

Investment News

The Weekly Newspaper for Financial Advisers

December 5, 2005

Nest-egg planning can leave egg on your face

By Jim C. Otar



Many of our clients spend between 20 and 30 years in retirement. In our current retirement planning practice, we assume an "average" portfolio growth rate for the entire time horizon. The reality is, all asset values fluctuate daily. Many in the financial planning industry naively think that if they use historical averages, everything will be fine in the long run.

Unfortunately, this is not the case. There always is a permanent loss due to the fluctuations in a distribution portfolio. In many cases, this loss can cut the portfolio life by half of what a standard retirement calculator predicts using an "average" growth rate.

If there are no cash flows in or out of a portfolio and you lose 20%, you must eventually gain 25% to break even. The first table shows how much you need to gain to make up for various losses.

Can we use the same table if there is a periodic withdrawal from the portfolio? The answer is no. In distribution portfolios, you need significantly higher gains to break even. That is because not only do you need to recover the market losses, but you also need to recover the differential losses between the original plan and the actual portfolio value. That is why more and more pension funds are going into an irrecoverable downward spiral. They are blaming the markets for that, whereas

the real reason is their lack of understanding of the concept of the time value of fluctuations.

We skip the formulas for the concept to keep things simple.

The second table shows how much you need to gain over a three-year time period for various loss and withdrawal rates, assuming a steady increase of the portfolio value after the initial loss and no indexation of withdrawals over time:

For example, if your initial withdrawal rate is 4% and your portfolio loses 20%, then it has to grow a total of 42% over the next three years just to break even.

The figures in this first table do not consider inflation, dividends and management costs. In real life, they are important. The following real-life example shows the effect of real-life time value of fluctuations for someone who retired at the end of 1999.

Bob retired at the end of 1999 at age 60. At that time, he had \$1 million in his portfolio. He invested all this money in a Standard & Poor's 500 stock in-

dex fund with an annual management fee of 0.25%. The annualized growth rate of the S&P 500 between 1975 and 1999 was 17.2%. However, Bob used a more conservative growth rate of 10% when he prepared his retirement plan five years ago. He withdraws \$60,000 from his portfolio each year indexed to the consumer price index. Bob assumed an annual average long-term inflation rate of 3% for his calculations.

Using a retirement calculator, Bob's original retirement plan projected that his \$1 million would grow to almost \$2 million over the next 15 years (Chart 1).

It is now five years later, January 2005. Bob's portfolio is down. He wants to know by how much the S&P 500 has to go up by the end of 2009 so that his portfolio can catch up with his original retirement plan projection. Chart 2 shows the actual performance of Bob's portfolio over the previous five years.

Going forward, he assumes a 3% inflation rate, 1.6% dividend yield and 0.25% annual management fees. Bob calculates how much the S&P 500 needs to go up by the end of 2009 to

TABLE 1

% loss	% Gain required to break even
5%	5.3%
10	11.1
20	25.0
30	42.9
50	100.0
80	400.0

TABLE 2

% loss	Initial withdrawal rate			
	0%	4%	6%	8%
	% gain required over 3 years			
10%	11%	28%	33%	41%
20	25	42	51	60
30	43	63	74	86
50	100	132	150	169
80	400	525	597	676

The Publisher's sale of this reprint does not constitute or imply any endorsement or sponsorship of any product, service or organization. Crain Communications 732-723-0569. DO NOT EDIT OR ALTER REPRINTS. REPRODUCTIONS NOT PERMITTED.

