The New Rules of Retirement

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> “A successful retirement isn’t one without problems, but one in which you learn to overcome them.
>
> ROBERT LAURA

What if you learned that all you believed about saving for retirement was incorrect? What if the rules changed somewhere along the way and no one told you? When would you want to know?

The dream is that you work hard until age 65, saving for retirement all along the way, and then you retire and live out the rest of your life comfortably with plenty of financial resources. In fact, retirement is sometimes likened to a “30-year vacation.” But before you get on that retirement cruise ship, you need to know if you are boarding the USS Smooth Sailing or, in reality, the Titanic.

What happens if you live too long? What if your investments don’t perform as hoped? Or what if you take too much out each year and you end up with nothing to live on? This is where not understanding the rules of retirement can get you into trouble.

The safe withdrawal rate refers to the rate that someone can withdraw from their portfolio each year and be reasonably confident that they will not run out of money. This article will discuss the safe withdrawal rate and the factors that affect it.

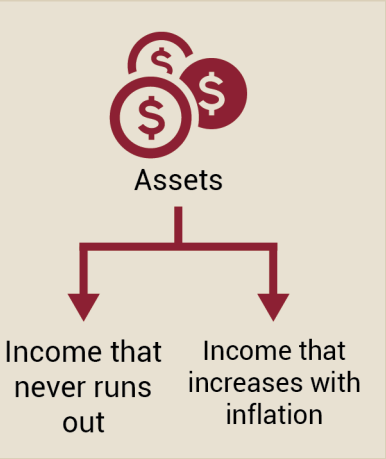
WHAT IS THE GOAL OF RETIREMENT?

To begin, let’s consider someone with a goal of climbing Mount Everest. If asked, they may respond that their ultimate goal is to “plant their flag” on the summit of Mount Everest. However, if they really think about it, they will eventually realize that planting their flag is only half of their goal. The full goal is to plant their flag… and then to safely descend back down the mountain.

This story reminds us that, just like climbing Mount Everest, there are two phases to retirement. The first phase is climbing up the mountain. In retirement planning, this is the pre-retirement phase or what is often called the Accumulation Phase. The goal of this phase is to accumulate as much wealth as possible before you finally scale the mountain and “plant your flag,” or retire. The second phase is climbing back down the mountain. In retirement, this is the post-retirement phase or what is often called the Distribution Phase. The goal of this phase is to make sure you safely descend the mountain, or live out your retirement years without running out of the wealth you accumulated.

WHAT IF I LIVE TOO LONG?

One of the challenges pointed out by this analogy is this: none of us know just how long climbing down the mountain is going to take. Life



expectancy, or what we call "how long I am going to live," is a huge factor in your retirement. What most people don't realize is the average person who is age 65 will probably live a minimum of 20 years until age 85. And if the person is married, there is actually an even greater chance that they will live an extra 10 years until age 95.

So how will you fund those 30 years of living in retirement? When you retire, aside from a pension and any Social Security you may have, you also have the assets that you saved for retirement, typically what is inside your 401(k) or IRA accounts. These assets will have to provide you with two things:

1. an income that never runs out: one that will last for an indeterminate amount of time. You don't know if you are going to need income for 10 years, 20 years, or even 35+ years if you live to the age of 100 or beyond! Because of this unknown, you want assurance that your income will never run out as part of your overall retirement calculation.

2. an income that increases every year to offset the effects of inflation.

For a stable retirement, you need to have a mapped formula that will give you income for the unknown length of your life and will keep up with inflation.

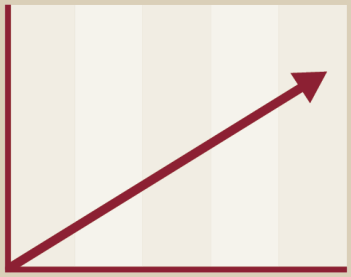
WHAT IS THE SAFE RATE TO WITHDRAW?

These considerations prompt the question: "How much should I take out of my portfolio?" As if dealing with an increasing income need over a potentially longer-than-expected lifetime isn't challenging enough, it is further complicated by something called sequence of returns risk (S.O.R). To put it simply, without factoring in S.O.R., people often can use correct math but incorrect assumptions in determining how much to withdraw. It is like solving an equation with incorrect starting information.

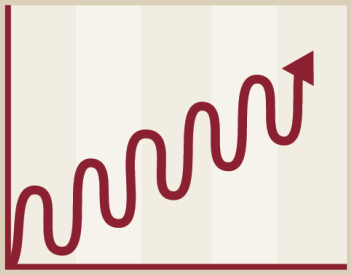
THE CORRECT MATH

Many times, in estimating their future rate of return, people will look at the historical rates of return. They see that the stock market or portfolio has averaged an 8% to 10% return during a certain period of time and assume it will be the same for the future. To find this average, they add up the rate of return of all of the years together and then divide that number by the number of years. For example, if they are looking at a portfolio over the past 20 years, they'll add up all of the annual returns over the last 20 years and divide by 20 to get an average return, say for example an 8% to 10% return.

Constant Increase



Reality

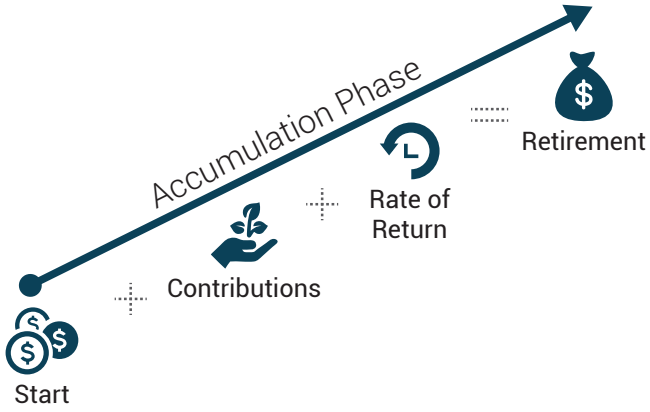


Yes, that is correct math. The issue is not with the math, but with its application. The stock market and investment portfolios don't perform at a constant rate. They are not just going up a perfectly level hill. In reality, they are more like going up a hill with a yo-yo. Yet people often use the average rate of return for their future growth projections.

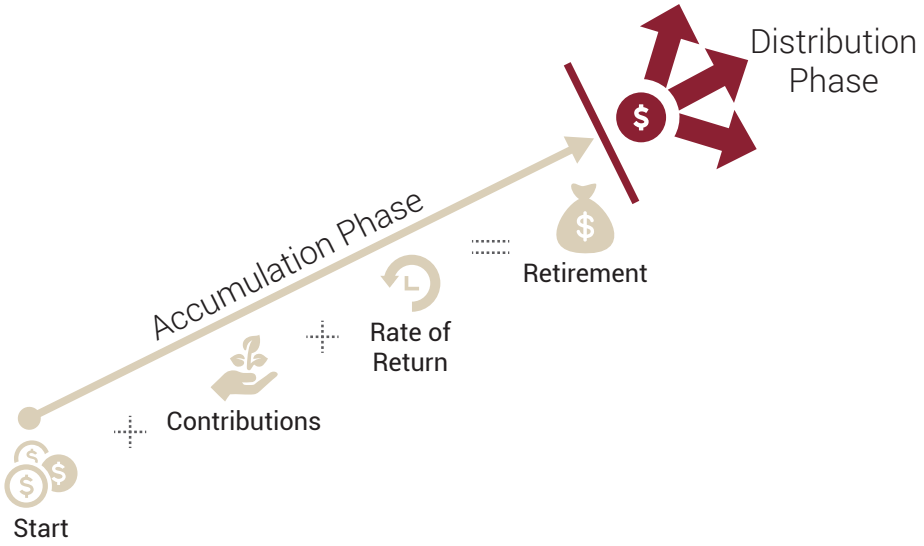
THE INCORRECT ASSUMPTIONS

The incorrect assumptions come into play when people view the period of time after retirement the same as the period of time before retirement.

In the Accumulation Phase (the period of time from when someone started saving in their 401(k) or IRA until retirement day), you can find the average rate that your money grew by adding up the money you started with, your contributions, and your ending value. And the order of the returns *does not matter*.



The problem comes when you shift from the pre-retirement Accumulation Phase to the post-retirement phase, which is sometimes called the Distribution Phase. A different set of rules come into play at this point. And here's why: when you factor in withdrawals, the order of the returns *now matters*.



$100,000
-20%
$80,000
+25%
$100,000

$100,000
+25%
$125,000
-20%
$100,000

$100,000
-20%
$80,000
-$4,000
$76,000

Need almost 32% to grow back to $100,000

Let's take a look at an example to understand the math. If you start with a portfolio of $100,000 and the market is down 20%, your $100,000 drops to $80,000. Now, what do you need to return the following year just to grow your $80,000 back to $100,000? Many people incorrectly assume 20%, but that's wrong. It's actually 25%. It is important to remember that you have to earn a greater rate of return to make up the lost ground from a down market. And without withdrawals, the order doesn't make a difference. If the market is first up 25%, your $100,000 grows to $125,000. If the market then falls 20%, your $125,000 still falls back to $100,000. *The order didn't make a difference.*

So, what happens if you factor in withdrawals? You are automatically putting negative pressure on your portfolio every year that you take a withdrawal. Let's assume you began the year with the same $100,000 and the market declines 20% so your portfolio falls to $80,000. If you also then withdraw $4,000 (only 4% of the initial value) you've now drawn the portfolio down to $76,000. Now for you to recover back to your original account value of $100,000, you need the market to increase not just 25%, but almost 32%. And that's before you take another withdrawal in the following year!

Sequence of returns comes into play on the distribution side of retirement because *now the order of returns can make a big difference*. Historically, it was believed that if your portfolio was going to average 7% year over year, that you could, in theory, withdraw 7% year over year. However, financial planner William Bengen introduced the concept of the sequence of returns risk to a portfolio. Basically, S.O.R. means that the volatility of the markets actually results in an individual having to withdraw less than the assumed rate of return in order to be reasonably confident that he/she will not run out of money. S.O.R. is the mathematical formula used in the attempt to find a suitable amount to withdraw.

Take a look at the following chart. Let's say you think you will live 30 years into retirement and you have read somewhere that you should have a 60/40 mix of stocks to bonds, which is very commonly used in the marketplace. Also, assume that you had some of the lowest costs in fees in your overall plan: 0.7% for stocks, 0.6% for bonds, 0.5% for short-term bonds. Subsequently, if you withdraw 4% as the rule of withdrawal (which was the safe withdrawal rate that resulted from Bengen's research), you have a 74% to 80% chance of not running out of money. Or simply, you have a 1 in 4 or 1 in 5 chance that you will be broke in retirement.

The following table shows how stocks—in varying proportions—coupled with a realistic initial withdrawal amount could increase the probability of comfortably funding a 30-year retirement. For example, this table suggests there is an 80% chance that a mix of 40% stocks and 60% bonds would sustain a 4% initial withdrawal amount (increased 3% annually for inflation) throughout a 30-year retirement.

30-YEAR RETIREMENT

Initial Withdrawal Amount	Stock/Bond* Mix				
	100/0	80/20	60/40	40/60	20/80
3%	90%	93%	96%	97%	98%
4	77	79	80	80	74
5	60	60	56	46	28
6	44	40	32	19	5
7	31	25	16	6	0
8	20	14	7	1	0

More likely — Less Likely**

*The following allocations include short-term bonds: 60/40 is 60% stocks, 30% bonds, and 10% short-term bonds; 40/60 is 40% stocks, 40% bonds, and 20% short-term bonds; and 20/80 is 20% stocks, 50% bonds, and 30% short-term bonds.

**The likelihood of having at least $1 remaining in the portfolio at the end of the retirement period.

If an airline stated, "We have a 1 in 4 or 1 in 5 chance that we are going to burst into a ball of flames and our aircraft is going to crash," would you get on that flight? I definitely would not! If that's the case, I'll drive! In retirement, since you don't know how long you will live, do you want to take those odds? Any logical person would say they don't.

WILL A LOWER RATE SUFFICIENTLY PROVIDE IN RETIREMENT?

Look again at that 30-year retirement chart. With a 3% withdrawal rate, you have between a 90% worst case and a 98% best case chance of success. Everyone would choose this option over the other! However, many people don't have enough assets to generate enough to live off of with only a 3% withdrawal rate. In addition to Social Security and possibly a pension, a person typically has what is inside their IRA, their 401(k), or their savings. Let's say they have $1 million in their account. They think, "Wow, that's a lot of money I've accumulated!" Congratulations! That is truly wonderful! However, keep in mind, if someone has $1 million, based on research, using the 3% withdrawal rate, the average American can only take $30,000 out in income per year.

Here lies the problem: for most people who accumulate $1 million, that $30,000 is not going to be enough to live on, even with a pension and

Retirement Income Sources

Pension

Social Security

Income from IRA/401(K)/Savings

$1,000,000 in Savings

only $30,000 each year
(at a 3% withdrawal rate)

Social Security. This puts them in a position where they only have one of four options:

1. They will have to work longer.
2. They will have to withdraw more and increase the risk that they will run out of money in retirement.
3. They will have to take more risk in their investments in the hopes of making more money, but also risk losing money before and in retirement.
4. They will have to live on less in retirement.

WHY DOES THE SEQUENCE OF RETURNS MATTER?

There is a serious risk to any retirement income strategy. I'm sure it would surprise most people to learn that if two people retired at the same age, with the same amount of money, averaged the same 8% rate of return on that money, and withdrew the same exact amount per year, that one could reach his 90s with more than he started, while the other retiree would become bankrupt in his mid 80s.

The sequence of returns may have less of an impact on the portfolio of a long-term investor who is no longer putting money in, nor taking money out. However, the relationship between an investor's rate of withdrawal and the sequence of returns can have a dramatic impact on a portfolio's ability to last during the withdrawal period (usually during retirement).

SEQUENCE OF RETURNS BEFORE RETIREMENT

The following example shows how the sequence of returns works in the Accumulation Phase. In this example, the ONLY difference between Portfolio A and Portfolio B is the sequence of the annual returns in each portfolio. Both portfolios have starting values of $100,000 (one time lump sum), and both average the same 8% overall annual return, the series is just inverted.

Annual Income Withdrawals: None

Starting Values (one time lump sum):
Portfolio A = $100,000 Portfolio B = $100,000

Average Annual Return:
Portfolio A = 8% Portfolio B = 8%

Value at Age 65:
Portfolio A = $684,848 Portfolio B = $684,848

No Difference

> "Retirement's great paradox? It takes work."
>
> ROBERT LAURA

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The question isn’t at what age I want to retire, it’s at what income.

GEORGE FOREMAN

THE ACCUMULATION PHASE

Age	Portfolio A		Portfolio B	
	Annual Return	Year-End Value	Annual Return	Year-End Value
41	-12%	$87,695	29%	$129,491
42	-21%	$69,426	18%	$152,281
43	-14%	$59,707	25%	$189,590
44	22%	$72,984	-6%	$178,404
45	10%	$80,136	15%	$204,272
46	4%	$83,595	8%	$221,183
47	11%	$92,707	27%	$281,124
48	3%	$95,210	-2%	$274,939
49	-3%	$92,155	15%	$315,355
50	21%	$111,507	19%	$375,272
51	17%	$130,129	33%	$498,737
52	5%	$137,026	11%	$554,097
53	-10%	$123,597	-10%	$499,795
54	11%	$137,316	5%	$526,284
55	33%	$182,493	17%	$614,174
56	19%	$217,167	21%	$743,150
57	15%	$249,091	-3%	$719,305
58	-2%	$243,611	3%	$738,726
59	27%	$309,629	11%	$819,247
60	8%	$335,262	4%	$854,602
61	15%	$383,875	10%	$938,354
62	-6%	$361,226	22%	$1,147,022
63	25%	$449,727	-14%	$986,439
64	18%	$528,878	-21%	$780,941
65	29%	$684,848	-12%	$684,848
Avg./Total:	**8%**	**$684,848**	**8%**	**$684,848**

The above example is for illustrative purposes only and not meant to represent the performance of any particular investment. Past performance does not guarantee future results.

Notice how NO contributions or annual income withdrawals are made in either portfolio in this example, and the result is an identical total of $684,848 at the age of 65, even though the annual returns were inverted. Once again, this demonstrates that during the pre-retirement Accumulation Phase, the order of returns does not matter.

SEQUENCE OF RETURNS AFTER RETIREMENT

In the Distribution Phase, it's important to note that averaging an 8% return doesn’t mean steadily receiving 8% per year of interest and earnings every year. There are some good and some bad years of investment returns.

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I believe that the biggest mistake that most people make when it comes to their retirement is they do not plan for it. They take the same route as Alice in the story from "Alice in Wonderland," in which the cat tells Alice that surely she will get somewhere as long as she walks long enough. It may not be exactly where you wanted to get to, but you certainly get somewhere.

MARK SINGER

Now let's look at that same returns data, but only this time in the post-retirement or Distribution Phase. In the following example, again, the ONLY difference between Portfolio A and Portfolio B is the sequence of the annual returns in each portfolio. The annual returns are exactly the same for the two retirees, the sequence of returns is just inverted. However, since this is post-retirement, each retiree is now taking a withdrawal each year. The withdrawals will be the same, beginning at 5% of the starting portfolio value of $684,848 and increased each year for inflation.

Annual Income Withdrawals: 5% of first year value (adjusted thereafter for inflation)

Starting Values (age 65):
Portfolio A = $684,848 Portfolio B = $684,848

Average Annual Return:
Portfolio A = 8% Portfolio B = 8%

Value at Age 90:
Portfolio A = $0 Portfolio B = $2,622,984

Big Difference

THE DISTRIBUTION PHASE

Age	Portfolio A		Portfolio B	
	Annual Return	Year-End Value	Annual Return	Year-End Value
66	-12%	$566,337	29%	$852,571
67	-21%	$413,086	18%	$967,355
68	-14%	$318,927	25%	$1,168,029
69	22%	$352,432	-6%	$1,061,698
70	10%	$348,431	15%	$1,177,105
71	4%	$323,772	8%	$1,234,855
72	11%	$318,176	27%	$1,528,614
73	3%	$284,653	-2%	$1,452,871
74	-3%	$232,143	15%	$1,623,066
75	21%	$236,215	19%	$1,886,771
76	17%	$229,644	33%	$2,461,500
77	5%	$194,417	11%	$2,687,327
78	-10%	$126,543	-10%	$2,375,148
79	11%	$90,304	5%	$2,450,746
80	33%	$68,219	17%	$2,808,226
81	19%	$27,833	21%	$3,344,606
82	15%	$0	-3%	$3,182,338
83	-2%	$0	3%	$3,211,664
84	27%	$0	11%	$3,503,440

Age	Portfolio A		Portfolio B	
	Annual Return	Year-End Value	Annual Return	Year-End Value
85	↑ 8%	$0	↑ 4%	$3,594,592
86	↑ 15%	$0	↑ 10%	$3,885,017
87	↓ -6%	$0	↑ 22%	$4,685,257
88	↑ 25%	$0	↓ -14%	$3,963,710
89	↑ 18%	$0	↓ -21%	$3,070,398
90	↑ 29%	$0	↓ -12%	$2,622,984
Avg./Total:	**8%**	**$0**	**8%**	**$2,622,984**

The above example is for illustrative purposes only and not meant to represent the performance of any particular investment. Past performance does not guarantee future results.

With each portfolio having the exact same factors except just the sequence of returns inverted, retiree A is broke at age 82! Withdrawing in a down market and having multiple bad years at the beginning caused the failure of Portfolio A. The balance could not keep up with the withdrawals and the portfolio was depleted. In the post-retirement Distribution Phase, the sequence of returns concept teaches that the order of returns is important. And since no one can accurately and consistently predict when investment returns will be good or bad, it explains why the Safe Withdrawal Rate is far below the expected average annual returns of the portfolio.

WHAT IS THE NEW SAFE RATE TO WITHDRAW?

Portfolio A and B are extreme examples of both the 8% rate of return and a 5% distribution, but Portfolio A illustrates that you probably need to take a lot less money than you currently take. Most experts agree you should not take out 5%, probably not even 4%, and some are actually arguing vehemently for 3%. Historically, 4% has been widely accepted as the initial starting point, but new research indicates that perhaps 3 to 3.5% is more appropriate. In fact, Morningstar, a leading provider of independent investment research, recently stated that they believe, looking forward, the safe withdrawal rate is actually 2.7%.

A decline in investment value, especially early in retirement, can have a significant impact including a reduction in retirement income or the premature depletion of investments. Our advisors would be happy to work with you to implement strategies which strive to minimize risk with a goal of providing dependable, long-term income so you can have a comfortable retirement.

The rules of retirement are changing. Our advisors work closely with our clients to make sure they are informed and ready for the future... and not about to board the Titanic!

ABOUT THE AUTHORS

Mark Kemp is a CERTIFIED FINANCIAL PLANNER™ professional and the founder and president of Kemp Harvest Financial Group. Mark enjoys using his knowledge and experience to educate and help his clients identify their financial goals. Additionally, Mark has a passion for comprehensive financial planning services with an emphasis in retirement planning, asset allocation, and investments. With an extraordinary knowledge of retirement plans and packages combined with his love of teaching, Mark effectively conveys complex financial concepts to his clients in a clear and straightforward manner. He regularly conducts educational workshops and has been featured in national investment magazines. Mark holds FINRA Series 7, 24, and 63 licenses with LPL Financial.

Todd Little is a CERTIFIED FINANCIAL PLANNER™ professional with a Bachelor of Science degree in Economics from Pennsylvania State University. Todd has a broad background in the financial services industry with an indepth understanding of the asset management business, investment products, and client management. In addition to meeting regularly with clients, Todd works very closely with Mark and the client service staff to create individual retirement income plans and help clients navigate the retirement process. Todd's background and exceptional focus on client service gives him the ability to provide our clients with unique insights into the financial and retirement planning process. Todd holds FINRA Series 7 and 63 licenses with LPL Financial.

ABOUT KEMP HARVEST FINANCIAL GROUP®

Kemp Harvest Financial Group® is an independent retirement services firm founded by Mark Kemp in 1989. As we've grown, we've stayed true to our founding values of integrity, communication, and relationship. We believe in providing personal, professional, and prudent financial planning. At Kemp Harvest Financial, we focus on a comprehensive approach, tailored to your specific needs. We understand that your choice in financial advisors is a highly personal one, and we strive to honor and protect the trust you place in us. We want your life after retirement to be one of independence and confidence, which is the reason our one-on-one approach begins with listening to you. Our comprehensive approach incorporates our passion and experience as we listen to your specific financial objectives. Through our analysis, we design an individual retirement plan for you, helping you pursue your goals and dreams.

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