How to Ruin Your Retirement

The Motley Fool
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Ah, retirement. What could be better than a reliable income that doesn't depend on how you spend your time? You could lie around in your pajamas all day, subsisting on beer and doughnuts, and you'd still receive checks from your pension, brokerage, and Social Security. (Now that's one way to Rule Your Retirement!) And well you should — you've worked for decades for the freedom to play all day and still get paid.

Unfortunately, over the past few years, many retirees have had to put away their pajamas and un-mothball their business suits. The bear market certainly is the biggest culprit — but not the only one. Many retirees received bad advice on how they should spend their savings. Let's look at an example.

Meet John, who at the end of 1999 was 60 years old. For decades he was a faithful saver, stuffing his retirement accounts with growth-oriented investments — companies such as **Cisco** (Nasdaq: CSCO), **Intel** (Nasdaq: INTC), **Qualcomm** (Nasdaq: QCOM), and other big boys in the Nasdaq **Cubes** (AMEX: QQQ). He had been handsomely rewarded, building a $2.5 million nest egg.

With gold watch and 30-year service plaque in hand, as well as the sage advice of his personal financial planner, John and his better half decided that it was time to start the enjoyment phase of their lives. He was advised he could withdraw $150,000 annually from his portfolio — 6% of the total value. The first distribution took place on Jan. 1, 2000.

Bears and withdrawals take their toll
Fast-forward to Jan. 1, 2004. The account is now worth approximately $625,000. Three-fourths of the market value from 48 months ago has vanished. How is this possible? His financial planner told him that his plan was OK — but it clearly was not. His account can't possibly last another three years, much less another 30. What went wrong?

As we all know, during the period of Jan. 1, 2000, to Jan. 1, 2004, the value of the Nasdaq dropped 51%. During that same time period, John disbursed 24% of the account principal to himself. For the past few decades, growth stocks worked well — sometimes really, really well. John did not need or want any of that money during those years. Instead, the whole purpose behind the IRA was grow, grow, and grow some more.

But on Jan. 1, 2000, John assigned his IRA a new task: Create income. Yet John did not change his investments. He figured that since growth worked for the last 30 years, it should still work reasonably well for the next 30. He failed to see the conflict between the investments and the changed objectives.

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A better plan

What if John had moved 75% of his assets to more income-oriented vehicles — some mixture of Treasury investments, corporate bonds, real estate investment trusts (REITs), and preferred stocks — and left 25% in growth-oriented common stock? Depending on the assumptions, John's portfolio would be worth between 90% and 110% of the Jan. 1, 2000, value. John would still be on a warm beach, enjoying himself. Instead, he's scouring the newspapers and reactivating his personal network to look for a job.

We can also look at John's predicament (and how to avoid it) from a different perspective. John started with $2.5 million and withdrew $150,000 per year, a 6% annual withdrawal rate. Numerous studies have examined how much retirees can withdraw from their retirement accounts and be reasonably confident that they won't outlive their savings. Experts have established that portfolio survivability is highly correlated to four factors:

So let's revisit John in January 2000. At age 60, he has a life expectancy close to 30 years and would certainly like his savings to last his lifetime with a series of inflation-adjusted annual withdrawals. How should he invest, and what should be his beginning withdrawal rate? The short answer: John should invest somewhere in the vicinity of 50% equities and 50% bonds, and his initial withdrawal rate should be somewhere between 3.5% and 4%. Further, if John has a minimum bequest he would like to make, then the initial withdrawal rate goes down closer to 3%.

Note that these studies require a leap of faith. They examine the past 75 to 100 years and make the core assumption that the next 25 to 100 years will look pretty much the same, at least regarding the performance of basic asset classes (particularly bonds and stocks). But the evidence is solid on two points:

Those two points will determine whether someone John's age will be flipping burgers at **McDonald's** (NYSE: MCD) or **Wendy's** (NYSE: WEN) at 90 or whether he will be paying his estate attorneys outrageous amounts in fees to transfer his assets to his heirs without undo tax burden. Neither alternative is perfect, but the latter is certainly preferable to the former.

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