Creative
wealth maximization strategies*

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"GUARANTEED" Is Better Than "Safe"

Remember story problems from high school math? Try this one, taken from an October 2013 *USA Today* article:

> **Assume that:**
> **R - is the amount of money you'll need to retire.**
> **X - is the number of years you'll live.**
> **Y - is your rate of return.**
> **Z - is the rate of inflation.**
> **You have no idea what X, Y, or Z is.**
> **Solve for R.**

This is the reality of retirement planning. While there are many after-the-fact aspects that can be quantified by numbers (accumulation values, rates of return, asset allocation percentages, etc.), success can't be guaranteed by adherence to a mathematical formula. *Because there are too many unknown variables.*

Instead, retirement experts often rely on rules of thumb for guidance. These standards are not exact, but if followed, they give individuals a reasonable chance for success. Many of these rules of thumb are for saving, how much you should set aside each year, the returns you should expect on these deposits, and how big an accumulation you'll want before you retire.

Using these benchmarks to guide the accumulation phase of retirement planning is easy and has little risk. If, for whatever reason, you don't save as much or receive the expected returns, you can adjust. You can save more, reallocate assets, work longer, or reframe your retirement goals.

It's when you get to retirement, to actually spending what you've saved, that using rules of thumb becomes a bit more challenging. Because, if reality doesn't match the assumptions, it's not as easy to adjust, and the consequences may be dire. An example is the Safe Withdrawal Rate.

The Safe Withdrawal Rate

The ultimate objective in retirement planning is to provide the largest possible income from accumulated savings without running out of money. Maximizing income requires the spending down of accumulated principal (as opposed to just drawing off the earnings). But how much can be spent down? That's the question the Safe Withdrawal Rate attempts to answer.

A **Safe Withdrawal Rate** (SWR) is an amount, usually expressed as a percentage, which can be withdrawn over a given period, and not lead to portfolio failure; i.e., running out of money. "Safe" is an SWR expected to have a success rate of 95% based on historical returns over the past 100 years or so. A Safe Withdrawal Rate also usually includes annual adjustments for inflation.

From its introduction as a rule of thumb in the 1990s, a prevalent safe withdrawal rate for a 30-year retirement has been 4 percent. However, several periods in the mid- to late-20th century featured atypically high returns. With a growing consensus that future returns will not consistently reach the highs of the recent past, and with lifespans continuing to inch up, many experts believe the SWR should be adjusted down.

Now, "3 percent is the new safe withdrawal rate," says Wade Pfau, a professor at the American College of Financial Services, who is sort of the Albert Einstein of SWR studies. "The 4 percent rule may be too high for those focused on identifying a sustainable withdrawal rate that will not deplete a portfolio over a 30-year period." This means…

If you have accumulated $1 million for

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retirement, an SWR of 3% results in a first-year retirement income of $30,000. With a projected annual inflation rate of 2%, next year’s income would be $31,600, and $32,212 in the third year. After 30 years, the total annual income would rise to $53,275.

What If 3% Isn’t Enough?

Lowering the SWR to 3% means a larger accumulation is required to produce the same income. If a first-year income of $40,000/yr. would allow you to retire at 65, a Safe Withdrawal Rate of 4% means accumulating $1 million. To produce the same income with the SWR at 3%, the capital requirement is 33% more, $1.33 million. If you’ve been saving with a 4% SWR in mind, this change could upset your plans, especially if you are close to retirement, and don’t have much time to accumulate additional capital. So what can you do if you want, or need, to spend more than 3 percent?

That’s a question *Wall Street Journal* personal finance writer Anne Tergesen put to several retirement experts in a February 10, 2018, article. Their response: start with a higher withdrawal rate, but be prepared to forgo inflation adjustments, and even reduce income, in the future. One scenario starts at 5%, but stops making inflation adjustments in any year when principal declines. Another begins at 5%, but requires a 10% reduction if the previous year’s withdrawals and investment results make next year’s income greater than 6%, because this indicates that principal is being consumed too quickly. (But you can give yourself a 10% increase if the amount drops below 4 percent.)

But whether you use a safe withdrawal rate or a less-safe modification of it, you alone are responsible for the management and investment risks associated with this approach. And this responsibility isn’t just at the beginning of retirement, but for every year thereafter. Maintaining a Safe Withdrawal Rate requires a lot of work, and a lot of money, and at least a little anxiety. Because, it’s up to you to *not* run out of money.

Given these challenges, it is somewhat surprising that other retirement income strategies don’t seem to get the same attention as SWRs. Like one that eliminates personal management and investment risk, requires less capital, provides more income – and ***guarantees*** you will not run out of money.

Joining a Group, Buying Guarantees

Individual retirement planning requires each household to account for every possible X, Y, and Z variable by themselves. But when individuals elect to become part of a large group of retirees who pool their funds under an insurance company’s management, in exchange for monthly payments, the math changes.

Instead of one person with an uncertain lifespan, retirees are members of a group with fairly well-defined life expectancies, i.e., out of this cohort, x number will die each year. These very accurate projections allow actuaries to guarantee lifetime payments for all participants. Thus, it becomes possible to make withdrawal plans not on an uncertain, changing rule-of-thumb basis, but from calculations with a high degree of certainty.

Suppose instead of committing the entire $1 million to an SWR plan, a 67-year-old male allocates $700,000 to purchase an immediate lifetime annuity, from which an insurance company promises to provide an annual income of $49,464 for the rest of the retiree’s life, no matter how long he lives.*

Compare this result to the income resulting from a safe withdrawal rate of 3% applied to a $1 million accumulation, with a 2% annual increase for inflation *(see graph)*. Some notes:

- The historic results of a self-managed SWR option would vary depending on the actual rate of inflation. The projection of 2% is close to the most recent 30-year average, and is also the Federal Reserve’s target number.
- The gradually rising income from a 3% safe withdrawal rate doesn’t exceed the guaranteed lifetime income from the $700,000 immediate lifetime annuity until year 28.
- A decision to use an annuity for income leaves $300,000 of “free capital,” i.e., money that doesn’t have to provide retirement income. This free capital can be invested, spent, serve as an inflation adjustment in later years, or left as an inheritance.
- The annuity transfers all management and investment risk to the insurance company.

So…are you sure you want to manage a safe withdrawal rate for the rest of your life?

“Yeah but…”

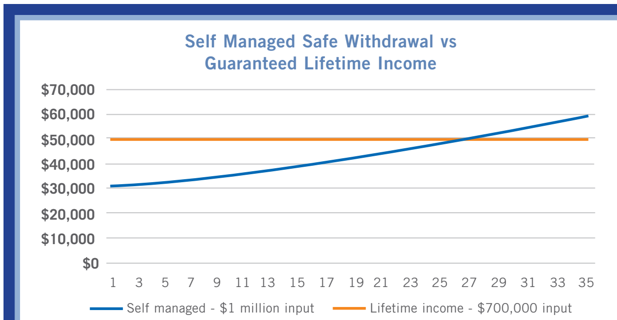
For someone who lives past life expectancy, a lifetime annuity is a great decision. But what about other situations? Like what if the $1 million has to provide income for a 65-year-old wife, and the husband dies first? Among the possible options:

Buy a lifetime annuity that will guarantee payments as long either one is alive. For $700,000, a joint life annuity provides $39,312 of annual income, which is still 31% more than the SWR starting at $30,000. The crossover doesn’t occur until year 18, and there is $300,000 in reserve to supplement income.

Buy the annuity on the husband, and invest the remaining $300,000. If the husband dies first, the accumulation can buy a life annuity for the surviving wife. If the husband lives to 80 before passing, that’s 13 years of accumulation. At an average annual return of 4%, $300,000 grows to $480,000. Using today’s rates, a lifetime annuity for a 78-year-old female would provide an annual lifetime income of $44,750 – for just one person, not two.

The very worst case would be for the husband to die shortly after starting the annuity, leaving his widow with the smallest principal and the longest period for which to provide income. This scenario could be addressed, if the husband is in good health, **by buying a $700,000 life insurance benefit on the husband** (perhaps using some of the “free capital”), to replace the annuity principal.

There are ways to address these challenges. Details will vary with individual circumstances, but the guarantees of an annuity might prove better than a safe withdrawal rate for both income and security.



If you haven’t yet considered how joining a group and buying guarantees might work, this article is a good starting point.

The next step is meeting with a financial professional to see what variation of this concept might work for you.

* An annuity guarantee is based on the claims paying ability of the issuing company.