

Choosing Your Annual Withdrawal Rate

Strategies to help ensure sufficient income in retirement

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TAKING RETIREMENT PLAN DISTRIBUTIONS

After years of building financial assets, the time will come when you begin drawing on them to support your lifestyle during retirement. Before that major turning point arrives, be sure to work with your financial advisor to determine how much money you will take out of your personal savings and investment portfolio each year. The rate at which you withdraw money from your assets is one of the most important factors affecting how long they will last. In other words, it's not only the amount of money you have saved, but how quickly you spend it that will help determine whether you can still live comfortably in your later years.

What to Consider

A number of factors may influence your choice of an appropriate withdrawal rate. These include:

- Your age and health
- The potential impact of inflation on your assets and cost of living
- The variability of investment returns you earn on your savings
- Your goals and dreams of what you want to accomplish during your retirement years

As you think about what your withdrawal rate should be, begin by considering your age and health. Although you can't predict for certain how long you will live, you can make an estimate. However, it may not be wise to base your estimate on average life expectancy for your age and sex. Particularly if you are healthy, you should take into account your risk of living longer than a life expectancy table would indicate. While average life expectancy has risen steadily in the United States, reaching 77.6 years for a child born in 2003, there's a 50% probability now that a healthy 65-year-old man could live to age 85 and a woman in good health could live to age 88.

Moreover, there's a 25% probability of the man living to age 92 and the woman to age 94. If they retired at age 65, they could be withdrawing from their assets for 30 or more years.¹

Dealing with Economic Realities

Once you've estimated your likely longevity, think next about inflation, which is the tendency for prices to increase over time. Keep in mind that inflation not only raises the future cost of goods and services, but also affects the value of assets set aside to meet those costs. The real return on assets is their value after subtracting for inflation. To account for the impact of inflation, include an annual percentage increase for inflation in your retirement income plan.

How much inflation should you plan for? Although the rate varies from year to year, U.S. consumer price inflation has averaged about 4% over the past 50 years, though that has fallen to approximately 3% over the last 25 years.² Therefore, for long-term planning purposes, talk to your financial advisor about an assumed inflation rate that makes sense to both of you. However, if inflation flares up above the level you assume after you have retired, you may need to adjust your withdrawal rate to reflect the impact of higher inflation on both your expenses and

investment returns. Keep in mind as well that you should periodically assess the potential of your investment portfolio to generate income that will at least keep pace with inflation.

Fluctuating Returns

When considering how much your investments may return over the course of your retirement, you might think you could base them on historical averages, as you may have done when projecting how many years you needed to reach your retirement savings goal. But once you start taking income from your portfolio, the timing of withdrawals and periods of weak market performance become more important and must be considered as a key part of the investment plan.

Just imagine the impact to your retirement plan if you experience meaningful portfolio losses during your first few years of retirement. When a retiree's need for annual withdrawals is added to poor performance, the result can be a much earlier depletion of assets than would have occurred if portfolio returns had increased steadily.

While it's possible that your portfolio won't experience any losses and will even grow to generate more income than you expected, it's prudent to assume some setbacks will occur, as was the case with stocks in 2000, 2001, and 2002.

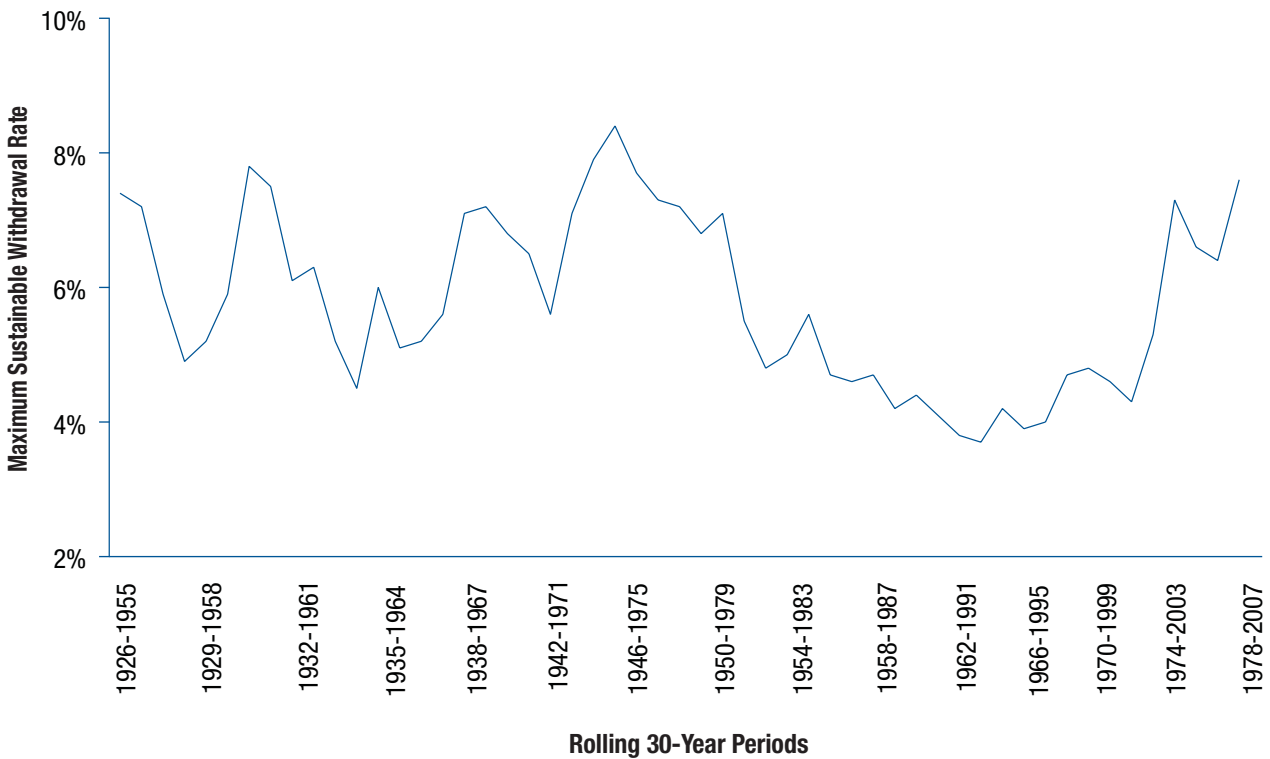
Coming to a Decision

Although past performance cannot predict future results, the ups and downs registered by the financial markets and inflation can be instructive when choosing an annual withdrawal rate. To provide an idea of how much might be withdrawn annually from a balanced portfolio so that it would be likely to last 30 years or more, Standard & Poor's looked back at the actual record for stocks, bonds, and inflation and analyzed all possible 30-year holding periods since 1926. It determined that the average sustainable withdrawal rate for a portfolio composed of 60% U.S. stocks and 40% long-term Treasury bonds was about 5.8% per year when adjusted for inflation (see chart).³

The chart also clearly shows that, although the average was 5.8%, the low was approximately 4% and the high was over 8%. In view of the variability of inflation and investment returns, as well as the risk of living beyond your average life expectancy, it is important to work closely with your financial advisor to develop the right plan specifically for you. The goal, after all, is to leverage your nest egg in such a way that it can provide you the best opportunity to achieve your goals and dreams.

How Long Will the Money Last?

The ups and downs of the financial markets and inflation largely determine the income-producing potential of an investment portfolio. This chart depicts the average rate of annual withdrawals that a hypothetical portfolio of U.S. stocks and Treasury bonds was able to sustain during a series of 30-year holding periods since 1926. The average sustainable rate for all 30-year rolling periods from 1926 to 2006 was 5.8% when adjusted for actual consumer price inflation.



Source: Standard & Poor's. This example assumes a portfolio comprised of 60% stocks represented by the S&P 500 and 40% bonds represented by U.S. Treasuries with average maturity of 10+ years, and annual withdrawals based on 5% of the first-year value and adjusted thereafter for inflation based on actual historical changes to the Consumer Price Index. Investors cannot invest directly in any index. This illustration does not take into account any transaction costs or taxes and is not representative of any particular investment or security. Past performance does not guarantee future results.

This example is not intended as investment advice. Be sure to consult a financial advisor about choosing a withdrawal rate and how these issues and examples relate to your own financial situation.

Points to Remember

1. The rate of annual withdrawals from personal savings and investments is a critical component in determining how long those assets will last and thus whether you will have sufficient income for your later years.
2. To determine a sustainable annual withdrawal rate, work with your financial advisor to review your investment goals and dreams. You'll also need to consider your age and health and how future variations in the rate of inflation and investment returns may affect your retirement assets.
3. Assuming you will live an average life expectancy may not be prudent in view of the probabilities for living longer than an average life span. Similarly, it may be misleading to assume that investment returns and rates of inflation will closely mirror their historical averages.
4. A jump in inflation, or the timing of investment losses due to market downturns, can have a significant impact on the income generated by retirement assets. As a result, it is important to work closely with your financial advisor to develop a plan designed specifically to give you the best opportunity to achieve your goals and dreams.

For more information, please contact your financial advisor.

Important Additional Notes

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1 Source: Society of Actuaries 2000 Mortality Tables (most current data available).

2 Source: Bureau of Labor Statistics, December 31, 2005.

3 This example is a compilation of each of all 30-year holding periods from 1926 to 2006. It assumes a portfolio comprised of 60% stocks represented by the S&P 500 and 40% bonds represented by U.S. Treasuries with average maturity of 10+ years, and annual withdrawals based on 5% of the first-year value and adjusted thereafter for inflation based on actual historical changes to the Consumer Price Index. Investors cannot invest directly in any index. This illustration does not take into account any transaction costs or taxes and is not representative of any particular investment or security. Past performance does not guarantee future results.

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