



3 Ways To Make Your Retirement Funds Last

by Steven P. Orlowski, CFP ([Contact Author](#) | [Biography](#))

Congratulations, you've made it to retirement! Hopefully you've planned appropriately, saved enough money and are prepared to start living off your savings. Unfortunately, it is common to find that retirees are unprepared for the *distribution phase* of retirement. They have spent their working lives focusing on the *accumulation phase*. They've contributed to [IRAs](#), participated in their employer-provided retirement plans and saved. Often it's not until right before they retire that they consider *how* to create and receive their income.

This article will address some of the basics of retirement income distribution plans. We will address three methods using a standardized 4% cash flow rate. Two of the methods are well known; the third, not so much. They are all viable methods; it is a retiree's personal circumstances that should determine which method, or combination of methods, are used. (For a background reading, see our [Retirement Planning Tutorial](#).)

Live on 4?!

Some of you may be thinking "4%? I can't live on 4%!" In some cases, this may be true, as the generally accepted rate of sustainable [inflation](#)-adjusted cash flow in retirement is 4%. Therefore, retirees should seek the counsel of a retirement income planning specialist prior to implementing any of these plans, but especially if their cash flow need is greater than 4%. Remember, the higher the cash flow, the higher the annual return on investments will need to be.

1. Interest-Only

With an interest-only plan, a retiree with \$1 million and an income need of \$40,000 per year might invest her money in a portfolio of [fixed income securities](#) with an average yield of 4% and use the interest as her retirement income. This approach works fine as long as there is no inflation and the investor needs nothing more than \$40,000 per year. Assuming a 3% inflation rate, the investor would need nearly \$54,000.00 in year 10 to maintain the same lifestyle. At a 4% average yield, she would be forced to sell part of her portfolio or reduce her standard of living. If she chose to sell, she would reduce her principal and therefore her income. She might also be forced to sell every year thereafter, putting her on the road to asset depletion.

The interest-only option works best for investors with excess savings. For example, an investor with \$2 million and an income need of \$40,000.00 has little to worry about when it comes to running out of money. (For ideas on how to beat inflation, see [Curbing The Effects Of Inflation](#).)

2. Systematic Withdrawal Plan (SWP)

A [systematic withdrawal plan](#) provides more flexibility than the interest-only option, but less predictability. However, an SWP can provide growth. With an SWP, a retiree might invest in an

array of stock, bond and [money market](#) mutual funds (or individual securities). Money is withdrawn periodically (most commonly monthly) from all funds proportionately or from specific positions if specified. The amount of "income" (interest, dividends and/or [capital gains](#)) is determined by the performance of the investments. Good performance can translate into surplus income and the possibility of growing the portfolio; bad performance can result in depletion.

With this system, the allocation of assets should be one where the return can reasonably be expected to meet or exceed the retiree's cash flow need. Our investor might invest in a generic "balanced" allocation (50% equities, 40% bonds, 10% short term) and expect the historical average return of such a portfolio - 7.85% according to a survey of returns between 1926 and 2008 conducted by Fidelity Investments. If the retiree in our example were to achieve this return every year, she might be able to maintain her lifestyle, including inflation, indefinitely. Of course this is easier said than done, as the 7.85% figure represents a long-term average, and actual returns can vary widely over time.

If the retiree retired in 2007, her portfolio might have declined significantly in 2008 and 2009. Assuming a 20% decline in value and her \$40,000 withdrawal, she may have found herself with a portfolio worth \$760,000 (\$1 million - \$200,000 - \$40,000.00) in 2009. Her annual withdrawal percentage is then 5.26% ($\$40,000.00/\$760,000$) of the portfolio and the probability of her money lasting the rest of her life decreases. The inverse could have been true had she retired at the market bottom in 2002 and grown her portfolio in the first few years of her distributions. This is because what happens in the early years of your retirement has the greatest influence on your long-term results. When using this type of strategy, the averages don't matter so much; what matters is what you earn *each year*.

3. Spend Down/Grow Back - The Two Headed Beast

A spend down/grow back strategy is quite simple in concept but can be complex in execution. Let's look at the basic form of this plan, which is often referred to as the "two-headed beast". The beast will grow more heads as a situation merits. The two-headed beast is created by separating your portfolio into two components: the money you are spending and the money you are growing.

The component for spending is money that you are intentionally depleting over a predetermined period of time; the money you are growing is intended to replace the income component at the end of the period. You can use any period, but the shorter the time frame the greater the risk.

Let's use 10 years. We will split our retiree's portfolio in two. The retiree will put \$400,000 into a 0% interest checking account and will spend it over the next 10 years. Therefore, the remaining \$600,000 needs to grow back to \$1 million over those 10 years to replace what she spends (ignoring inflation). In this case, the retiree will need an annual return of 5.25% for 10 years to get back to \$1 million.

If, instead of a 0% checking account, she invests the income component at 4% interest for the 10 years, she wouldn't need \$400,000, she would need the [present value](#) of \$40,000 per year

over 10 years at 4%. That would be about \$337,500.00, leaving \$662,500. Bringing the investment back to \$1 million would then require an annual return of 4.20%. The balanced allocation mentioned earlier could be used and the average would have more relevance. This is because the investment is more likely to average 7.85% over a 10-year period than to earn 7.85% each year. With that average, the retiree should be able to maintain her inflation-adjusted lifestyle. At the end of the decade, she would repeat the process. (To learn more, read [Understanding The Time Value Of Money.](#))

Summary

Of all of the methods we went through, the interest-only method provides the greatest predictability, while systematic withdrawal plans provide the greatest potential for growth (or declines) and flexibility. The spend down/grow back strategies (the multi-headed beast) provide elements of both, with a predictable stream of income, the potential for growth and a predetermined time frame over which to plan for that growth.

All three methods have merit, but all three methods also require monitoring. The method you use depends on how much money you have, how much income you need, whether you care to try to grow the portfolio and whether you care to leave any money behind for your heirs, among other things. For investors who don't mind depleting some of, or their entire, portfolios the numbers would be very different. See your financial adviser for more on retirement income planning. (To learn more, check out [Systematic Withdrawal Of Retirement Income.](#))

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