MarketWatch

How to reduce your anxiety about having enough money in retirement

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Build a retirement-income portfolio that works for you

Going into retirement, one of the most overwhelming concerns you may be having is, “Will we have enough money to support us for the rest of our lives?”

We spend about 40 years of our lives working, contributing money to our nest egg, and watching it grow. Then at retirement, we must suddenly switch gears and start depleting it. The fear of the unknown, and starting to whittle down that nest egg that we are so used to building up, can be very scary — no matter how much money we’ve saved.

At some point or another we ask ourselves, “What is the best way to live off our nest egg and at the same time, make sure it will last? How do I invest to avoid the anxiety of market dips?” There are many age-old rules of thumb out there, like the 4% withdrawal rule that says you should be able to safely take out 4% of your portfolio per year to avoid depleting your investments. That used to be a decent rule of thumb when money market mutual funds were generating 4% interest, but those funds are yielding about 0.50% to 1% now; so, our investments have to work a lot harder to get returns.

In reality, there is no set percentage that works for everyone universally. Instead, what truly matters is your “quality of life amount.” This is the amount of withdrawals needed from your investment savings to maintain your current lifestyle.

This amount is different for everyone, which is why strategic financial planning is incredibly important to determine it. There are multiple factors that are integrated into the withdrawal rate including your current spending rate on fixed and discretionary expenses, taxes, rate of return, and number of years in retirement being the largest factors. And don’t forget about inflation. Inflation can creep in and eat away at investment returns very quickly. Health care costs alone are increasing at least 6% annually.

One of the easiest ways to come up with your spending rate (and your quality of life rate) is to take the after-tax income you have received for the past several years and subtract your annual savings amount. Essentially, the rest was spent to support your daily life, which is your quality of life spending. From there, you will want to project this withdrawal rate over the span of your retirement (incorporating inflation and investment returns). Once you have these projections you should ask yourself, “How can I invest my assets so I feel confident they are going to support my withdrawal plan?”

The typical answer one might get from an investment adviser is that to generate the returns needed to fund your withdrawal needs in the financial plan, you need to invest in a 70/30 or 60/40 stocks-to-bonds ratio of investment allocation. While this might be the right mathematical answer, it typically doesn’t help retirees connect the dots from the financial plan to the investment allocation. It doesn’t explain how the investments will support that withdrawal strategy throughout retirement so it leaves the investor feeling anxious about market crashes. One solution to make this connection and bring this from the adviser’s world to your world is to get to what matters to you: a deposit of cash into your bank account.

Instead of thinking about it in equity-to-bond ratios, look at it with a different lens. This lens will segregate your cash flows into three timeframes and match the investments and risk characteristics to each of these segments in time. Every client has a short-term, a mid-term, and a long-term withdrawal need. Their personal short-term need should span the amount of time they would need assets to support them through a prolonged downturn in the market. Think of it as “preservation” time. Their mid-term need would then start to support a number of years extended to allow for a market recovery and the long term would be there to provide growth for the years thereafter.

Let’s say after much thought, you determine you would be comfortable with a short-term time frame of six years and a mid-term of five years. If we forecast the withdrawal rate with inflations for six years, we will determine an amount that would need to be invested for our short-term preservation needs. This money would be invested in short-term assets that would be the least affected by a market dip so you always know you have six years of cash flows in your retirement mix that can support you through traumatic dips in the market. The same calculation would be done for the mid-term withdrawal needs and brought back to present value to tell us what amount you need to have invested today, for years seven to 12 — the prudent growth and income strategy years.

Everything else can be invested for the long-term growth, which is 100% equity-like assets. For those lucky people, if the long-term assets are more than enough to support them through years 13 and beyond, they can choose to reallocate some of those funds to the short and mid-term investments to provide more support.

After running through these calculations, you will come up with a short/mid/long-term allocation of say, 30%/20%/50%. You can interpret this as 30% of your assets will be invested in a way that will not lose money, but will preserve and keep up with inflation so you don’t have to worry about those investments being affected by a sharp turn in the market. This segment of investments will support the short-term withdrawal needs, providing six anxiety-free years of cash flows coming in while allowing the longer-term assets to either grow with the market or recover from a downturn.

This process also allows for an additional five years of cash flow (or 20% of your portfolio) that is invested in assets that will be expected to generate returns at a rate higher than inflation with less risk than equities. So in the event of a market downturn, the assets in this mid-term segment would recover faster than the equity-like assets that are held in the long-term segment. Through this process, your portfolio can literally let the growth assets (approximately 50%) be untouched (in theory) for 11-plus years if they needed to.

In good market years, your investment adviser would trim from growth and reallocate it to the preservation and income assets in the portfolio. In market downturns, only the preservation assets are sold to cover withdrawals. At the end of the day, in the adviser’s world, this still leads to an investment allocation of 60%/40% or 70%/30% equity to bond ratio (or something else) that is predicted to yield the amount of return necessary for your portfolio to support your living need.

However, it’s so much more meaningful in your world when you overlay this financial plan onto your investment portfolio, providing that extra layer of security thanks to the meaningful plan backing up your investment philosophy. You can rest easy knowing that in a downturn, you have created a thoughtful plan that you just need to follow instead of making knee jerk decisions that may be harmful in the long run. Because of this, your level of anxiety about market volatility can be reduced significantly because you always know when and where your withdrawals will come from, in good times and bad.

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