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Planning for a Decline?

Retirement income strategies should reflect retirement spending realities. Whatever needs Social Security and pensions do not cover must be addressed using other sources, including income from IRAs, 401(k) plans, or other retirement savings accounts. While every retiree's circumstances are unique, industry experts have sought to create general guidelines for generating *sustainable* income—the ideal combination of asset allocation and withdrawal rates that ensure people meet all income targets and avoid running out of money during retirement.

Often these guidelines assume that retirees' spending needs rise with inflation, so that income targets have to be increased every year. Perhaps the most well-known example, the so-called “safe withdrawal rate” of 4.0 to 4.5 percent of initial portfolio, adjusted for inflation (Consumer Price Index, or CPI) annually, has been a cornerstone of retirement income modeling for a quarter century. In 1994, William Bengen developed the safe withdrawal rate paradigm by examining historical market returns for various asset classes and inflation. Using an optimal asset allocation, rebalanced annually, he found that in no 30-year historical period since 1926 would a withdrawal rate of 4.5 percent or less result in a retiree depleting his or her investment portfolio.¹

But while useful for some purposes, this common paradigm may be uninstructional for real-world retirees. Why? Because, as a growing number of retirement experts have noted, *real-world retirees do not spend down their assets to meet annual inflation-adjusted targets.*²

- Many retirees don't touch their savings at all and instead rely entirely on Social Security (which is inflation-adjusted) and pensions for their spending needs.³ Our research indicates that some retirees

withdraw interest and dividends from their savings, but do not tap their principal.⁴

- Even those who do deploy their portfolios to provide a proportion of their income are usually not trying to meet income targets that rise in line with CPI. In some cases, these assets are allocated toward discretionary spending needs, many of which do not vary with CPI and represent a varying proportion of a retiree's total spending.⁵
- U.S. government data, such as the Consumer Expenditure Survey and other research, suggest that overall spending remains level or even declines during retirement.⁶ Cross-sectional data indicate a decline in expenditures with age, though that pattern could reflect generational cohort differences—perhaps those raised during the Great Depression are thriftier than their Baby Boomer children. More compelling are longitudinal data that indicate within a single cohort, over a 7-year stretch, spending levels change very little.⁷

Under the “safe withdrawal” paradigm, periods of high inflation, like the 1970s, would be especially challenging to navigate. The first half of the 30-year period beginning in 1969 witnessed very high inflation, resulting in a year-15 income target 2.7 times as high as the year-1 income target. Using the standard asset allocation conditions established by Bengen, starting in 1969, an initial withdrawal target of 4.5 percent of the portfolio, adjusted for inflation annually, would have resulted in savings depletion by year 26.

What happens to the “sustainable” withdrawal rate if income targets are adjusted to align with real-world, 21st-century spending patterns? If income targets are set to *decline* 1 percent per year, withdrawals beginning in

1969 could have been sustainable over 30 years, even when the initial withdrawal rate is set as high as 8.2 percent.⁸

So should advisors and their clients assume that the “go-go” early years of retirement will be followed by the “slow-go” and “no-go” years, with activity levels and spending inexorably declining? Before doing so, they should consider some major caveats to the “planning for decline” strategy.⁹

- Models are based on aggregated data. There is a lot of individual variation in spending patterns, with some retirees steadily increasing their spending while others cut back, and non-linear changes in spending, with a surge around the time of retirement and late in life.¹⁰ Some degree of liquidity and flexibility must remain to account for these uncertainties.
- Spending may decline because a spouse dies, as opposed to a planned, voluntary reduction in discretionary activities. While some types of spending usually decline, certain fixed expenses, like rent, do not.
- Annual inflation has been very tame for three decades, averaging around 2.5 percent, which may partly explain why many recent retirees’ spending levels haven’t increased. Similarly, future investment returns could be lower than historical returns, making it more difficult for withdrawal rates to be sustainable.
- Sequence-of-return risk exposure could worsen if withdrawals are front-loaded instead of spread out more evenly during retirement.
- When possible, retirees employing this strategy should limit the use of the portfolio to spending on non-essential discretionary activities that tend to occur earlier in retirement—depletion of the portfolio would not pose a major threat to long-term security in that case.

Perhaps most important, many people planning for retirement may reject the spending-decline strategy because it is placing limits on their future selves. But as

noted, this is the spending pattern many retirees already follow—and people are already limiting their *present* selves by under-consuming during the years in which they are most able to enjoy retirement activities. Moreover, the industry may be able to play a role in making the strategy more attractive. For example, annuity or fund payouts designed to maximize consumption in the early stages of retirement, with initial payouts considerably higher than level income options, could be explored. Regardless, the industry must ensure that its products and services meet the needs of real retirees—and strategies for income should reflect spending realities. 🌐

¹ Bengen, William P. “Determining Withdrawal Rates Using Historical Data.” *Journal of Financial Planning*: 14–24, 1994, pp. 171–180. Bengen’s original article identified the maximum safe withdrawal rate to be 4.0 percent of initial portfolio value, but in subsequent work he increased the rate to 4.5 percent. His analysis, as well as those reported in the present article, do not include portfolio fees or other adjustments to market returns.

² For example, see Roy, Katherine, and Kim-Steiner, Yoojin, “Three Retirement Spending Surprises,” January 2019, JP Morgan Asset Management website (<https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/three-retirement-spending-surprises>) [Accessed August 2, 2019]; Blanchett, David. “Exploring the Retirement Consumption Puzzle,” *Journal of Financial Planning*: 27–5, 2014, pp. 34–42; Banerjee, Sudipto. “Expenditure Patterns of Older Americans, 2001–2009,” *EBRI Issue Brief*, February 14, 2012.

³ Banerjee, Sudipto. “Asset Decumulation or Asset Preservation? What Guides Retirement Spending?” *EBRI Issue Brief*, April 3, 2018.

⁴ A 2015 LIMRA Secure Retirement Institute survey of consumers age 50 and older found that 1 in 5 planned to draw down only investment earnings, interest, and dividends to cover their expenses, not tapping their principal.

⁵ For example, see *Retirement Spending: Experience Versus Expectations*, LIMRA Secure Retirement Institute, 2017.

⁶ Consumer Expenditure Survey, U.S. Bureau of Labor Statistics, September, 2018 <https://www.bls.gov/cex/2017/combined/age.pdf> [Accessed August 5, 2019].

⁷ Banerjee, Sudipto. “Expenditure Patterns of Older Americans, 2001–2009,” *EBRI Issue Brief*, February 14, 2012. Spending rates are generally level except among the oldest cohort (85 years old or more) where spending increased about 20 percent, possible due to stepped-up late-life spending on healthcare.

⁸ Since inflation is not part of the analysis, the main concern for sustainability is market performance. So in this context, the “worst” recent historical period (since the 1930s) does not begin in 1969, but rather in 2000. If retirement begins in 2000, with investment returns in 2019 onward set to equal those experienced in 1969 onward, then the initial withdrawal rate can be up to 7.0 percent and still meet the (declining) income targets across a 30-year period.

⁹ For discussion on some of the implications of retirement spending research, see Guyton, Jonathan, “Why David Blanchett’s Retirement Spending Research Is a Big Deal,” 2016, Financial Planning Association website. <https://www.onefpa.org/journal/Pages/MAY16-Why-David-Blanchett%E2%80%99s-Retirement-Spending-Research-Is-a-Big-Deal.aspx> [Accessed August 2, 2019].

¹⁰ Roy, Katherine, and Kim-Steiner, Yoojin, “Three Retirement Spending Surprises,” January 2019, JP Morgan Asset Management website (<https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/three-retirement-spending-surprises>) [Accessed August 2, 2019].