

PORTFOLIO STRATEGIES

How to Score a Retirement Home Run

A look at hypothetical returns using four different scenarios reveals the optimal combination of assets and withdrawal strategies.

BY PAUL MERRIMAN

Our topic for this issue of the *AAII Journal* is retiring with enough—or better yet, more than enough—to live the life you want.

Retirement is many things to many people. But here's my personal definition of how to keep score, using the well-known nomenclature of baseball.

» I have scored a single if I can retire and live the rest of my life without having to work.

» I have scored a double if I can also leave enough money for my spouse to live comfortably for the rest of their life.

» I have scored a triple if I have a double and, during retirement, I can do everything on my bucket list plus anything else that I fancy.

» I score a home run by doing all the above and knowing I will leave a legacy to benefit my family and my favorite causes.

Taking money out of your portfolio in retirement doesn't get all the attention it deserves. Along with many other authors, I've written hundreds of articles and a handful of books about accumulating assets in order to retire. Last year, Richard Buck and I published a book aimed at young people, "We're Talking Millions! 12 Simple Ways to Supercharge Your Retirement," (The Merriman Financial Education Foundation, 2020).

Many of the "12 Simple Ways" we described to accumulate retirement savings apply to retirees as well. For example: Pay attention to taxes, keep your expenses low, don't try to beat the market, invest in equities, diversify by using index funds and include small-cap and value stocks in your portfolio.

From working with thousands of investors over the past half century (and by studying enough statistics to make many people want to run for cover), I've discovered more lessons that can be very important to retirees. Here are four:

» Too little equity in your portfolio plus inflation can erode your retirement savings and put you at risk of running out of money before you run out of life.

» Too much equity in your portfolio plus a serious bear market can lead to the same outcome.

» A prolonged period of poor returns plus too little diversification can lead you down the same path.

» Retiring with what you think is "just enough" to meet your needs can come back to bite you; but retiring with "more than enough" can be a luxury.

When I talk to investors who are on the brink of retiring, it's always fun to hear about all the things they're looking forward to. Unfortunately, we also need to talk about what might go wrong in this stage of their lives.

Perhaps the biggest thing that could go wrong in retirement is running out of money before you run out of life. Another major peril is being spooked by the market so much that you bail out and find yourself without a plan and at the mercy of inflation.

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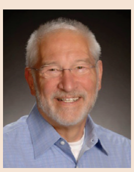
How Different Allocations Impact Retirement Outcomes

I'll get back to that, but first, let's continue the baseball analogy, using hypothetical returns based on actual investment results (and actual inflation) to show how somebody who retired in 1970 might have fared. In the tables, I assume you started with $1 million and adopted a withdrawal plan that would let you start out with $50,000 in your first year (a 5% withdrawal rate, in other words).

In each case, half the portfolio is invested in short-term and medium-term government bonds. The other half is either all in the S&P 500 index or divided equally among four U.S. asset classes: large-cap blend stocks (the S&P 500), large-cap value stocks, small-cap blend stocks and small-cap value stocks. (I explained my rationale for



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Merriman is speaking at AAII's virtual conference this fall, see https://conference.aaii.com for details.

using those four asset classes in the September 2020 *AAII Journal*: "The Four Asset Classes With Great Long-Term Performance.")

Table 1 shows the results for a portfolio invested in the S&P 500. An initial withdrawal of $50,000 was started in 1970. The amount was adjusted in subsequent years by whatever was necessary to keep up with actual inflation.

TABLE 1

S&P 500 Allocation, 5% Fixed Distributions

Portfolio Value as of Dec 31, 1969	$1,000,000
Portfolio Value as of Dec 31, 1979	$1,068,410
Portfolio Value as of Dec 31, 1989	$1,543,818
Portfolio Value as of Dec 31, 2004	$80,233
Total Withdrawals 1970–2004	$4,885,153

An initial withdrawal equivalent to 5% of the starting balance ($50,000) was taken in 1970. The withdrawal amount was adjusted each year to reflect the impact of the previous year's inflation.
Source: The Merriman Financial Education Foundation.

I refer to this as a fixed distribution plan because you take out the specified amount (which presumably is necessary to meet your cost of living) regardless of how your investments are performing.

For 35 years, this portfolio and withdrawal plan provided enough retirement income to keep up with inflation. But if you were the retiree, you were plum out of money early in 2005. Too bad.

Score: *We could probably call this a single. The investor was able to retire and live the rest of their life without having to work. It was not a comfortable retirement in the later years as the fixed withdrawals removed a higher and higher percentage of the portfolio.*

Addressing the Problem of Outliving Savings

Tables 2 and 3 show two ways to address the problem.

Table 2 follows the same choice of assets, but with annual distributions calculated as 5% of each year's starting value, without regard to inflation.

TABLE 2

S&P 500 Allocation, 5% Flexible Distributions

Portfolio Value as of Dec 31, 1969	$1,000,000
Portfolio Value as of Dec 31, 1979	$1,192,349
Portfolio Value as of Dec 31, 1989	$2,986,947
Portfolio Value as of Dec 31, 2004	$5,273,244
Total Withdrawals 1970–2004	$4,760,404

An initial withdrawal equivalent to 5% of the starting balance ($50,000) was taken in 1970. The withdrawal amount was adjusted each subsequent year to equal 5% of the portfolio's value.
Source: The Merriman Financial Education Foundation.

After 35 years, the total "output" of this approach (2004 year-end value plus total withdrawals) was just over $10 million, compared with just under $5 million for the fixed-distribution approach.

But this second approach had a huge drawback. During a string of high-inflation/low-return years in the 1970s, the withdrawals from this portfolio fell significantly behind, forcing the retiree to live at a lower level than in 1970, that first year of retirement.

Score: *Because of the reduced standard of living in the early years of retirement, it's doubtful that this qualifies as a single, and therefore it's also dubious as a double. This combination left substantial money for heirs and ample withdrawals in the later years of a 35-year retirement. But it was not kind to the retiree in their early years.*

Table 3 shows the fixed withdrawal plan, this time with the equity part of the portfolio made up of a much more diversified combination of four major asset classes.

TABLE 3

Four-Fund Combination, 5% Fixed Distributions

Portfolio Value as of Dec 31, 1969	$1,000,000
Portfolio Value as of Dec 31, 1979	$1,347,573
Portfolio Value as of Dec 31, 1989	$3,043,818
Portfolio Value as of Dec 31, 2004	$6,858,519
Total Withdrawals 1970–2004	$4,885,153

An initial withdrawal equivalent to 5% of the starting balance ($50,000) was taken in 1970. The withdrawal amount was adjusted each year to reflect the impact of the previous year's inflation.
Source: The Merriman Financial Education Foundation.

The 35-year "total output" of this combination (portfolio value at the end of 2004 plus withdrawals) was $11.7 million, a meaningful improvement. However, all that extra benefit went to the heirs. Because the withdrawal schedule was fixed, the distributions were identical to those in Table 1.

One thing is crystal clear: This four-fund combination had much more robust returns. At the end of 1989, after 20 years of withdrawals, this portfolio was worth almost twice as much as the one shown in Table 1.

Score: *This was probably a double, and perhaps a near-triple in the later years. There was ample money so the retiree could take out enough "extra" to do more things. That certainly would not have been possible with the equity part of the portfolio invested exclusively in the S&P 500 (Table 1).*

In Table 4, you'll see a combination that in my mind undoubtedly results in a home run. You get this by diversifying your portfolio and adopting a flexible withdrawal schedule.

In order to score a home run:

» I want to be able to retire without working. Check.

- » I want to know that after I'm gone, my spouse is financially secure for life. Check.
- » I want enough money to do whatever I want during retirement. Check.
- » I want to know I'm leaving a legacy in addition to all that. Check.

TABLE 4

Four-Fund Combination, 5% Flexible Distributions

Portfolio Value as of Dec 31, 1969	$1,000,000
Portfolio Value as of Dec 31, 1979	$1,492,012
Portfolio Value as of Dec 31, 1989	$3,955,237
Portfolio Value as of Dec 31, 2004	$8,273,912
Total Withdrawals 1970–2004	$6,171,398

An initial withdrawal equivalent to 5% of the starting balance ($50,000) was taken in 1970. The withdrawal amount was adjusted each subsequent year to equal 5% of the portfolio's value.
Source: The Merriman Financial Education Foundation.

I said earlier I would show you how to get a home run, and that's it. You can stop here if you like. But why settle for a homer? How about a grand slam?

Three Main Points About Retirement Withdrawals

Before I show you how to hit a grand slam, let's review three main points about withdrawing money in retirement.

First, if you take out what you need every year and adjust for inflation (fixed withdrawals), you're likely to do fine for a few years no matter what happens in the market. But a string of years with either poor market returns or high inflation could make this impossible to continue for the long haul.

Second, if you take out only what your portfolio can "afford" to pay you (flexible withdrawals), the portfolio will remain healthy. But you may have to tighten your belt in some years. In the scenario I outlined in Table 2, you would have had to get by with less than $40,000 in 1975 (and that's before taking inflation into account).

Third (and this is the good news), if you start your retirement with truly ample savings, you are likely to avoid both those problems.

Hitting a Retirement Portfolio Grand Slam

Here's a two-part recipe for a retirement grand slam:

- » Start with 1.5 times as much in your portfolio as you really need. So if you need $50,000 in your first year, start with $1.5 million instead of $1 million. This way, you can take out as much as $75,000 without fear of getting into a danger zone.
- » Whatever percentage of your portfolio you keep in equities, use the four-fund combination I described instead of the S&P 500.

To start with "more than enough" in savings, you may have to postpone your retirement. I once calculated that by delaying retirement for five years, you could potentially double the money you take out in retirement and leave to your heirs.

In 2008, I had enough money to retire comfortably. But I wanted more of a cushion, and I enjoyed my work. So I kept working until 2012. That gave my investments four more years to grow. It gave me four more years to add to those savings. And when I retired, there were fewer years in which my portfolio would be required to support my wife and me.

That has put me in grand slam territory. I am confident that my portfolio will never be in danger, and I have an ample cushion to take out more money for extras without jeopardizing my other priorities.

Really, folks, I recommend doing whatever it takes to get to this point in your life!

In addition to delaying your retirement, you can move toward grand slam status by paring down your basic living costs or taking a second job for a few years and putting those earnings into your retirement savings. You can also plan to continue working part-time after you're retired. Some people, especially workaholics, find this is a stimulating and satisfying way to spend some of their time, quite apart from the money they earn.

I haven't said much about inflation, but it's an extremely important force that impacts retirees. In fact, it turns out that the biggest bear market for investors in the last century was not the Great Depression, nor the two severe downturns between 2000 and 2010.

The biggest bear market has been the long-term erosion of buying power from inflation, a very real cost that's too often overlooked. From 1928 through 2020, inflation compounded at 3% and turned the value of $100 in 1928 into a mere $6 in 2020.

In Table 1, we saw the long-term results of starting with a withdrawal of $50,000 in 1970 and adjusting it upward every year to keep up with actual inflation. What we did not see was the speed with which your withdrawals had to go up just to stay in place.

In 1974, it took $61,273 to equal the purchasing power of $50,000 just four years earlier. By 1979, you needed $89,788 to equal the buying power of $50,000 just nine years earlier.

Long-term inflation is particularly dangerous for people who hope to retire early and live a long life without working. This is another powerful reason to do all you can to retire with "more than enough" in your portfolio.

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In fact, I have never met anyone who regretted having done that.

In order to make meaningful comparisons, all the examples I have cited assume 5% withdrawals, a starting date of 1970, a starting amount of $1 million and a portfolio that's split 50/50 between equities and bonds. ■

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