Give Your Retirement Spending a Boost

August 2, 2004

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Here's the dilemma: You want to enjoy the golden years you've worked so hard for all your life, but, frankly, you're held back by the nagging fear you may run out of money before you die.

Is there a practical solution for this uncomfortable balancing act? As with dieters searching for that magic pill that will melt the pounds away without exercise, easy answers are in short supply. Postponing retirement and reducing your standard of living are viable options, but only up to a point: You can't work forever, and there's likely a minimum amount you need to spend.

Depending on your circumstances, however, there's another option: Create your own defined benefit pension by purchasing an immediate fixed annuity.

A rule of thumb for retirement

In Spending Confidently in Retirement we talked about how much you might need to have saved when you retire. If you're a conservative-to-moderate investor and you want a high level of confidence you can maintain your standard of living and keep pace with inflation for 30 years, the basic rule of thumb is this: You should shoot for a portfolio approximately 25 times as large as your first-year portfolio withdrawal.

This roughly translates into a 4% withdrawal rate in the first year of retirement. Some folks get confused on this point. It doesn't mean you withdraw 4% of your portfolio's value each year. If you did, your cash flows would be all the over the map, up in some years and down in others as your portfolio fluctuates over the short term. Remember, you want to strike a balance between not running out of money prematurely AND maintaining a reliable standard of living, adjusted for inflation, from one year to the next.

In order to achieve a 90% confidence level of sustaining cash flows in retirement, the 4% withdrawal rate applies to the *first year only*. After that, the goal is to grow the first-year *dollar amount* for inflation each year throughout your retirement.

A do-it-yourself pension

A fixed annuity can increase the likelihood of maintaining your lifestyle in retirement without running out of money too soon. We'll use a hypothetical example to illustrate:

Larry's ready to retire. He's accumulated $1 million in retirement savings, allocated as 40% stocks, 50% bonds and 10% cash. To maintain his desired standard of living, he estimates he'll need $65,000, pre-tax, in his first year of retirement.

Larry would like to grow that amount each year to keep pace with an expected average annual inflation rate of 2.7%, and he wants to be at least 90% confident he won't run out of money for at least 30 years.

Since he'll receive $21,000 in Social Security his first year of retirement, adjusted for inflation thereafter, Larry will need to withdraw $44,000 from his portfolio ($44,000 withdrawal + $21,000 Social Security = $65,000 first-year spending). The problem is, that's a first-year portfolio withdrawal rate of 4.4%, well above the approximate 4% rate associated with a 90% spending confidence level.

In fact, growing that first-year withdrawal of $44,000 for inflation over 30 years reduces the probability of success to about 75%—in other words, there's a 25% chance his portfolio won't last. Assuming Larry is unwilling to live with a confidence level of 75%, he would need to immediately reduce his standard of living by roughly $333 per month, supplement his income by working part time, or do a combination of both.

There's a third alternative, however. Larry could take a portion of his retirement portfolio and purchase an immediate fixed annuity with a lifetime payout. Given current interest rates, he might expect to obtain about $24,000 per year for the rest of his life (single-life annuity) with a $300,000 lump-sum payment (30% of his $1 million portfolio). Larry now only needs to make a first-year withdrawal of $20,000 ($20,000 withdrawal + $24,000 annuity + $21,000 Social Security = $65,000 total spending) from his remaining $700,000 portfolio, which he continues to manage under a moderately conservative asset allocation.

By exchanging a portion of his portfolio assets for the promise of lifetime cash flow, Larry can effectively withdraw 4.4% of his pre-annuity portfolio in year one—more cash than the general 4% target provides—and still be 90% confident he can maintain his desired lifestyle for 30 years. The reason? The fixed annuity provides guaranteed income that never fluctuates and can't be outlived. (The guarantee of income for life depends on the issuing insurance company's ability to pay claims, so be sure to choose a financially strong company.)

The combined $44,000 Larry needs from his annuity and portfolio in his first year of retirement will increase each year due to inflation (Social Security is adjusted automatically). But the $24,000 from the annuity in this example stays flat for the rest of his life—it never gets a cost of living adjustment (COLA).* Every year, Larry will need to withdraw a little more from his portfolio to make up the difference.

Think of it this way: After Larry buys a fixed annuity, his $700,000 portfolio has to do double duty as far as inflation is concerned. Not only does it have to allow for withdrawals that keep pace with inflation over 30 years, but it has to compensate for the annuity payment's gradual loss of purchasing power over that time. So the first-year withdrawal rate needs to be lower than the normal 4% guideline—the idea being to withdraw a little less from the portfolio now so there's potentially more later, when it's needed.

In this case, Larry looks to be in good shape. The $20,000 he withdraws in his first year of retirement is a little less than 3% of the $700,000 portfolio that remains after purchasing the annuity ($20,000 / $700,000 = 2.9%). He's comfortably below the normal 4% target.

This hypothetical example shows how purchasing a fixed annuity with a portion of your retirement portfolio can help you boost your confidence for a given level of spending. Similarly, a fixed annuity might let you spend more

* While you can buy fixed annuities with COLA protection, they require a bigger lump sum up front for the same monthly payment, all else being equal (proving again that there's no free lunch).

than you originally planned, without sacrificing your desired level of confidence that you won't run out of money too soon.

What's more, a fixed annuity provides a spending floor—a minimum cash flow you can rely on regardless of your portfolio's performance. In our example, Larry would continue to receive his Social Security and annuity payments no matter what's happening to his stocks, bonds and mutual funds.

So, is adding a fixed annuity to a retirement portfolio the financial equivalent of that elusive "magic diet pill?" If so, why aren't immediate fixed annuities more popular?

A closer look at fixed annuities
You may already be familiar with deferred variable annuities. Here, we're talking about **single premium immediate fixed annuities** (SPIA)—"single premium" meaning you pay for the annuity with a lump sum, and "immediate" meaning it starts kicking out payments right away.

By pooling investor assets and averaging mortality rates, insurance companies are able to offer annuities that can provide a source of regular, monthly income for the rest of your life.

So why have fixed annuities been less popular than their variable cousins with investors? Three possible reasons:

- In the past, more people received defined benefit company pensions.
- The mega-bull market between the early 1980s and 2000 may have convinced many folks they would always do better under a variable structure.
- Loaded variable annuities can be more profitable for salespeople paid by commission.

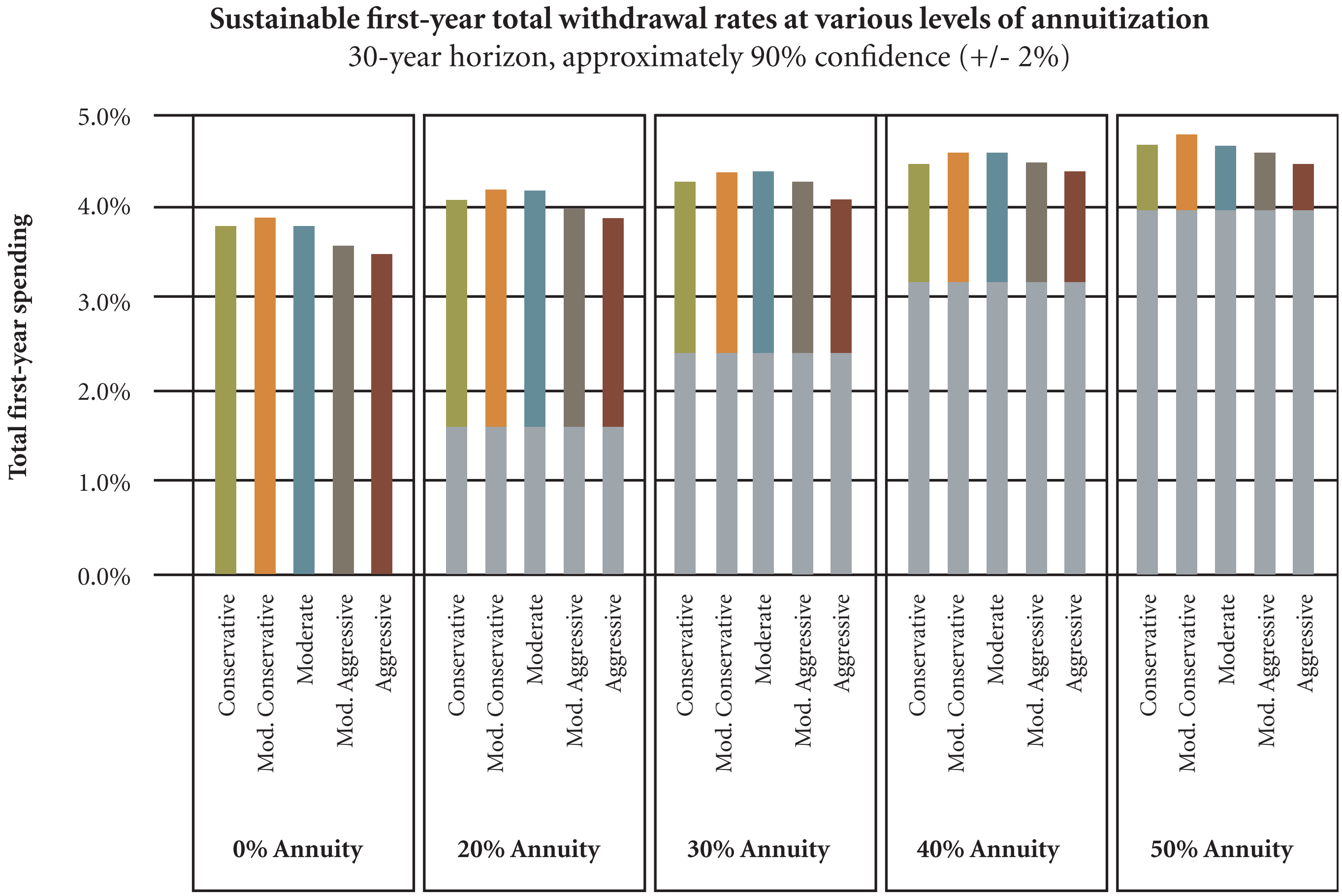
Whatever the reasons, we believe immediate fixed annuities will likely play an increasingly important role in planning for retirement income.

Of course, people who manage to save a huge portfolio relative to their retirement spending needs may not need to worry much about "immunizing" their cash flows. And for those who've saved little to nothing, an immediate fixed annuity may not be a viable option.

But for the many investors somewhere in the middle, a low-cost immediate fixed annuity might be an appropriate solution.

How much of your portfolio should you annuitize?
In the hypothetical example above, Larry boosted his confidence that he could spend as planned in retirement from about 75% to 90% by annuitizing 30% of his moderately conservative portfolio. In fact, depending on current interest rates and how much of his portfolio he was willing to annuitize, he might have been able to increase his sustainable spending even more.

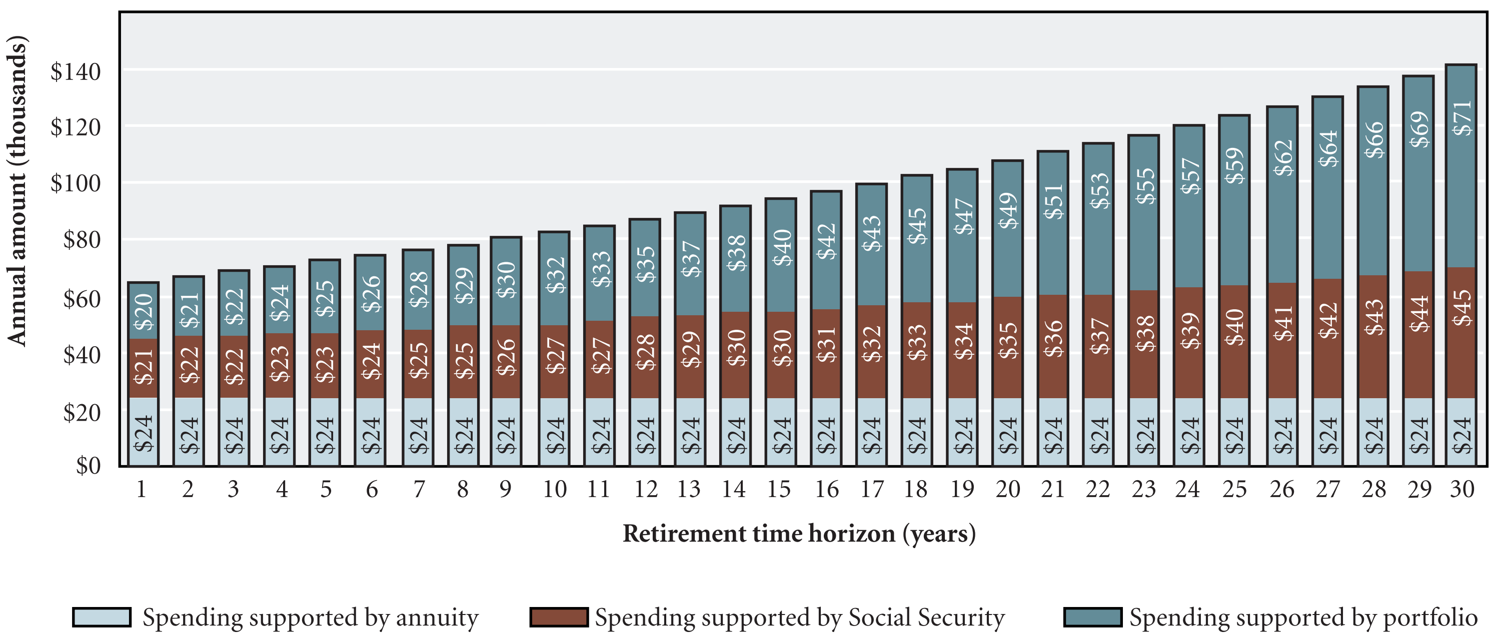
The chart below shows how sustainable first-year spending (as a percentage of the pre-annuity portfolio) can rise at various levels of annuitization.



Annuity estimates are based on a 65-year-old male, single life, at a time when the 30-year Treasury is yielding approximately 5.5%.

Over time, the portion of total spending that comes from your portfolio would increase relative to your annuity payment, which stays flat (that's why it doesn't make sense to annuitize much more than 60% of your portfolio unless you purchase COLA protection). Based on our example, here's what it might look like, with Social Security thrown into the mix:

Annual retirement spending grown for inflation



Remember, the annuity payment in the chart is hypothetical. In the real world, actuarial assumptions and your choice of annuity options (period certain, joint life survivor, inflation adjustment, etc.) will affect pricing. Importantly, all else being equal, pricing for immediate fixed annuities is very sensitive to current interest rates. Your level of sustainable spending would likely go up if you could lock in your annuity payment at a time when interest rates are higher. Conversely, during a period of lower interest rates you would get a smaller annuity for the same lump sum. See Shopping For A Fixed Annuity for more on how to evaluate the purchase of an immediate fixed annuity.

Also keep in mind that when you buy an immediate fixed annuity you're trading an asset for the promise of a future cash flow. Some folks just aren't comfortable letting go of a large portion of their assets in this way. But it doesn't have to be an all-or-nothing choice. For some, just having a minimum level of assured income is all it takes to provide the comfort they're looking for.

Estate goals enter the picture here as well. Deciding how much of your portfolio to annuitize may include a compromise between your goal of living comfortably in retirement and the desire to leave something behind after you're gone. Everyone's different in this regard.

How to allocate what's left in your portfolio?

Once you've annuitized a portion of your retirement portfolio, some might say you can afford to take on more risk—in other words, allocate more of your remaining portfolio to stocks since you don't have to rely on it as much.

One justification for this approach involves taking the annuity payment and imputing it onto your balance sheet as if it were the equivalent of a low-risk asset. For example, if high-quality bonds are yielding 5%, then having a $24,000 income stream is like having $480,000 in bonds ($24,000 / 0.05 = $480,000).

There are several problems with this line of reasoning. First, it assumes you'd be able to consistently maintain that yield and only spend interest income. Living solely off interest income implies a much bigger portfolio. For many, it's more practical (and realistic) to draw down both return and principal over time—as is the case with an immediate fixed annuity (which is why Larry only needed a $300,000 lump sum in our hypothetical example).

Second, although they look nice on paper, imputed assets don't really exist. That's why they're sometimes called phantom assets. Your risk tolerance is what it is, and isn't likely to change because of a hypothetical. Say there's a period of market adversity during your retirement—if your remaining portfolio is allocated too aggressively to suit your personality, your head may have a hard time convincing your gut that all's well because of your "imputed" balance sheet.

There's a more concrete reason why it may not be such a great idea to get too aggressive with your remaining portfolio. Anything short of 100% annuitization means your portfolio will still need to generate some level of reliable cash flows. And, as mentioned above, your remaining investments will also need to protect your annuity income from inflation (unless your annuity offers COLA protection). This results in an increasingly higher rate of withdrawal from your portfolio, which, if your allocation is too aggressive, can put excessive pressure on your assets in later years. Structured properly, your remaining portfolio should provide adequate protection from inflation at your desired level of confidence that your money will last.

Risk does have its rewards—to a point

Is there *any* potential benefit to increasing risk in your retirement portfolio? If your focus is sustainable spending, taking on risk beyond the moderate level could work against you. When you're in portfolio distribution mode, the increased volatility associated with riskier portfolios tends to offset the higher expected return.

Taking on more risk can work well for younger investors still in accumulation mode. At this stage, cash flows are going *into* the portfolio over a long period of time, and during an adverse market additional investments can be purchased at lower prices. But when money's coming *out* it's hard to recover from downside volatility, especially if it occurs in the early part of your retirement—you may be forced to "sell low" in order to fund your spending needs.

However, sustaining cash outflows is only part of the picture. You could increase your chances for potential upside wealth by taking on more risk. But don't forget the first chart above—spending confidence levels are similar between conservative and moderate portfolios. So taking on more risk up to the moderate level (if you can tolerate it) could provide the best of both worlds: greater potential for upside wealth without giving up much in terms of sustainable spending. Above the moderate level, however, the tradeoff becomes less favorable if spending confidence is your primary goal.

The table below shows the upside wealth potential of various model portfolios at the end of 30 years, again based on the case of our hypothetical retiree Larry. Remember, at the 90% confidence level you expect to meet your inflation-adjusted spending needs over 30 years (you end up with $0 or more at the end). Conversely, it means there's a 10% probability your money will run out at some point shy of 30 years.

Think of the confidence levels below in the same way. For example, if Larry decided to shift his portfolio allocation from moderately conservative to moderate, he wouldn't give up anything in terms of sustainable spending because the first-year withdrawal rate is the same for both. But he would significantly increase his chances of accumulating more wealth at the end of the day.

As you look at the table, keep in mind that a 50% confidence level is like flipping a coin—roughly half the outcomes could be better and half could be worse. The 25% confidence level means three-quarters of the outcomes are expected to be worse. Ideally, you should shoot for a high level of spending confidence when possible and not stake your future on a long shot.

Potential ending wealth after 30 years

	Portfolio allocation			
	Conservative	**Moderately Conservative**	**Moderate**	**Moderately Aggressive**
Initial investment	$700,000	$700,000	$700,000	$700,000
First-year withdrawal (grown for inflation thereafter)	($19,000)	($20,000)	($20,000)	($19,000)
Ending wealth after 30 years				
75% confidence level	$298,700	$496,600	$743,600	$1,060,400
50% confidence level	$667,400	$1,291,700	$2,028,700	$2,919,500
25% confidence level	$1,105,300	$2,319,300	$3,934,900	$6,570,600

Of course, if you NEVER need to touch your portfolio because all your needs are met from other sources of income, including your annuity, then you might be willing to be more aggressive.

The bottom line
An immediate fixed annuity could help you boost your retirement spending by taking some of the pressure off your remaining portfolio.

Of course, you'll still have to manage your portfolio, taking income from dividends, interest, mutual fund distributions, and, most likely, the sale of shares as part of your periodic rebalancing (see Generating Cash Flow From Your Retirement Portfolio).

Still, having that annuity check wired into your account every month might make the process a little less stressful. Be sure to get professional help if you need it, particularly as you get started.

Disclosure

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