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TOPIC #4: Sustainable Withdrawal Rate Theory

PROMPT: How could one test the hypothesis that the presumed “sustainable withdrawal rate” can be modified to enhance retirement outcomes?

It is not easy to presume modifications to sustainable withdrawal rate (SWR) theory will better determine retirement outcomes. Some will be multiplicative, some may perform worse, and some may be altogether different. SWR as it stands reflected in Kitces report, advocates 4% as the initial withdrawal rate.

The additive methodology is principled in slight adjustments to spending decisions or floor-leveraging, slight adjustments to spending patterns or tax rates, slight adjustments to life expectancies, to social security step-ups or step-downs, to quarterly rebalancing, advisor fees or tax loss harvesting. But additive changes do not account for radical differences in the way securities perform or correlate, radical differences in potential legislative changes (i.e, what if social security tax on gifting or trust creation?), radical differences in scientific advancements that alter life expectancies, or rampant deflationary pressure.

A big concern of mine is how we may see the teeter-totter correlation of stocks and bonds look dramatically different over the next 2 decades as bond market performance may continue to remain suppressed by both fiscal and fed pressure but also, the level of demand for high yielding issuances from a growing population of baby boomer retirees.

Investors also face levels of interconnected global economic growth, and therefore potential parity across large cap US and international equity markets— as developed international countries forge new trade deals and common currency alliances (i.e Eurozone), so increases the need to review the true underlying degree of diversification in one’s portfolio. As Kitces (2012) points out, war on our soil would have an “all bets are off” impact on SWR as well.

Legislatively (decided by congress), minimum distribution tables historically grow with inflation, as do annual deferral limits, having a multiplying effect on future withdrawal rates. With more dollars entering tax efficient vehicles (i.e earning compounded growth) means a larger quantity at retirement and a possibility of taking larger percentage annual distributions.

Testing this hypothesis is a very interesting question. I do believe utilizing monte carlo analysis based on actual results versus assumptive averages is already a step in the right direction. Modeling more radical assumptions does not sound prudent, though it could be an exercise for an academic. The best course of action in my mind is to continue gathering as many data points and continue updating our asset class and tax table analysis with the most current inputs to have the most relevant statistics. I think an advisor should stick to the modeling assumptions condoned by their parent company, but remain grounded in new research/education opportunities to avoid complacency in modeling know-how. It is key to remember model outcomes for retirement solvency are far more impacted by changes in clients’ timeline and income level, rather than changes in outcomes due to economic and legislative assumptions.

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References:

Kitces, M. (2012). "Practical Application of 20 Years of Safe Withdrawal Rate Research." *The Kitces Report* (March 2012).

No investment strategy can guarantee a profit or protect against loss. All investments carry some level of risk including the potential loss of principal invested.

Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

With fixed income securities, such as bonds, interest rates and bond prices tend to move in opposite directions. When interest rates fall, bond prices typically rise and conversely when interest rates rise, bond prices typically fall. This also holds true for bond mutual funds. When interest rates are at low levels there is risk that a sustained rise in interest rates may cause losses to the price of bonds or market value of bond funds that you own. At maturity, however, the issuer of the bond is obligated to return the principal to the investor. The longer the maturity of a bond or of bonds held in a bond fund, the greater the degree of a price or market value change resulting from a change in interest rates (also known as duration risk). Bond funds continuously replace the bonds they hold as they mature and thus do not usually have maturity dates, and are not obligated to return the investor's principal. Additionally, high yield bonds and bond funds that invest in high yield bonds present greater credit risk than investment grade bonds. Bond and bond fund investors should carefully consider risks such as: interest rate risk, credit risk, liquidity risk and inflation risk before investing in a particular bond or bond fund. With fixed income securities, such as bonds, interest rates and bond prices tend to move in opposite directions.

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