

Square The Peg Or Round The Hole

By Steve Kelley



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Last week, I had a couple of interesting client meetings that underscored some of the roadblocks we often encounter in retirement planning. The things these roadblocks have in common: They are both derivatives of barriers created by the clients themselves and often based on things not necessarily true.

The most common issue we see with clients is a fear of running out of money. The second- most common is the misconception that to ensure their money lasts, people must live like paupers all their lives. These two meetings underscored these issues. The first couple was adamant that they didn't want me to plan for 40 years, even though they are both 55 and the average lifespan for them is 89. The second couple was very

concerned that they would run out of money and wanted a plan that would help them scrimp and save so their money would last.

You might have missed it, but both sets of clients were dealing with the very same issue: We have no idea how long we are going to live and, therefore, have no idea how long our money needs to last. Wall Street wants you to believe this is solely a function of the size of your nest egg and how much return you can get on your investments. While we recognize that as a component of the issue, it is merely a piece – and not the most important piece, at that.

We baby boomers have been sold on the idea that a successful retirement is tied to how much of a return we get on our investments, leading to what's known as the "4% Rule." This rule of thumb states that one should begin by withdrawing 4% of their retirement holdings per year and add a 3% inflation adjustment each year. In theory, this will give them an 89% chance of not running out of money over a 30-year retirement.¹ Recently, there have been studies which have determined that a 4% withdrawal rate is too high, considering what happened during the last decade. Morningstar has determined one should begin withdrawing no more than 2.8% per year.²

Our primary challenge as planners is this 4% approach, which represents a status quo that suits the financial industry just fine. It demands cutting back, or "squaring the peg." We think you should find a round hole: Instead of focusing on how big you can grow your nest egg, why not focus on maximizing the income payout you can get from it?

The "square-peggers," or those who swear by the "4% Rule," would have you believe the two are one and the same – but they are not. To maximize your income stream, look toward refocusing your attention from "How much can I earn on my investments?" to "How long am I going to live?"

Imagine you have a crystal ball that could tell you exactly how long you will live. What a difference it would make! Let's look at a hypothetical example: If you are 65 years old, are married, and know you would live to be 89, you could easily do the math and figure out that you could pay yourself 4.167% a year for life with a 0% rate of return. How would that impact your approach? Assume you need \$10,000 a year in income on top of your Social Security benefits. Using the "square peg method," you would divide that \$10,000 by Morningstar's recommended

withdrawal rate, 2.8%, and find out you need approximately \$357,000 total in retirement savings for an 89% probability of success in providing income for your entire retirement.

$1/(89 \text{ years old} - 65 \text{ years old}) =$	4.17% withdrawal rate
\$10,000 a year/.028 withdrawal rate	\$357,142.86 total savings needed

Using our same hypothetical example, if you know you are going to live to age 89, you could multiply \$357,000 by 4.167% and determine you could take approximately \$14,876 a year from the same \$357,000 total.

\$357,000 x .04167% =	\$14,876.19 a year
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Now, dive a bit deeper and consider that the difference between ages 89 and 75 is 14 years, and 100% divided by those 14 years is approximately 7.14%. Divide \$14,876 by 7.14%, and you get \$208,347 – if you can delay your Social Security payouts until then. But, that's 10 years out. If you could purchase an annuity with an income rider for 10 years, offering a hypothetical interest-crediting rate of 6.5%, you could potentially have that \$208,347 in 10 years by putting aside about \$111,000 today. This could allow you to help solve your allocated income needs from age 75 to however long you and your spouse live for just about \$111,000!

$1/(89-75 \text{ years old}) =$	7.14%
\$14,876/7.14% =	\$208,347 total savings needed
.065 x 10 years in an annuity	\$110,985 needed to reach \$208,334 with an annuity at 6.5%

That leaves planning to age 75, but that's easy. If you want the full \$14,876 a year, you just need \$148,760 total in retirement savings. Add that to \$111,000, and you will have created an income stream of \$14,876 for life with just \$259,760. That's a 5.7% payout, which is twice what you could get from the square peg method: $\$259,760 \times .028 = \$7,273$, with only an 89% chance of success.

$(\\$14,876 \times 10) + 111,000 =$	\$259,760.00
$\\$14,876 / \\$259,760 =$	5.73%

We call that "More now; more later." You can just call it a round hole.

¹<https://www.investopedia.com/terms/f/four-percent-rule.asp>

²<https://corporate.morningstar.com/us/documents/targetmaturity/LowBondYieldsWithdrawalRates.pdf>

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