OSBORNE PARTNERS
Capital Management, LLC

Summertime and Retirement Income Planning

July 2017

"Summertime and the livin' is easy"[1], which makes it an ideal time for financial reflection and second-half of the year retirement income planning. Most successful endeavors start (and continue) with a plan, and summer time can give us some unhurried days to check that the goals we are pursuing still have meaning, and if so, to then consider strategies to help reach those goals.

How do you define wealth? I think of it as being the absence of financial worry, and having an income that I will not outlive. The amount of income that supports the freedom to live life on one's own terms is different for everybody, and changes too, over time. The amount of income necessary for this year in today's dollars is a straightforward tally of planned and expected expenses. It is easy to feel confident that this year's expenses can be met through a thoughtful draw-down of retirement assets. It becomes less easy to have that same level of confidence when projecting two, three, or four decades into the future.

Have you heard of the 4% Rule? In 1994, the 4% withdrawal rule was embraced as a "fail-safe" way to pull inflation-adjusted income off of a portfolio, with an expectation that the money would last for 30 years. This would suggest that a $5 million portfolio would provide a sustainable inflation adjusted income of $200,000 per year, without worry for 30 years. Like many overly simple solutions, the reliability of the 4% rule is being questioned, for a variety of reasons.

The formula relies on average rates of return from an average portfolio, yet at January 1st of this year the 10 year Treasury bond had a yield of 2.43%, compared to a yield of 5.75% on January 1st 1994, a significant impact on an "average" portfolio return. Another complication is that while 30 years of income could be long enough, what if it isn't? Unexpected health costs can also throw a set percentage withdrawal strategy into disarray. Differences in the tax treatment between IRA and non-IRA withdrawals suggest that the same formula surely cannot be used for both pools of money. Even the amount of existing guaranteed income being received has a large impact on an estimated safe withdrawal rate. Over the last 23 years we have also learned of the importance that timing plays in the draw-down of retirement assets. A fixed percentage withdrawal from a stock portfolio during times of a stock market correction can be very destructive for the longevity of a portfolio. These situations confirm that creating sustainable retirement income is far from a "set-it and forget-it" approach.

What then is a reasonable strategy to produce lifetime retirement income if the 4% rule cannot be used, and the notion of scrimping on lifestyle is unappealing? I think that the only reasonable solution is to run a financial plan solving for sustainable income every year.

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A financial plan is a reliable approach for determining lifetime income needs to adjust for annual changes in the macro variables that are the foundation of a retirement income calculation such as: interest rates, stock and bond market returns, health care costs, taxes and inflation. It would also look each year for ways to improve the results by evaluating if there is a tax advantage to a particular transaction if done this year or next, or whether a RMD withdrawal might best be used as a charitable gift, or whether there is a taxable income gap between one year and the next that can be used for a tax-efficient draw-down of an IRA, and all of the other personal financial decisions we make every year that can have long-term consequences.

A yearly analysis allows us to set a personal withdrawal plan for each year, with the confidence of knowing that the annual withdrawal number was calculated within a framework that was also solving for sustainable lifetime income. And that next year, the plan will again be confirmed and a new withdrawal amount will be decided upon, allowing us to pursue our goals and live our life.

[1] Holiday, Billie, "Summertime" Lyrics. Billie Holiday: The Quintessential Billie Holiday Volume 2, Sony, 1987