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Retire Now, and Risk Falling Short on Your Nest Egg

By TARA SIEGEL BERNARD

If you have just retired or are about to retire, your timing could not be worse.

Leaving the work force just as markets stumble can do real damage to retirement savings. Your nest egg has shrunk just as you need to start withdrawing money from it; you are essentially locking in your losses. (And at the moment, sinking home values make matters even worse.)

Of course, if you have managed to put away much more than you will ever be able to spend, you can stop reading now. This article is for everybody else — those who thought they had saved just enough but now fear their retirement funds will not last.

If the market plunges while you are still early in your career, you have plenty of time to make up for it. In fact, market declines work in your favor while you are still on the payroll; they allow you to buy more stock or mutual fund shares cheaply. But should the market plummet the day after your retirement party, or even in the first years after, the risk that you will outlive your savings increases sharply.

“Any money that retirees take out of their portfolios or that they lose in market declines in the first five years of retirement has a higher cost because it’s money that won’t be invested to earn returns in succeeding years when the markets recover,” James Tzitzouris Jr., an investment analyst on T. Rowe Price’s asset allocation team, said in a study. “And the less they have invested after a bear market, the less potential they have to benefit from the compounding of any earnings in subsequent years.”

Right now, we are dipping in and out of bear territory. That is why it is crucial, especially if you are on the cusp of retirement or recently retired, to look closely at how your portfolio is invested. You should make sure your money is divided across different slices of the stock and bond markets. You also need to be sure your allocation is one your stomach is strong enough to handle.

The conventional wisdom is: ride with the ups and downs in the market and all will work out in the end. But retirement is the proverbial end.

Look at it this way. Since Nov. 28, 1980, there have been five bear markets, if we count the current downturn. Yet the market has managed to return an average of 8.62 percent to investors annually, as measured by the Standard & Poor’s 500-stock index as of Aug. 1. If you include dividends, the S.& P. 500 has yielded an 11.38 percent return on an annualized basis.

But financial markets do not travel in straight lines. If you happen to retire when those lines are pointing downward, you may have to make some sacrifices. And yes, that may involve working longer or spending less.

“It’s all about trade-offs,” said Christine Fahlund, senior financial planner at T. Rowe Price. “There is no perfect solution.”

Take a 65-year-old investor who retires with a $500,000 portfolio, with 55 percent invested in stocks and 45 percent in bonds. She withdraws 4 percent of her portfolio (or $20,000) in the first year and increases the amount she withdraws by 3 percent each year to keep pace with inflation ($20,600 in the second year, $21,218 in the third year, and so on).

If she follows this schedule, she has an 89 percent chance of having enough money to sustain her for 30 years, according to a T. Rowe Price analysis involving 10,000 simulated market situations.

But a bear market could throw everything off. The picture becomes rather grim if the portfolio earns 5 percent or less on an annualized basis in the first five years after retirement and the investor continues to make the same withdrawals. Suddenly, that 89 percent chance of having enough money shrinks to as low as 43 percent for the remaining 25 years of retirement, according to T. Rowe Price.

Fortunately, you can soften the blows of retiring in a slumping market. Here are some ways to help make sure your savings last as long as you do:

WORK LONGER AND SPEND LESS This may sound obvious, and somewhat depressing, but working just a few years longer can make a big difference.

Besides, it does not have to be entirely unpleasant. Maybe you could continue to work a bit longer but start taking the trips you planned for retirement: say, keep your job, but go to Maui. Or perhaps you could work part time and earn enough to cover the amount you would have drawn from your retirement portfolio. At least you are not dipping into your savings while they are down.

Thomas S. Rogers, a certified financial planner and co-owner of the Portland Financial Planning Group in Portland, Me., said he had one client who had planned to retire in July, just as the S.& P. 500 index entered bear territory. Mr. Rogers said he determined that his client, with $1.4 million in savings, could afford to retire. But the client was having trouble selling his condominium and decided to work a bit longer.

“Psychologically, people find it hard to retire when the market is down 20 percent,” Mr. Rogers said.

EASE UP ON WITHDRAWALS One of the most practical alternatives, planners say, is to skip the annual adjustments for inflation and keep the withdrawal amounts steady. “That’s a self-imposed discipline that retirees would be wise to adhere to,” said Ian Weinberg, a certified financial planner in Woodbury, N.Y.

To get a better idea of how much you can afford to withdraw, you can test different amounts with a retirement income calculator on the Web, like T. Rowe Price’s.

FIND YOUR RISK TOLERANCE If the latest market dive tempted you to make major changes to your portfolio, it is time for a gut check. This goes for everyone, whether you're on the cusp of retirement or you already consider golf your full-time occupation.

"You want to figure out what is the right portfolio mix for you and to also understand, or have a realistic sense, of how bumpy the risk is likely to be," said Hersh Shefrin, a professor of behavioral finance at Santa Clara University in California. It may make sense, for instance, to reduce the stock portion of your portfolio and possibly invest more in bonds or cash.

Just remember that you can also invest too conservatively. Putting all your money into bonds is not a good idea, either, as stock returns will help the portfolio keep pace with inflation. A reputable adviser can help strike the right balance.

DIVERSIFY At this stage in your life, you should already have a diversified portfolio. It is one of the most important factors in generating more consistent returns and cushioning against sharp declines.

It is hard to generalize what stock-bond-cash split new retirees should have because it depends on their age, tolerance for risk and other individual factors. But investors also need to diversify carefully within those major asset classes.

"It's not sufficient to say that 'I'm well diversified because I'm 60-30-10 in stocks, bonds and cash,'" said John Nersesian, managing director for wealth management services at Nuveen Investments. He said that within stock funds, for instance, that money should be divided among "large cap and small cap, growth and value, domestic and international."

And naturally, as retirement approaches, your mix of investments should gradually become more conservative. You should review your long-term asset allocation plan every 12 to 24 months, mainly to see whether you misjudged your risk tolerance or whether you need money for unforeseen circumstances, said Holly Isdale, head of the wealth advisory group at Lehman Brothers.

Some investors would rather leave this to professionals, whether a financial planner or a target-date retirement fund, whose investment mix gradually becomes more conservative as the retirement date nears. The strategies and fees of target-date funds vary from company to company, so be sure to do a side-by-side comparison.

REBALANCE When markets are volatile, your original asset allocation may be thrown off kilter. Investors should rebalance their portfolios once a year. That means selling positions that have done well and putting that money into areas that have fallen out of favor.

"Rebalancing forces us to do what is emotionally uncomfortable, but financially productive," Mr. Nersesian of Nuveen said. "The natural thing to do is to add to areas that are doing really well," when we should be doing the opposite.

"That will ultimately lead to a more consistent return," he said, "which is the key to a more successful retirement experience."

Making Your Retirement Money Last in a Market Downturn

A study by T. Rowe Price looked at ways to counteract the impact of a bear market on a newly retired person's $500,000 portfolio. One of the most effective strategies was to cut back on withdrawals, which greatly improved the likelihood that those savings would last. Here is how four different approaches would have played out for a person who retired in 2000, at the start of a bear market.

Likelihood of still having retirement money at age 95

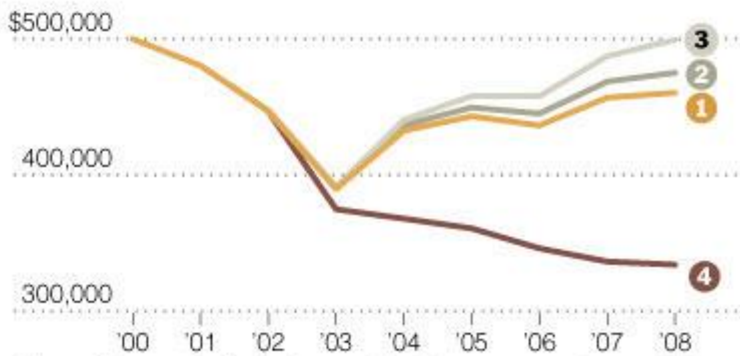
1 USUAL WITHDRAWALS 83%
Advisers generally recommend an initial annual withdrawal of 4 percent — $20,000 in this case — then increasing that amount by 3 percent a year for inflation. But in a bear market, this is not ideal.

2 FLAT WITHDRAWALS 92%
Holds the annual withdrawal steady at $20,000 for an additional three years while the market is down, improving long-term success.

3 LOWER WITHDRAWALS 99%
Starts by taking the usual withdrawals, but cuts that amount by 25 percent in late 2002, during the bear market. At the start of 2003, increases for inflation resume, but from the lower base.

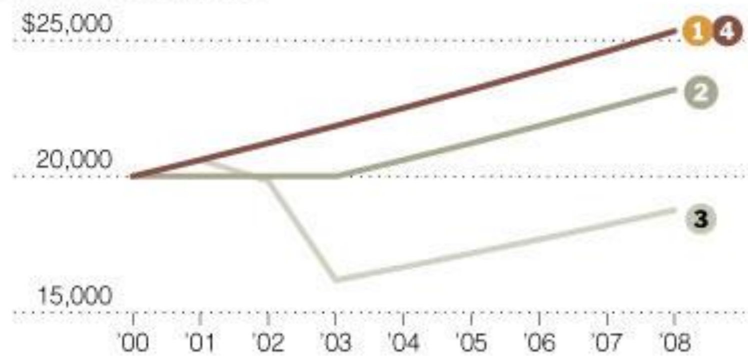
4 SWITCH TO BONDS 5%
By switching to bonds in 2002 — without cutting withdrawals — the retiree locks in losses and will most likely run out of money by age 95.

Retirement account balance



All portfolios are initially invested in 55 percent stocks and 45 percent bonds. 4 switches to 100 percent bonds in Sept. 2002.

Annual withdrawals



Source: T. Rowe Price Associates

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