Living Off A Lump-Sum Without Going Broke

By Ryan Zacharczyk, CFP, CSA, CRPC

There are two major issues that retirees today must deal with in respect to asset withdrawal. First, how can I ensure that I won't run out of money, and second, how can I protect my purchasing power against inflation. These are not questions that can be answered lightly. Each individual must investigate their own situation or talk to an advisor to determine what strategies are right for them, given your specific needs and risk tolerances. But, what I can do is elaborate on some common rules that will cover the largest cross section of individuals and retirement situations.

The 4%-5% solution

The most common rule for asset withdrawal through retirement is 4%-5% of assets annually. This means that if you have $1 million invested in your retirement accounts with a balanced investment strategy of 50% stocks and 50% bonds, you can withdraw $40,000-$50,000 every year, increasing annually for inflation, without ever running out of money. This is generally considered the most conservative withdrawal strategy, with 4% being as close to a guarantee as there is in the investment business. Although 5% holds a slightly higher risk of running out of cash before you reach the pearly gates, the country would need to fall into depression or see runaway inflation before you would need to apply to Wal-Mart as a greeter. In fact, if the market continues at a rate of 10%, you will probably increase your nest egg over time.

What about climbing Mt. Everest?

Many people want to slowly dip into their principle, so they can enjoy it in their early retirement years, while travel and entertainment are still a regular habit. To those individuals, I propose a 6%-7% withdrawal rate. This strategy poses a significantly higher risk of running short of cash sometime in retirement, but for many, it is a risk they are willing to take to see the world while they can. A 6% withdrawal rate leaves a 42% chance that your cash will be depleted in 30 years, according to the Monte Carlo Simulation of a 50/50 balanced portfolio, while the 7% rate leaves you with a 60% chance of eating Alpo sometime in your golden years.

The strategy I tend to implement in these situations is what I like to call, "High Risk with Insurance". Taking a higher withdrawal rate, although risky if done alone, can be a better way to utilize your retirement funds early in your retirement if you can figure out a way to pay for your later retirement years. In order to protect against running out of funds, I like to try to use other assets, like the clients home or vacation property, as a type of insurance policy. If the client wishes to remain in their home throughout retirement, they can always reverse the mortgage in 10 to 15 years if their retirement nest egg runs dry. A reverse mortgage fallback can help accomplish all tasks, increased quality of life, the ability to stay in the house throughout retirement, as well as the availability of income if funds run dry. The only downside to this strategy is the estate left after the clients death, which might be significantly reduced. If the client is unconcerned with the family's inheritance, then this strategy can be very successful.

I can't, in good conscience, recommend withdrawing at a greater rate than 7%. A large withdrawal rate, coupled with an annual increase to cover inflation, will lead to a quick depletion of resources in as little at 10 to 12 years. For most retirees, this is unacceptable. Living off social security alone during late retirement is a challenge I hope fewer and fewer retirees will face.

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Where Do I Start?

Now that we know how much to withdraw, where should it come from? Generally, living off interest and dividends in a taxable account is a no-brainer first place to start. You will be paying taxes on these distributions regardless of whether you spend that money or not, so why not spend it first. The next place to take income from is selling assets in a taxable account. Usually, these assets would be profitable and your tax burden would be minimal, since it is taxed as capital gains as opposed to ordinary income. This means you are paying either 5% or 15% tax on your gains, a very low dollar amount. This also allows the benefit of letting your tax deferred accounts grow without the added weight of taxes. Finally, once all taxable accounts are depleted, withdrawing from the retirement accounts is the last resort. These withdrawals are taxed as ordinary income, so they probably have a higher tax liability than the taxable accounts. Remember, this only holds true until April 1st of the year after you turn 70 _. Don't forget to take your required minimum distribution from your tax deferred accounts or you will be hit with a whopper of a penalty.

There are exceptions to these rules, the largest being the Roth IRA. If you have all your money in a Roth, it can get tricky and you need to look at your individual tax situation. I like using the Roth for big ticket items since there is no tax at withdrawal. If you want to buy that $100,000 boat to sail around the world or a beach front vacation home for cash, you could avoid paying Uncle Sam a small fortune in taxes. Otherwise, save your Roth as long as possible. This will benefit you for two reasons, first, there is no required minimum distribution from a Roth, and second, the money grows tax free.

It is crucial that each individual or family take a look at their situation in order to determine what strategy is right for you. What must be kept in mind is that you need to decide how your needs can best be met. Are you more concerned with higher income early to enjoy life while you can, or is it more comforting to know you are guaranteed to never run out of money? These questions should not be taken lightly. Long, in-depth soul searching and discussion with your spouse or family is ideal to get at the decision that works for you. Once that decision is reached you now have the tools to create the retirement you want.

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