The Street

Dealing With Retirement Withdrawals in Bear Market

How much can retirees afford to spend each year?

Financial planners traditionally suggested a simple rule of thumb: To avoid exhausting nest eggs, retirees should only withdraw about 4% of assets in the first year of retirement. After that, the annual withdrawals could increase by the inflation rate. So if you had $1,000,000, you would withdraw $40,000 in the first year. Assuming an inflation rate of 3%, you could take out $41,200 for the second year.

The approach seemed to work, but then the financial crisis disrupted the arithmetic. In the wake of the market downturn, it became clear that retirees couldn't afford to blindly follow the old rules.

Now advisors are scrambling to come up with new approaches. According to some of the latest thinking, retirees shouldn't withdraw a fixed amount. Instead, they must review their situations annually and only take withdrawals that will not drain portfolios.

Among the most compelling strategies is an approach developed by researchers at T. Rowe Price(TROW_). The researchers found that investors should reduce withdrawals after a bear market.

To develop the strategy, T. Rowe Price considered the outlook for people who retired at the beginning of 2000. The researchers assumed that the retirees followed the 4% withdrawal strategy and maintained portfolios that had 55% of assets in stocks and 45% in bonds. The portfolios were clobbered during the downturn that began in 2000 and again in the collapse of 2008. What were the odds that the nest eggs would last for 30 years?

There is no sure way to tell, but to make an educated guess the researchers ran 10,000 Monte Carlo simulations. These are scenarios of how portfolios would perform in good and bad times. The researchers found that in 71% of the scenarios the retirees would be bankrupt within 30 years.

To improve the odds of success, the researchers tested other approaches. In one of the more effective strategies, the retirees would continue taking the 4% withdrawals but eliminate the annual inflation adjustment for three years following a bear market. By trimming withdrawals, the retirees could avoid bankruptcy in 69% of the scenarios. To boost the chance of success up to 84%, retirees could reduce withdrawals by 25% for three years after a bear market.

Investors can take initial withdrawals of more than 4% in an approach developed by Jonathan Guyton, a financial planner with Cornerstone Wealth Advisors in Edina, Minn. Guyton said that if you have 65% of your assets in stocks, you can take an initial withdrawal of up to 5.6% -- provided that you are prepared to trim withdrawals in hard times.

Under his system, retirees must forgo an inflation raise following any year when the portfolio loses money. In addition, withdrawals must be cut when they exceed certain thresholds. Say you take a 5% initial withdrawal. Over time your portfolio shrinks and your annual withdrawals increase to the point where you will withdraw 6% of the remaining assets in the next year. Because the withdrawal percentage is now 20% bigger than the initial rate, you must cut the annual payout by 10%.

While the new withdrawal systems improve the odds of success, they do not provide complete protection against bankruptcy. For an additional layer of security, consider buying income annuities.

Issued by insurance companies, annuities can provide guaranteed income for life. Because they are expensive, you should not put all your assets in annuities. Instead, consider a mix of annuities and conventional stocks and bonds. Say you are a 65-year-year old man with $1 million in assets. You can put $350,000 into annuities and get monthly income of about $1,300 for life. For the rest of the $650,000, you can invest in conventional investments and take withdrawals based on some variation of the 4% rule. If markets crash, you could exhaust your conventional investments. But chances are that the annuities would continue paying monthly checks.