SUNDAY MONEY: PLANNING

New Advice to Retirees: Spend More at First, Cut Back Later

By Ilana Polyak

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HOW much can you take out of your retirement nest egg each year without running out of money?

Not much, according to the standard, conservative advice of many financial planners. They often say that people who retire at the age of 65 can safely remove only about 4 percent of their portfolios each year, along with adjustments for inflation. On that basis, the initial withdrawal from a portfolio worth $1 million would be just $40,000.

But some experts have been making waves by suggesting that it may make more sense to withdraw bigger amounts in the early years of retirement.

Ty Bernicke, a financial planner in Eau Claire, Wis., for example, says retirees generally spend less as they age, so that it is reasonable for them to spend more when they are in retirement's early stages. Mr. Bernicke's conclusions, which relied on data from the Bureau of Labor Statistics' Consumer Expenditure Survey for 2002, were published in June in The Journal of Financial Planning (www.fpanet.org/journal/articles/2005--Issues/jfp0605-art7.cfm).

Spending in practically every category, from housing to clothing to entertainment, declines with age, the data showed. The only category in which spending rises with age is health care, he said.

"It's almost a tug of war between inflation pushing costs up and human nature pulling them back down," Mr. Bernicke said.

People over 75 spent 26 percent less, on average, than those in the 65-to-74 age group. And the greater the age difference, the greater the difference in spending: Those over 75 spent 46 percent less than those aged 55 to 64, and 51 percent less than those aged 45 to 54. "Most retirement planning today assumes that a person retains the same lifestyle throughout their life," Mr. Bernicke said. "But as age increases, spending decreases."

George and Kathy Magaw, both 59 and clients of Mr. Bernicke in Eau Claire, expect to spend less as the years advance, Mr. Magaw said. He has decided to take early retirement from his job as a training manager for a manufacturing company in late 2006, when he will be 61; Mrs. Magaw is not employed. He plans to spend time on his fishing boat and to go on waterfowl hunting trips in remote parts of Wisconsin. The couple also expect to visit grandchildren in Wisconsin and Connecticut.

"Am I going to end up spending a little bit more money up front? Yes," Mr. Magaw said, but the period of higher expenditures should be relatively brief. It "won't be more than the first two or three years," he said.

Then he expects to reduce spending gradually on things like travel and entertainment -- making up for increases in health care, Mr. Magaw said.

The traditional advice that calls for an initial withdrawal of 4 percent is based on several assumptions. To compensate for inflation, the withdrawal rate would increase 3 percent every year. Someone with a $1 million nest egg could take out $40,000 the first year and $41,200 the next year, for example.

And the nest egg would generally be invested at least 50 percent in stocks -- as a further hedge against inflation -- with the remainder in fixed-income investments and cash.

The approach is based on risk-assessment studies using all kinds of hypothetical examples of market returns. The withdrawal rates are intended to leave very little chance of running out of money.

"Our whole premise is that if this $40,000 is to have the same purchasing power for the rest of your life, we have to inflate it," said Christine Fahlund, senior financial planner with T. Rowe Price Associates, the asset management firm in Baltimore, which advocates this method. "We're assuming that inflation is part of life."

T. Rowe Price's method assumes a 40-year retirement. Mr. Bernicke assumes one of 30 years.

To Mr. Bernicke, a couple who spend $40,000 in their first year of retirement may not need to spend as much when they are in their 80's. People who are 75 and older spend an average of $674 a year on apparel and services, for example, while those who are 65 to 74 spend twice as much, based on the consumer survey he used. Those 75 and up spend an average of $896 a year for entertainment, compared with $1,371 for those 65 to 74.

According to his calculations, a couple in the first year of retirement at age 55, with expenditures of $60,000, might be able to safely withdraw that much from a portfolio worth $1 million -- a 6 percent initial withdrawal rate. They would not run out of money so long as they reduced their spending later on according to the pattern shown in the survey, he said.

"Of course it depends on the mix of stocks and bonds in someone's portfolio," Mr. Bernicke said. "But a 6 percent withdrawal rate becomes very realistic."

He said that this rate could vary because of many factors, including a retiree's spending level and the size of the nest egg.

Others advocate loosening the purse strings in retirement, but for other reasons. In the October 2004 issue of The Journal of Financial Planning, Jonathan Guyton, a planner at Cornerstone Wealth Advisors in Minneapolis, advocated an initial withdrawal rate as high as about 6 percent, drawing his conclusions from a study of market returns from 1973 to 2003. Mr. Guyton found that a person who retired in 1973, in the middle of a punishing bear market with very high inflation, could have supported a 6.2 percent initial withdrawal rate over 40 years with a portfolio that

was 80 percent stocks. A portfolio with 65 percent in stocks could have borne a 5.8 percent rate, and one with 50 percent in stocks could have supported a 5.4 percent rate.

"The difference between a 4 percent or a 5 percent withdrawal rate might be the difference between someone taking their grandkids on a vacation or not," Mr. Guyton said. "It's usually the last $10,000 that puts the quality in 'quality of life."'

In order to take out more than 4 percent that first year, Mr. Guyton said, investors need to follow a few rules. To generate income, they must always sell winning stocks before bonds or losing stocks. They cannot add more than 6 percent a year to their withdrawal even if inflation is higher than that. And no increases are permitted immediately after a year of investment losses.

Mr. Guyton's research can be found at www.fpanet.org/journal/articles/2004--Issues/jfp1004-art6.cfm.

TO be sure, Mr. Bernicke's and Mr. Guyton's ideas have been met with skepticism by many planners who worry that medical costs may rise so fast that they will undo a well-constructed financial plan.

The cost of prescription drugs, for example, has been rising more than three times as fast as inflation, according to data from AARP, a lobbying organization for older Americans. Nursing home costs, meanwhile, have been rising 6 percent a year, according to surveys by Metropolitan Life, an insurance company.

To hedge against these expenses, Mr. Bernicke advises retirees to buy insurance policies, but many planners say people need to save more and withdraw less.

"I prefer a more conservative estimate of distribution," said Stephanie Hancock of Hancock Wealth Advisory in Los Angeles. "I can't go back and say: 'Oops. You shouldn't have been taking out as much money the last few years,' if someone doesn't have enough." She is also skeptical about the assumption that people will cut back on expenses as they shift into retirement. "You have all this time on your hands," she said. "You could actually spend more."

And Mr. Bernicke, who is 30 years old, said he is saving furiously for his own retirement. He advises others to save as much as they can in their working years, and not to count now on spending a big part of their nest egg immediately after retirement. Such thinking isn't wise, he said, "for younger people who are just starting to save."

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