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Turning a lifetime of savings into income

The way you withdraw from your portfolio will determine how much income you will have in retirement. Here are a few options.

By Walter Updegrave, Money Magazine senior editor
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NEW YORK (Money) -- **Question:** The 4% rule seems to have become the conventional wisdom for drawing money from your savings in retirement. But I believe the rule is flawed. I think it might make more sense to choose a percentage of your savings that you will withdraw annually and then just apply that percentage to your savings balance at the beginning of each year so you would have more money to spend in years when investment returns are good and less to spend in years when returns are bad. What do you think? --*E. W., East Lansing, Michigan*

Answer: No method for turning your savings into spendable income in retirement is going to be perfect. Any withdrawal system you come up with is going to have pros and cons.

So rather than thinking of one system as better than another, I believe it's important to understand the implications of different approaches and then come up with a way that's right for you.

Fixed annuities

If I wanted to know exactly how much income I would have each month and also minimize the chances of running out of money during retirement, I'd buy a fixed-income lifetime immediate annuity.

Today, a 65-year old man who puts $500,000 into such an annuity would receive about $3,200 a month for life, which translates to just under an 8% annual payout. (To see how much you might receive for other amounts and ages, you can check out our Income For Life calculator.)

But despite the predictability that approach offers, it has drawbacks too, probably the biggest being that when you buy such an annuity you typically no longer have access to your money for emergencies and such.

What's more, since the payments are fixed, their value would decline in the face of inflation over the years. And you would also be counting on the insurance company having the financial wherewithal to make those payments as long as you live (although you can mitigate that risk by sticking with highly rated insurers and limiting the amount you invest.

The 4% rule

By keeping that $500,000 in a diversified portfolio of stocks, bonds and cash and following the 4% rule, you would continue to have access to your savings should an emergency arise or you just need extra cash.

The 4% rule also helps assure you'll maintain your purchasing power during retirement since you're boosting your withdrawal by the inflation rate each year. And by limiting your initial draw to 4% of your savings, there's a high probability -- generally 75% to 90%, depending on investment performance assumptions -- your savings will last at least 30 years.

But this rule has shortcomings too. A 4% initial withdrawal on a $500,000 portfolio is just $20,000, or $1,667 a month. Granted, that amount will grow with inflation, but it will take a while to overtake the $3,200 an immediate annuity would provide. And while the odds of your money lasting 30 years are relatively high if you stick to the 4% rule, they can drop precipitously if you run into a string of lousy returns or a big market crash like 2008's early in retirement.

The 4% rule has yet another risk people often overlook. If you follow the 4% rule and your investments perform well, you could end up with a very large portfolio late in retirement. That may be okay if you want to leave a large legacy to heirs. But it would also mean that you lived a lower standard of living in retirement than you could actually have afforded.

The fixed-percentage system

This "go with the flow" approach makes intuitive sense in a way. By withdrawing a fixed percentage, you would take out fewer dollars after your portfolio has taken a hit and have more capital left to participate in rebounds from market setbacks. And by boosting your withdrawals in rising markets, you'll be able to increase spending and enjoy yourself more in the good years.

But your system has shortcomings too. Letting your income fluctuate with the ups and downs of your portfolio's value could make budgeting a lot tougher. I suspect many retirees aren't looking for a lot of uncertainty about how much spending money they'll have year to year.

And the success of your system depends heavily on what withdrawal percentage you choose. If you go with a relatively high figure, say, 7%, it would be tough to maintain your purchasing power in the face of inflation.

And unless you're generally able to earn a rate of return greater than your withdrawal percentage, the value of your portfolio would fall over time, as would the annual income you would receive, forcing you to get by on less and less income.

Setting a lower withdrawal percentage would raise your chances of being able to generate income that would keep pace with inflation or at least not decline. But that introduces another risk. The lower you set your withdrawal percentage, the more you increase the chance that your portfolio will earn more than you're pulling out and balloon over time. In other words, you would die with a large portfolio balance. Again, that may be okay if you want to leave bucks to your

heirs. But it might not be so great if you stinted on travel or other pleasures during retirement because you were afraid you couldn't afford them.

So which is better? I don't think you can say. They're approaching the issue of turning savings into income from different perspectives. Whichever you choose, you ultimately face the same risks.

You may also want to consider combining withdrawals from your portfolio with guaranteed annuity income. Essentially, you put enough in one or more annuities to cover basic expenses, and then tap your portfolio for whatever else you need.

But ultimately, you can't put any plan for turning savings into income on autopilot and follow it mindlessly. You've got to monitor your spending needs, the size of your nest egg, the performance of your investments -- and then decide whether some fine-tuning makes sense.

Bottom line: A withdrawal system can serve as a roadmap of sorts for getting you through retirement with the income you'll need. But as with any journey, you'll also need to exercise your own good judgment along the way.