Rate

The safe portfolio withdrawal rate is defined as the amount of savings you can withdraw each year without running out of money before you die. Academic research on this topic typically uses a 30-year time horizon with a 90% probability of success (i.e. not running out of money). All expected withdrawal amounts are adjusted for inflation. Success rates beyond 90% generally lead to large portfolio balances when you die and a reduced lifestyle while still alive.

The 4% Withdrawal Rate Rule of Thumb

For many years, a 4% withdrawal rate was considered the gold standard. However, when interest rates fell dramatically in 2021, safe withdrawal rates declined as well. According to Morningstar, the highest starting safe withdrawal rate for a 30-year time horizon was only 3.3% in 2021, 3.8% in 2022 and returned to 4% in 2023. Because portfolios can rely heavily on income from bonds, when bond yields rise, they provide higher cash flows to retirees, and allow for higher safe withdrawal rates - which happened in 2022 and 2023.

Sequence of Return Risk

Negative market returns occurring late in working years or early in retirement can reduce the amount of money you can withdraw over the entire course of your retirement.

When you withdraw money from your portfolio after it has gone down in value, you must sell more investments to raise a set amount of cash. This process leaves you with fewer assets that can appreciate during subsequent market rallies, hurting your ability to spend money in the future. A more conservative investment approach during these periods can mitigate sequence of return risk.

The Withdrawal Strategy You Choose Depends on Your Goals

There is a tradeoff between higher withdrawal rates, steadier cash flow streams and having more money for beneficiaries at death. Some people want to maximize withdrawals while living and have almost nothing left when they die. Others want to live comfortably but also provide for heirs or other beneficiaries. Some are more concerned about having very steady cashflows even if it means their spending levels will be lower. To evaluate the six strategies presented below, we used the Morningstar report [The State of Retirement Income: 2023](#) published in November of this year. We divide the strategies between those with a primary goal of steady income versus a goal of higher spending levels.

Primary Objective: Predictable Income Stream

1. Fixed Real Withdrawal Rate – the most commonly used strategy. The retiree starts with a fixed withdrawal amount in the first year of retirement. Today that would be 4% of the portfolio (based on the 2023 safe withdrawal rate). Subsequent withdrawal dollar amounts are adjusted by inflation every year.

Pros

- Predictable paycheck like income
- Likely high ending portfolio value at death for beneficiaries

Cons

- Doesn't maximize lifetime withdrawal rates
- Can lead to lower than preferred lifestyle and may leave too much money to beneficiaries

Good balance of lifestyle and opportunity to leave money to heirs.

2. Forgo Inflation Adjustment – compared with Strategy 1, the retiree starts with a higher fixed withdrawal amount in the first year of retirement. Subsequent withdrawals amounts are typically adjusted by inflation every year. However, to increase the likelihood of success, when the portfolio goes *down* substantially in value, you forgo the inflation adjustment in the following year. This change has a ripple effect through all subsequent withdrawal amounts.

Pros

- Paycheck like equivalent, with some minor variation
- Allows for higher initial spending than Strategy 1
- The tradeoff for higher initial withdrawals is modest income reductions in the future if portfolios decline
- Leads to lower but still healthy ending portfolio values than Strategy 1

Cons

- While starting withdrawal amounts are higher, lifetime withdrawals will be lower in the case of adverse portfolio performance

Good for retirees who want consistent income but a higher starting withdrawal amount.

3. Treasury Inflation Protected Securities (TIPS) – This strategy involves purchasing individual TIPS for each year of retirement and creates an essentially risk-free fixed withdrawal retirement strategy. Each year, an individual TIP matures and provides a fixed dollar amount adjusted for inflation.

Pros

- 100% success rate assuming the U.S. Government doesn't default
- Provides a higher safe withdrawal rate

Cons

- Very rigid strategy and portfolio goes to zero after the last TIP matures
- No equity upside for possible beneficiaries
- More difficult strategy to implement

Good for retirees who don't have longevity risk and don't plan to leave anything behind.

Primary Objective: Highest Possible Withdrawal Rate

4. Required Minimum Distributions (RMDs) – calculated by dividing the prior year's ending account balance by your remaining life expectancy. The resulting number is the dollar amount you can withdraw during the year. This strategy allows for the highest starting and lifetime withdrawal rate of all the strategies analyzed by Morningstar.

Pros

- Much higher starting and lifetime withdrawal rates than other strategies

Cons

- Annual spending amounts vary significantly - by 60% on a typical 60% equity/40% bond portfolio
- Portfolio values at death are low if you want to leave money to beneficiaries

Good for retirees with shorter than average life expectancy or have substantial other sources of income to cover fixed living expenses and don't plan to leave money to beneficiaries.

5. Higher Spending in Early Years – Withdrawal rates are based on a specific plan of spending, more in the first part of retirement and less in later years. Beware if income in later years is too low to support long term care unless a long-term care plan is in place.

Pros

- High cash flow predictability
- More money available for spending when retirees are likely to spend the most
- High expected ending portfolio value at death

Cons

- Very low spending late in retirement can be a problem for long-term care
- Does not maximize *lifetime* withdrawal rates

Good for retirees who want to spend more in early retirement but still want the opportunity to leave substantial money to beneficiaries.

6. Guardrails – After an initial withdrawal rate is set, guardrails determine future withdrawal rates dependent on market performance. If the portfolio goes up substantially withdrawal rates can increase, and if portfolio values decline substantially, withdrawal rates must decrease. This strategy is similar to the RMD, but it has slightly more stable cash flows.

Pros

- Allows for high initial and lifetime withdrawal rates.

Cons

- More complicated and difficult to implement.
- Highest cash flow volatility other than RMD strategy.
- Low portfolio value at death if you want to leave money to beneficiaries.

Good for retirees who prioritize spending over leaving money behind and don't mind altering their spending based on portfolio performance.

Impact of Portfolio Investment Style

The amount of equities in investment portfolios can have a significant impact on withdrawal rates and the success of your withdrawal strategy. Morningstar's analysis assumes 40% in equities with the remainder in cash and bonds. Many find that level of equities too conservative.

What happens if you use more than 40% percent in equities? During the years shortly before retirement and shortly after, portfolios with higher equity levels can experience more severe sequence of return risk if the stock market falls dramatically (or for an extended period of time). Further, in the RMD and Guardrail strategies, higher equity percentages increase the variability of cash flows significantly. Higher equity percentages aren't all bad. If you are willing to use a variable investment strategy such as RMD or guardrails, higher equity percentages can lead to higher lifetime withdrawal rates and more money to leave to heirs.

Conclusion

In developing a withdrawal strategy, the first step is to decide what is most important to you - steady income, higher spending or leaving money to beneficiaries. The rest of your choices flow from your priorities. Keep in mind the following:

- Even though you may have been good at saving for retirement, living off a retirement portfolio is entirely different.
- Understand your risks - those you can control *and* those you can't control
- Over time, your goals may change, and you can always readjust your strategy.

If we can help, please get in touch.

Need help sorting this all out? Make an appointment with us to help you through it.

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