

# Lowly Analyst Newsletter

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## In this issue:

The Market

Safe Withdrawal Rates

## The Market

The U.S. economy is in a recession. Individuals and government are still spending like drunken sailors. Healthcare and Social Security problems are not being addressed. Politicians on both sides promise anything that gets them elected. Congress is engaged in partisan bickering preventing work from getting done.

We continue to run large foreign trade deficits causing the dollar to fall. With the dollar falling, dollar-based commodities such as oil and gold are increasing in price. Both parties talk about trade restrictions.

Defaults in the housing market are still rising. Credit card delinquencies have been increasing but are still low by historical standards. Lenders are tightening credit requirements for both individuals and corporations. Leveraged buyouts are more difficult to accomplish.

Hedge funds have been short. In a short sale, investors make money if the market falls and lose if the market rises. Short sales are risky.

The US markets have been in a decline. Protect your gains. Keep cash in Money Market Funds. For high risk accounts consider going short on rebounds in markets. Take tax implications of any changes into account.

**Asset Classes:** For January, small value down 4%, large value down 4%, mid value down 5%, micro down 8%, large growth down 8%, mid growth down 8%, small growth down 9%.

**Sectors:** For January Silver up 14%, Agric. Commodities 12%, Gold 11%, Swiss Frank 5%, Transportation 4%, Euro 2%, Financial Srv. 2%, Covered Calls 1%, Commodities -0%, Real Estate down 1%, Consumer Srv.-2%, Biotech -4%, Basic Metals -5%, Health Care -5%, Industrials -5%, Consumer Goods -6%, Oil -7%, Aerospace -8%.

**Foreign Investing:** For January Malaysia up 3%, Mexico down 1%, Latin America -3%, Switzerland -4%, Japan -4%, Brazil -5%, Canada -6%, US -6%, Global -7%, Pac-J -8%, Emerging Markets -9%, Taiwan -9%, Europe -10%, S. Africa -10%, Hong Kong -10%, Russia -11%, BRIC -11%, Australia -12%, India -14 %, China -16%, S. Korea -17%.

## Safe Withdrawal Rates

### 1. Introduction

Safe withdrawal rates depend on the strategy you use to determine the amount to withdraw each year, stock market returns, inflation and what happens to real returns in the first few years of retirement.

We will examine the effect of various withdrawal rates for different markets and different withdrawal strategies. We will always deal in real returns, the amount of purchasing power that you have after inflation

### 2. Linear Projections and Safe Spending

Figure 1 shows an unrealistic ideal situation to help our understanding. The markets real return rate is a constant 7%, i.e. 10% nominal return minus 3% inflation. Under these conditions you could withdraw 8%/yr for 30 years.

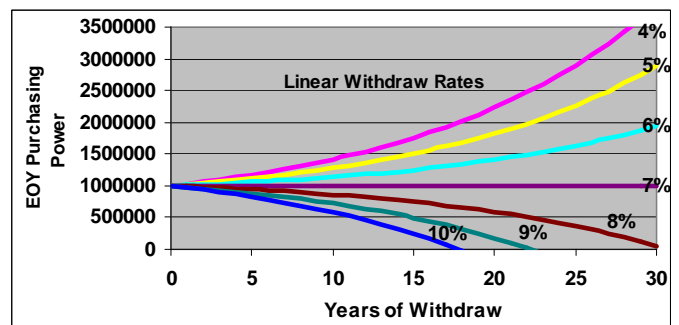


Figure 1 Linear Withdrawal Rates - Constant return.

### 3. Effect of Return Sequence

In Figure 2 the first 2 years the return is 10% lower, in the last two years returns are 10% higher otherwise the real return is 7%. Under these conditions safe withdrawal rates fall from 8% to 6.5%.

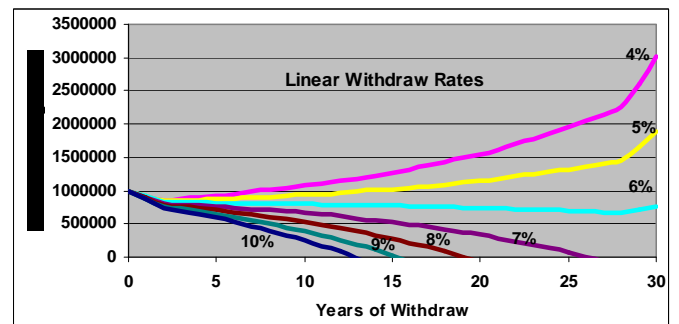


Figure 2 Linear Withdrawal Rates. First two years have 10% lower returns; last two years have 10% higher return.

#### 4. Safe Withdrawal Rates In Bad markets

If we start to withdraw in years of large stock market declines, and withdraw a fixed percentage of assets, we obtain the results shown in Figure 3. Even at a 4% withdrawal rate the assets fall to 44% of the original amount, but eventually recover. The vertical lines in Figure 3 show the range of assets in a 12 month period.

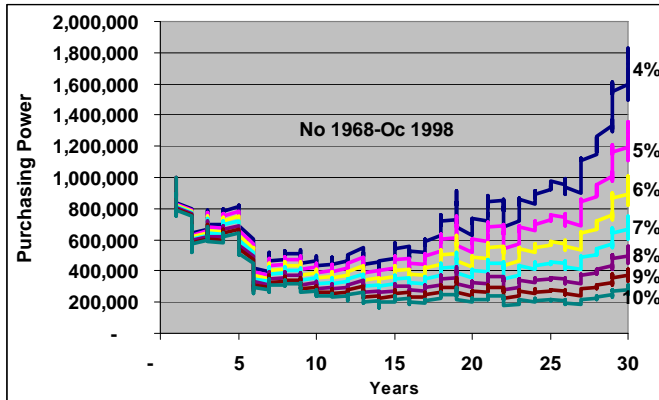


Figure 3 Fixed Percentage Withdrawal Rates November 1968 through October 1998. All Stock Portfolio.

The strategy is only acceptable if you can live for long periods on a fraction of your original withdrawal amount in terms of purchasing power.

An all bond portfolio draws down to 63% of asset value at a 4% withdrawal rate (Figure 4). In contrast to the all stock portfolio, the bond portfolio never recovers.

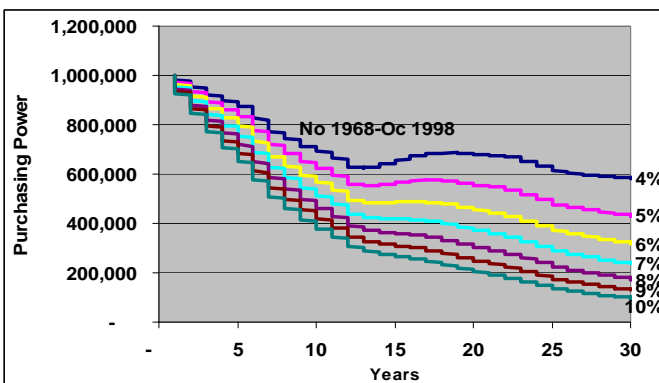


Figure 4 Fixed Percentage Withdrawal Rates November 1968 through October 1998. All Bond Portfolio.

#### 5. Other Strategies

Most other strategies withdraw a fixed amount of purchasing power. Bengen; Cooley, Hubbard & Walz; Ameriks, Veres & Warshawsky hold that rates of 4.1%, 5-6% and 4.5%, respectively, are safe in a balanced portfolio.

#### 6. Rules Based Withdrawals

According to Guyton and Klinger withdrawal rates can rise to 5.4% if you are willing to pay for the higher

withdrawals with a lower withdrawal in periods of poor portfolio returns. They assume a diversified portfolio: 80% stocks, 10% bonds, and 10% cash. The rules to achieve this high withdrawal are shown below.

##### Portfolio Management rules

- If an asset class exceeds its target allocation, invest excess in cash.
- Withdraw first from excess equities, then from excess bonds, then from excess cash.
- Do not withdraw equity following a year of declining stock market.

##### Inflation rules

- Withdrawals are adjusted to maintain purchasing power up to a maximum of 6%.
- There is no inflation adjustment when portfolio return is negative.

##### Freeze rule

- Do not increase withdrawal when portfolio declines if new withdrawal would be higher than the initial rate. There is no makeup for missed increases.

##### Capital Preservation rule

- For the first 15 years, reduce withdrawal rate by 10% if it would have risen by 20% over initial rate.

#### 7. Take Aways

Safe withdrawal rates depend to a large degree on what happens in the early years of withdrawal and on the method of calculating withdrawal.

Volatility decreases the amount that can safely be withdrawn.

Stock portfolios can eventually recover; bond portfolios do not.

4% can generally be safely withdrawn from a well diversified portfolio heavily in stocks. If you are willing to curtail spending you can raise withdrawal to 5%. However living standards are hard to lower.

We have shown in previous newsletter methods for increasing sustainable withdrawal rates. The newsletters are available on my website [www.CurtFey.com](http://www.CurtFey.com). If you need help determining a safe withdrawal rate for your circumstances give me a call (585 244-0152).

#### 8. Further Reading

Jonathan T. Guyton & William J. Klinger, Decision Rules and Maximum Initial Withdrawal Rates, *Journal of Financial Planning*, March 2006.

Danny M. Ervin, Larry H. Filer, & Joseph C. Smolira, International Diversification and Retirement Withdrawal, *American Journal of Business*, Spring 2005.