Financial Planning

Taking a Swipe at SWiP

Why the 4% withdrawal rule no longer works.

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The "SWiP" method of spending 4% of savings each year in retirement is widely accepted by advisors. After all, Systematic Withdrawal Plans are simple. They maintain full liquidity and let advisors manage clients' money much the same way they did before the clients retired. SWiP is also backed by science, of a sort. Stochastic and retrospective research shows that few clients will ever go broke if they sip only 4% from their savings a year. Just divide 100% of retirement assets by 25 years of retirement (from age 65 to 90) and what do you get? Four percent.

But the 4% solution has drawbacks. In the recent crash, it didn't protect older investors from big losses. It's a form of self-insurance against longevity risk that Nobel laureate William F. Sharpe has called "wasteful"-producing "surpluses when markets outperform... and shortfalls when markets underperform."

As a result, some advisors have adopted other drawdown or "decumulation" techniques, which use the classic "bucket" method or incorporate annuities into the distribution process and appear to deliver more income than the SWiP method at much lower risk. Any advisor who's dissatisfied with SWiP might consider them.

BUCKET BRIGADE

The bucket method is one of the most time-honored and widely used non-SWIP ways to create retirement income. It helps reduce financial anxiety in retirement, mitigate "sequence" risk and control investment risk, while also setting aside money for long-term growth.

Imagine three separate accounts: The first holds cash or cash-equivalents and provides income for the next one to five years; The second typically holds bonds and will be tapped for income in the intermediate future; and a third holds stocks, and won't be tapped for 10 years or more.

For flexibility, the bucket method knows no bounds. Each advisor and client can specify the number of buckets, the amount of assets in each, the risk profile and incubation period of each. The experience or philosophy of the advisor and the income needs and risk tolerance of the client dictate the details.

Larry Frank Sr., an advisor in Rocklin, Calif., uses a highly disciplined variation of the bucket method, which is often only two buckets. "There's a long-term bucket for three years and beyond, and there's a short-term bucket for three years or less," he says. As the client spends down the assets in the short-term bucket, Frank steadily refreshes it by liquidating assets in the long-term bucket-except in extraordinary circumstances. Last fall, he temporarily halted the cascade to avoid selling devalued assets at their nadir. Frank described his method in detail in the April 2009 issue of the Journal of Financial Planning.

Frank sets an initial client spending rate that varies from 3% to 6%, depending on the client's retirement age, life expectancy, asset level and spending needs. During retirement, he adjusts the spending rate up or down, depending on whether the risk of running out of money rises or declines.

Frank reduced his clients' exposure to stocks in early 2007. As account balances grew in mid-2009, he has considered increasing equity exposure, but he questions the strength of the summer rally.

Another bucket system advocate is Denver-based advisor Phil Lubinski, who sets up as many as six buckets of five years each to cover the life expectancy of a healthy 65-year-old couple. The first bucket, containing enough cash-equivalents to finance the first five years, is funded before retirement. The last bucket, invested in volatile assets like small-cap equities, won't necessarily be opened for another quarter-century.

Each succeeding bucket starts out with less money than the last, in anticipation that it will appreciate enough by its "maturity date" to fund the next five years of retirement. If the bucket matures early, Lubinski may reduce its risk profile. If it lags, clients may spend less or borrow from the sixth bucket. If untouched for 25 years, the value of the sixth bucket should equal the client's initial wealth and provide a legacy.

BUENOS DIAS

Burlington, Iowa, insurance rep Curtis Cloke believes that retirement peace of mind can be obtained through inflation-adjusted deferred income annuities (DIAs) with period-certain only payouts. These are bought at a steep discount today to provide guaranteed income in, say, 10 years. A 65-year-old client might pay about $313,000 today for single-premium immediate annuity that pays $64,000 a year for five years, with a 2% annual inflation adjustment, according to Vanguard's online calculator. A 55-year-old client would pay only about $218,000 for the same income 10 years in advance.

The advisor can build a ladder of these deferred payout annuities. "It's an investment play, not an insurance play," Cloke says. "You're buying an income based on a rate of return, whether you live or die. The longer you defer, the higher the return."

Dean Barber, who specializes in advising retired clients in Lenexa, Kan., thinks many retirees neglect an opportunity for huge savings by not leveraging the value of Social Security benefits. Instead of taking benefits at age 62 and letting tax-deferred assets alone, his clients spend private savings first and postpone Social Security benefits until age 70, when the monthly payments are actuarially the same (because of the recipient's shortened life expectancy) but much higher in dollar terms. "Social Security is a misunderstood, misused asset class," Barber says. "We start our planning process with Social Security at the core."

The average person would need about $250,000 in savings, or take the risks necessary for 8% or 9% annual market appreciation, to match the age-adjusted, inflation-adjusted income from optimizing Social Security. Depending on when the client decides to retire, he or she can keep their near-term money in cash, CDs or a short-term, period-certain annuity, he says.

For clients who like the idea of an all-in-one, product-based solution to the retirement income challenge, a variable annuity contract with a guaranteed lifetime withdrawal benefit (GLWB) or a guaranteed minimum income benefit (GMIB) might be in order.

These products have some optional and some built-in components. The chassis is a variable annuity—a portfolio of mutual funds whose assets can grow tax-deferred until they can be withdrawn penalty-free, usually after age 591/2-that typically carries a death benefit with a minimum guaranteed payout to beneficiaries if the owner dies. Most variable annuities include an alphabet soup of living-benefit riders. GLWBs, for instance, promise retirees an annual income of at least 5% of the original premium for life, even if bear markets drain the account. GMIB riders resemble traditional income annuities. Unlike GLWBs, they are irrevocable and illiquid, but typically pay a higher rate of income.

Tens of billions were invested in these products during the bull market, and people who bought them in 2005 or 2006 should be pleased: Their future rate of income was protected from the meltdown. Insurers lost billions on GLWB riders, however, and have since raised living-benefit prices, reduced coverage or required owners to hold more conservative portfolios.

These alternatives to the 4% SWiP method have two major pluses. First, they typically involve guarantees or pre-funding strategies that protect people near retirement age from sequence-of-returns risk-the risk that a downturn will shock their portfolio value and permanently reduce their standard of living in retirement.

Second, they help mitigate the anxiety retirees suffer when the same investments they are drawing down are at risk in the market. Assets in later buckets are exposed to risk—that's how they appreciate—but they won't be needed for many years.

These methods (except the variable annuities) are labor intensive. They require careful design, frequent monitoring and periodic adjustments. Each plan is somewhat unique to the needs of the investor. But they appear to be an improvement on the 4% solution.