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Investing Compass

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The webinar will begin shortly

# Important Information

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# Morningstar retirement bootcamp

Webinar 1 - Retirement spending: How to estimate retirement spending and the basics of a safe withdrawal rate.

**Webinar 2 - Creating a plan for retirement: A step-by-step process for estimating how much you need to retire and a plan to get there. As part of the presentation, we will address retiring early.**

Webinar 3 - The transition to retirement: How to successfully navigate this challenging time for your finances and what to do it you don't have enough to retire.

Webinar 4 - How to manage your portfolio in retirement: Asset allocation in retirement including an income strategy for retirement and the bucket method.

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# Learning objectives

1.    Estimate your retirement lump sum goal as a target for your savings goals and investment strategy

**What you need for today:** An estimate of your first-year retirement spending needs

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# A safe withdrawal rate: The 4% rule

An American financial planner named Bill Bengen set out to determine the so called 'safe' withdrawal rate. He ran a portfolio of 50% shares and 50% bonds through every historical return combination between 1926 and 1992  to find a withdrawal rate that would not result in running out of money in retirement using the following parameters:

1.  The portfolio used a consistent **real** withdrawal rate– meaning that each year the initial 4% withdrawal would be increased by the level of inflation

2.  'Retirement' was defined as 30 years

The future is unknowable, and the 'safe' withdrawal rate must account for **unknown levels of returns**, an **unknown sequence of returns**, an **unknown level of inflation** and an **unknown length of retirement**.

The 4% rule is separate from the ATO mandated super withdrawals. A safe withdrawal rate is designed to prevent running out of money before death. The ATO has different motivations. Withdrawing money from super does not mean it needs to be spent.

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# A personalised withdrawal rate

*Our goal today is to estimate a personalised withdrawal rate based on your circumstances which will be used in conjunction with your first-year spending needs to calculate your retirement target.*

We are going to start with the rule of thumb 4% rule and personalise it across three dimensions:

1. Inflation

2. Length of retirement

3. Certainty of retirement outcomes
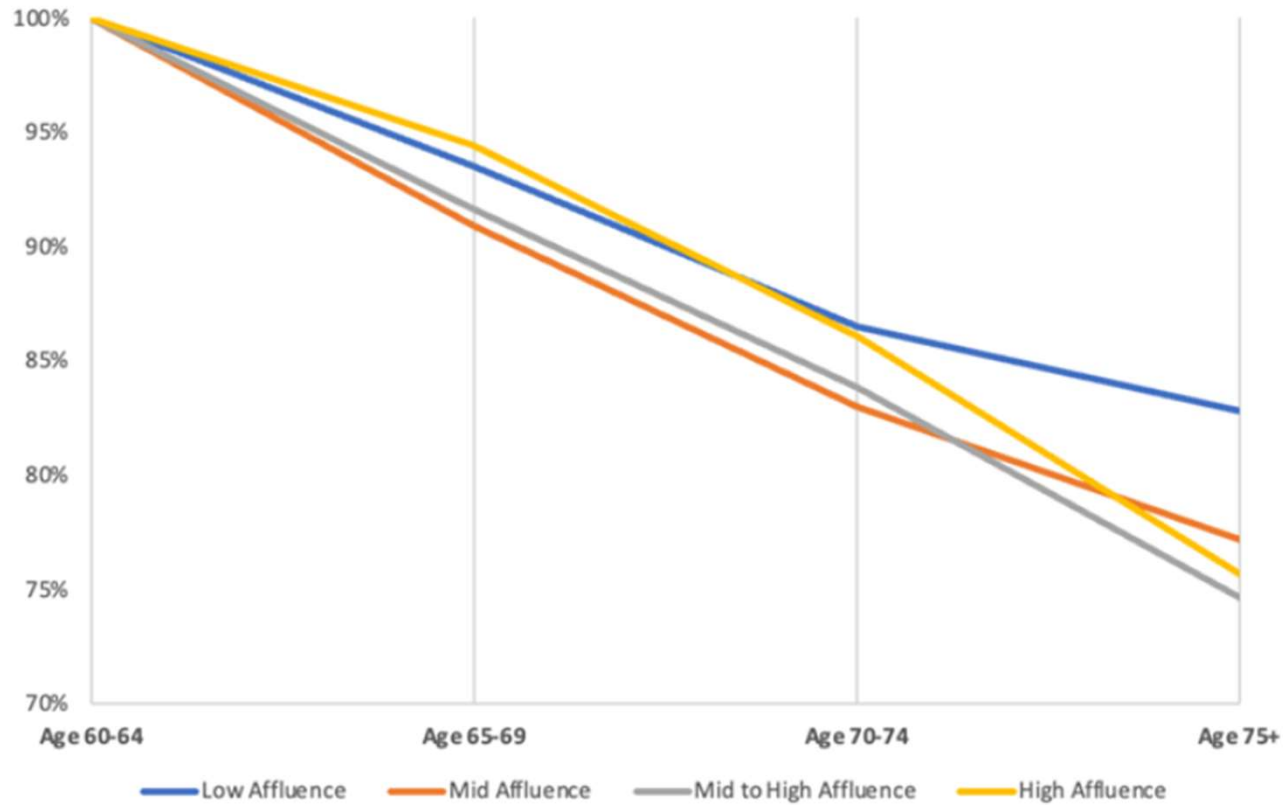
# A personalised withdrawal rate: Inflation

*The 4% rule assumes that the dollar amount of withdrawals is increased by inflation each year to help a retiree maintain a steady real standard of living. Given this assumption higher inflation will decrease the amount of time a portfolio lasts as more is taken out.*

While this assumption makes senses for a rule of thumb it doesn't distinguish between the differences in each of our finances and the categories that we choose to spend money. Spending can be bucketed into 'needs' and 'wants.'

Spending on wants and needs is fundamentally different. It is harder to substitute your needs. Wants are easier to substitute. Spending on wants also tends to diminish as people age. Needs tend to stay the same or even increase if you require more medical care.

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# A personalised withdrawal rate: Inflation



Chart 1: Average retirement spending for different age bands (percentage change)

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# A personalised withdrawal rate: Inflation

The default is to continue to use a 4% withdrawal rate on both wants and needs. But given the difference between the spending and the changes in spending levels over the course of retirement I've proposed that people consider making the following adjustments for inflation as part of a retirement plan:

- **Use the classic 4% safe withdrawal rate for needs and a 5% withdrawal rate for wants:** Most people want more certainty that needs will be meet. Wants can be substituted more easily. 5% is a Morningstar calculated safe withdrawal rate based on the historical propensity to reduce spending as retirees age. I've been a little more conservative with my model but each individual should adjust based on their personal circumstances.

- **Apply non-portfolio income for needs:** That includes the age pension, annuities, and a reverse mortgage. The age pension and some annuities are indexed for inflation which provides additional protection. Having guaranteed income applied to needs provides additional safety for a retiree.

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# A personalised withdrawal rate: Inflation

*Julia wants to retire at 60 and has estimated $69,0000 in spending needs for her first year of retirement. She expects to receive $20,000 in non-portfolio income during her retirement. She is in excellent health and has longevity in her family. She owns her home outright and ideally would like to leave it to her daughter.*

| Category | Spending for needs | Spending for wants |
|---|---|---|
| Housing and food | $ 50,000.00 | $ - |
| Travel | $ - | $ 19,000.00 |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| | $ - | $ - |
| Total non-portfolio income | $ 20,000.00 | |
| Total | $ 30,000.00 | $ 19,000.00 |
| Weighting | 61.22% | 38.78% |
| Withdrawal rate | 4.00% | 5.00% |

| Weighted withdrawal rate |
|---|
| 4.39% |

| Annual portfolio supported spending |
|---|
| $ 49,000.00 |

| Retirement goal |
|---|
| $ 1,116,744.19 |

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# A personalised withdrawal rate: The length of retirement

*The 4% rule assumes that retirement will last 30 years. While the amount of money left after 30 years will be based on levels of returns, sequence of returns and inflation an individual planning retirement should understand the ramifications of a longer retirement period.*
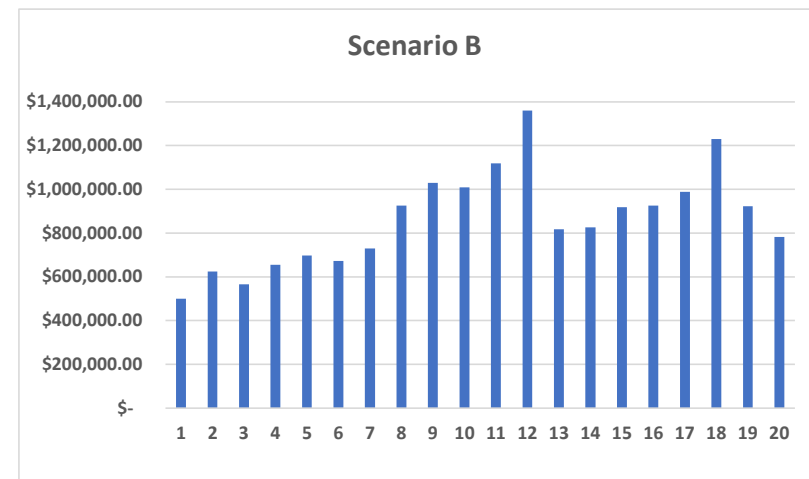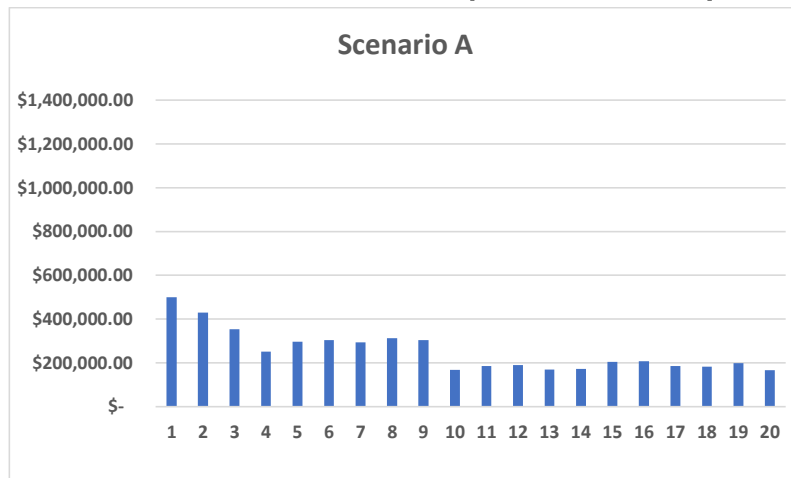
I've used the baseline of a 30-year retirement embedded within the 4% plan. Based on Morningstar modelling I have reduced the withdrawal rate for retirements longer than 30 years and added to the withdrawal rate for retirements less than 30 years.

This allows a retiree to account for early retirement, family health history and any pre-existing conditions to adjust withdrawal rates. An individual planning a meaningfully early retirement should particularly be mindful of the withdrawal rate used as the typical spending decreases in retirement will not occur for a long time.

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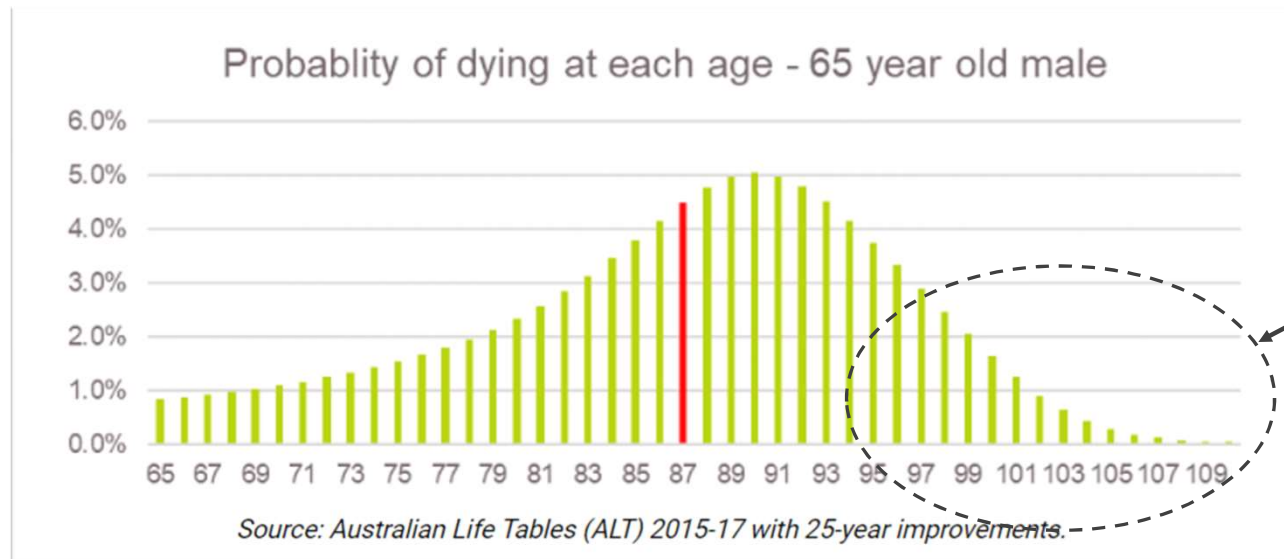# A personalised withdrawal rate: The length of retirement

The order / timing of returns on your portfolio during retirement matters almost as much as the level of returns you receive. Negative returns early in retirement can significantly reduce the number of years until you run out of money given a standard withdrawal rate.

**Two scenarios of 20 years for a $500k portfolio invested in the S&P 500 with $20k a year withdrawals**



Scenario A: Actual returns between 2000 & 2020 results in $165k

Scenario B: Reversed sequence of returns between 2000 & 2020 results in $782k

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# A personalised withdrawal rate: The length of retirement

Planning retirement for a large group of people is relatively easy because you can use the average life expectancy as the basis for the approach. When planning your own retirement you need to account for that fact that you may get lucky and exceed the average. Your portfolio needs to be designed to stay around as long as you do.



The risk is in the tail outcomes of living a long time

# A personalised withdrawal rate: The length or retirement

*Julia wants to retire at 60 and has estimated $69,0000 in spending needs for her first year of retirement. She expects to receive $20,000 in non-portfolio income during her retirement. She is in excellent health and has longevity in her family. She owns her home outright and ideally would like to leave it to her daughter.*

| Preliminary withdrawal rate | 4.39% |
|---|---|

| Estimate for length of retirement | Change to withdrawal rate | Select 'Yes' or 'No' in appropriate cell |
|---|---|---|
| 10 years | 4.80% | No |
| 15 years | 2.80% | No |
| 20 years | 1.40% | No |
| 25 years | 0.50% | No |
| 30 years | 0.00% | No |
| 35 years | -0.40% | Yes |
| 40 years | -0.60% | No |

| Length or retirement adjustment | -0.40% |
|---|---|
| Total withdrawal rate | 3.99% |

| Annual portfolio supported spending | $ 49,000.00 |
|---|---|

| Retirement goal | $ 1,228,761.51 |
|---|---|

# A personalised withdrawal rate: Certainty of retirement outcomes

*4 factors will influence how long a portfolio will last when you start taking money out of it under historic market conditions. The rule uses a 90% success rate - in 90% of the scenarios the retiree will not run out of money over 30 years.*

Any outcome that is based on the sequence of returns and inflation levels means that the timing of retirement matters. And since the timing of retirement is driven by birth year, we must acknowledge how big of a role luck plays in retirement outcomes. A retiree that does not have the bad luck of retiring into a poor market environment with high inflation will be fine even at a rate higher than 4%.

Adjusting the success rate will change the withdrawal rate. If a retiree wants more certainty the withdrawal rate is reduced. If a retiree is comfortable with a lower success level the withdrawal rate will increase.

There are factors that may cause a retiree to choose to lower the success rate. These can include significant non-retirement assets (a home) or a meaningful contribution from non-portfolio sources of income include an annuity, a reverse mortgage or the age pension. Consider the success rate in light of your overall financial position.

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# A personalised withdrawal rate: Certainty of retirement outcomes

*Julia wants to retire at 60 and has estimated $69,0000 in spending needs for her first year of retirement. She expects to receive $20,000 in non-portfolio income during her retirement. She is in excellent health and has longevity in her family. She owns her home outright and ideally would like to leave it to her daughter.*

| Preliminary withdrawal rate | 3.99% |
| --- | --- |

| Success rate | Change to withdrawal rate | Select 'Yes' or 'No' in appropriate cell |
| --- | --- | --- |
| 50% | 1.30% | No |
| 60% | 1.00% | No |
| 70% | 0.80% | No |
| 80% | 0.50% | Yes |
| 85% | 0.30% | No |
| 90% | 0.00% | No |
| 100% | -1.60% | No |

| Length or retirement adjustment | 0.50% |
| --- | --- |
| Total withdrawal rate | 4.49% |

| Annual portfolio supported spending | $ | 49,000.00 |
| --- | --- | --- |

| Retirement goal | $ | 1,091,859.94 |
| --- | --- | --- |