Secure Your Retirement Income With These Three Essentials: Uncommon Knowledge for the Common Good III

Saturday's With Jim

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Key Points:

- Three things are critical to retirement income success:
  - Rate of withdrawal
  - Investment rate of return
  - Sequence of those rates of return
- A long-term 2% spread of investment rate of return over withdrawal rate offers a sustainable safe harbor for our capital
- If we begin retirement when stocks are at unsustainably high valuations or just before war or recession seriously threaten, we must lower the stock allocation until valuations normalize or thereabouts

Dear Friends,

We've written over the last couple of weeks in the "Uncommon Knowledge" series about how to optimize savings and investments over the short term (under 15-20 years maximum) and over the long term (20 -25 years or more). Today let's examine three drivers which, if practiced successfully, will greatly enhance our chances of a comfortable and financially secure retirement. Looking beyond such obvious requirements as having adequate savings for emergencies and health care, enough retirement capital to meet at least our minimum retirement income requirements and our expected longevity from the date of retirement, there are three investment-specific drivers of our retirement income. These drivers are:

- Rate and timing of withdrawals
- Investment rate of return on our retirement capital
- Sequence of those returns

Let's look at the first two drivers together. It's not hard to see that if we earn 3% on our money and withdraw 4%, our capital will deplete if we live long enough. But it's not really clear what the optimum relationship between our rates of return and our withdrawals should be. The answer depends on the number of years we

expect to draw on our funds, our experience with inflation and the amount we want to have in reserve at all times and at the end of life for bequests. For taxable accounts, minimizing income taxes while not compromising returns helps to increase our after tax return - the money which can actually go in our pockets.

The dance between withdrawal rate, investment rate of return and the sequence of those returns

If we achieve an average 2% positive differential between our withdrawal rate and investment rate of return, we will with a very high degree of probability not outlive our resources. But what if we achieve little or no return on the stock portion of our portfolios in the first five or ten years while still drawing our recommended rate of 4% from our accounts? We preserve our capital for later withdrawals by not fully investing our stock allocation when stocks are very, very overvalued, as they were in 2000 and 2007. We also must go light on stocks if a recession threatens or war clouds appear as they will cover wide areas, raining death and destruction upon the world and our precious capital. We must instead lean more heavily on the only asset types which do not move the same direction as stocks – quality bonds and cash. In short, account management will help us steer clear of making portfolio decisions which will harm our ability to earn enough in later years to sustain us.

How much "spread" is enough?

The optimal spread between investment rate of return and withdrawal rate will vary for each person by their needs, their account size, the expected number of years the account must provide income and the amount of bequest desired.

Concluding

Two areas of concern need to be addressed to ensure that our retirements will be successful. First, we must develop a retirement lifestyle that suits us. Second, we must arrange our finances so that they are sustainable within our chosen lifestyle, always aware that inflation eats at fixed incomes (bank CDs and bonds). We must be very wary of beginning retirement, only to suffer early and significant market losses over a multi-year period as they normalize by returning (and sometimes passing for a time) the mean long-term investment return we can expect. In other words, we can accept shallow losses so long as the general trend of our capital growth is upward, but we must avoid the deep losses that inevitably arise when we invest our lump sum in seriously overvalued and frothy markets. We use account management techniques to reduce the stock (most volatile portfolio asset type) proportion until we arrive at or near a market bottom.

Thank you for investing with us.

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