How to make your retirement savings last forever

By Mark Hulbert
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New research explores various retirement spending strategies

At the first sign of trouble, cut back temporarily.

Do you expect to spend the same amount in each and every year in retirement?

Of course not. Yet many financial plans nevertheless assume that you will. The famous 4% rule, for example, grew out of research about what steady withdrawal rate you could maintain throughout retirement and never run out of money—even if the markets perform as terribly as they have in the worst periods in U.S. history.

By definition, of course, avoiding the worst-case scenario ends up, in most cases, leaving a lot of money on the table. New research shows that there is a better way.

This new research, which began circulating in academic circles earlier this month, was conducted by Javier Estrada, a professor of finance at IESE Business School in Barcelona. His new study is entitled: “Managing to Target (II): Dynamic Adjustments for Retirement Strategies.”

In it, Estrada measured the success rates of various strategies that adjusted withdrawal rates depending on whether your portfolio in any given year is ahead or behind of what your retirement financial plan had assumed it should be. It will be ahead, needless to say, if your investments perform better than had been assumed by your financial plan—and behind if your investments have performed more poorly.

Estrada refers to strategies that adjusted withdrawal rates as “dynamic,” in contrast to the “static” strategy implicitly assumed by many financial planners.

To illustrate: Let’s say you retire with a $1 million portfolio, want to fund a 30-year retirement, and your investments grow at an annualized rate of 5% above inflation. Assuming you do not intend to leave a bequest, and assuming your portfolio’s investment return is 5% in each year along the way, you can withdraw the equivalent of $61,954 in today’s dollars in each and every one of those 30 years.
In fact, of course, that italicized assumption is unrealistic. Given the inevitable variability of yearly returns along the way—some good and some bad, it’s not unlikely that, at some point along the way, your portfolio’s performance would be insufficient to support that rate of steady withdrawals. You’d run out of money, in other words.

Estrada wanted to know if it would be a better idea, at the first sign of trouble, to temporarily reduce your withdrawals—rather than wait until your portfolio is completely depleted. He found that doing that significantly increased the likelihood of achieving your retirement financing goals. And increasing your chances of success didn’t require overwhelmingly large adjustments. Even reducing your withdrawals by 10% or 20% had a significant impact—meaning, in the above example, that your annual withdrawal would be no lower than $55,759 or $49,563 (for a 10% or 20% temporary reduction, respectively).

You might find such a reduction intolerable, of course. But bear in mind several things. First, the required reduction wouldn’t come as an immediate surprise, since it would be obvious nearing the end of a particular year that your portfolio was falling short—giving you time to plan for the reduction. Secondly, there aren’t any great alternatives when your retirement portfolio falls short. Not reducing your withdrawals only postpones your pain, since eventually you will have to reduce your spending.

Thirdly, the dynamic strategies Estrada explored also allow for increased withdrawals following years in which your retirement portfolio is ahead of its targeted value. There is no requirement that you spend that extra amount, of course, and you could put it in a rainy-day fund to support you in those years in which withdrawals are lower.

Estrada also explored another type of dynamic retirement financing strategy, which involved adjusting your equity allocation according to whether your retirement portfolio is ahead or behind its targeted value. Though he found that these strategies also helped, they were not nearly as helpful as those dynamic strategies that adjusted withdrawal rates.

Estrada’s new study complements an earlier one that focused on strategies during the preretirement phase of your life when you’re saving and investing. You may recall that I devoted another column to that earlier study, which also found that dynamic strategies are superior to static ones: A willingness to adjust the amount you save and invest, depending on the performance of your portfolio, increases the chances you will achieve whatever goal you have set for how big your portfolio should be when you retire.

This new study extends that conclusion, allowing us to conclude generally that being dynamic—a willingness to adjust investment or withdrawal amounts—increases your chances of reaching your goals.

The even broader implication is that the world is profoundly uncertain, and no amount of good planning can possibly deal with every eventuality. So it behooves all of us to plan for flexibility.

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