RETIREMENT WITHDRAWALS: A REAL-WORLD CASE STUDY

By J. David Lewis

Based on his own experience managing his mother's retirement savings, a financial planner chronicles some of the personal and practical issues involved with using one's portfolio to sustain their lifestyle in retirement.

As a fee-only financial planner, I have many times contemplated portfolio allocations and withdrawal rates in retirement for clients. I have read many articles on the subject and have done my own, less formal, research.

However, in recent years, I have started to think that much of this work has been too focused on income tax and estate tax planning rather than on retirement lifestyle. And I base that on my own experience of managing a portfolio for my mother, which introduced a series of real-world and personal issues that aren't addressed in the theoretical models.

In this article, I thought it would be interesting to chronicle my own experience with my mother's retirement portfolio. By adding this new dimension, perhaps my experiences, when considered along with the more theoretical studies of retirement withdrawal rates, will help others think through more fully the issues involved with using one's portfolio to sustain their lifestyle in retirement years.

THE 'EARLY' YEARS

The story of my mother's portfolio starts in about 1985, with roughly $200,000 in total assets. Although she was 78 at that time, she has always been in generally good health, and many of her family members lived well into their 90s, so I always assumed her investment assets may have to support her lifestyle for a very long time.

I more or less managed about $145,000 for her in a brokerage account. In addition, she had about $60,000 in six bank CDs that were laddered—each $10,000 CD matured every two months, and when it matured, it was renewed. The interest from the CDs, however, was deposited to her checking account. Her other major asset was her home, worth roughly $100,000 at the time.

During the late 1980s, the cash flow from these six CDs as well as Social Security payments sustained my mother's lifestyle. She has always been a rather frugal person, but she did not deprive herself either. She bought the clothing she wanted and owned a comfortable automobile. Her home was much larger than one person needed, but she was comfortable living there after the death of her husband (my father) in 1976.

Although at first she was not using assets from the investment portfolio I managed, the conventional wisdom of the time was that people her age should invest primarily in stable fixed-income instruments. However, I preferred not to keep all the savings in a fixed-income allocation, since she was not spending any money from this portfolio at the time. In the years since 1985, I have seen this older conventional wisdom change, and many financial planners now talk about the appropriateness of equities in the portfolios of older people.

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In 1985 and 1986, I ventured out on what would have appeared to be an insecure limb, and I allocated roughly 50% of the portfolio to fixed-income instruments and 50% to equities. The fixed-income instruments were bank CDs, corporate bonds, municipal bonds, and Treasuries. These had various maturities extending over several years, starting in about 1989.

The equities were invested in mutual funds, half of which were chosen for their equity-income or balanced category designations. Thus, there was some fixed income in the mutual funds that I was considering a part of the equities allocation. But I had motivation to be cautious: It was not my money but my mother's money, and I wasn't sure how much volatility she could withstand. In addition, I have siblings, and I wasn't sure how they would view a volatile portfolio that I was managing for our mother, particularly if they ended up receiving something at a lower value than when I had started managing it.

For some time, there were few withdrawals from this portfolio. It did experience a stock market shock—in October 1987—but the damage was nominal, compared to the publicity that event generated. The conservative allocations served their purpose. As was the case for most investors that didn't panic but kept their allocations, her portfolio recovered very well within a year or so.

ALLOCATION CHANGES

As time passed, the portfolio I managed grew, but my mother's living expenses also grew. At various times, she liquidated her maturing CDs to keep her checking account at a level she considered comfortable and to give several generous gifts to grandchildren. Because the portfolio I was managing was growing, her total wealth was actually increasing, so I was not very concerned about using principal from the CDs. In addition, the probability of her living long enough to outspend her wealth was decreasing as she aged.

However, something else was happening while the $60,000 in CDs was dwindling away—the fixed-income instruments I was managing were holding roughly at a constant value, while the equity allocation was growing. Distributions were being reinvested and at least some of the growth was in the form of unrealized capital gains. In addition, after a time my mother started to spend, or give away, much of the cash income from the fixed-income instruments, while the equity mutual funds continued to reinvest distributions. This was probably around 1990.

By this time, periodic transfers to the checking account were coming from the portfolio I managed. Initially this was accomplished by writing checks on the brokerage account, but eventually we arranged to have the brokerage firm make monthly direct deposits. Through the years, this monthly transfer has been steadily ratcheted up.

During the first few years of these monthly savings withdrawals, interest payments from the fixed-income funds in the portfolio covered the transfers. Eventually, however, the withdrawals were more than the cash flow from interest. Through the early 1990s, I decided to let the brokerage account drift into margin loan status to cover these transfers. At that time, there were always fixed-income instruments that were soon maturing that could be used to pay off the margin, and there would be expenses associated with selling anything to cover the loan.

At this point, my mother's lifestyle, including all of her gifts, was being maintained by the interest income as well as maturing fixed-income instruments, but the total portfolio was still growing because of the performance of the equity portion.

By the time of the stock market shock associated with the Persian Gulf War, I calculated a five-year total return with an ending period at the bottom of the trough and found that number was still positive—in fact, it was significantly positive. This relieved my concerns for my allocation decisions.

However, I was continually faced with a dilemma. For example, in 1992, I would have been dealing with an 85-year-old woman's portfolio and capital gains tax rates equal to ordinary income tax rates. She appeared to be in good health and might live many more years, but the probability of living another year was getting smaller. Should we sell equity mutual funds and pay tax on the gains simply to rebalance the portfolio? If she died owning the equity mutual funds, potential tax on all her unrealized capital gains would disappear. Or should we continue to let maturing fixed-income instruments fund her lifestyle?

I did change the equity mutual funds to pay cash distributions. From time to time, I have decided to eliminate various mutual funds from those I use, and I replaced those with fixed-income mutual funds, paying cash distributions. Nevertheless, the portfolio eventually became very skewed to equity mutual funds. At the end of 1995, the portfolio had just over 80% in equity mutual funds.

Ironically, this is the opposite of what "conventional wisdom" tends to assume—that a person's fixed-income portion becomes larger with age. In effect, my mother's experience was the opposite.

Eventually, the portfolio reached a point where it had no more fixed-income instruments, except for the two fixed-income mutual funds and whatever instruments were in the balanced mutual funds. Also, increasing monthly withdrawals were producing a significant drain on the portfolio. In 1998, I started a schedule of selling a percentage of one mutual fund position each month. This has kept the cash balance of the brokerage account more or less in line. Sometimes it drifts into margin loan status and returns to liquidity. Even with capital gains rates now reduced, I prefer to pay a little margin loan interest expense, as opposed to tax on the capital gains.

HEALTH ISSUES

Health issues tend to become a much larger financial and lifestyle concern during retirement, and that has been the case with my mother as well.

For several years, we have noticed my mother's weakening mental capacity, although it has been gradual. I could see enough of the cash flow from the portfolio to know that things seemed to be normal, so I respected my mother's desires to be independent except when she specifically asked for assistance.

In January 1997, at the age of 89, my mother's condition had deteriorated to a point where she could not live alone any longer. My sister stayed with her for a few months and took over the bill-paying functions. This was a significant and necessary event, since an aggravating part of her deterioration seems to have been related to poor nutrition, even though there was plenty of money to buy food.

However, my mother has always been a very independent woman, and her independence kept that living arrangement from lasting. Instead, a woman was hired to be in the house at least some period every day. Transfers from the brokerage account to the local bank account increased from $800 per month to $2,000 per month. The woman who came to the house every day prepared meals and cleaned, charging $500 per week, which seemed expensive, but there did not seem to be other alternatives. Mother still adamantly wanted to live in her own home, and the relationship to this woman seemed to be comfortable for her. My sister would visit about twice a week, to maintain a food supply and tend to other operations of the household.

In the spring of 1997, when her household care expenses started rising so significantly, the portfolio I managed had grown to $270,000. Since she was turning 90 in May of that year, the $2,000 per month did not seem like a major issue.

At about that time, my mother inherited about $130,000 from her sister, who had died without children. My mother did not want to keep the money, but instead wanted it passed on to her grandchildren. However, we convinced her that keeping some of the inheritance for her own security would be prudent, and so it was placed in a revocable trust, with her fourteen grandchildren listed as beneficiaries at her death. Nonetheless, near Christmas 1997, she instructed that each grandchild be given $5,000 from the trust. At the time I was, and today I am, convinced that she understood her actions, although her mental capacity was such that the communication process required significant effort. The remainder of the revocable trust stands as security for her lifestyle, but it is kept separate from the portfolio of money that sustains her current living expenses. The trust assets are invested in a small money market account and a Treasury bill bought at a 52-week auction, since there is a high probability of death in the coming 12 months, and I want to keep this portion as conservative as possible.

By January 1998, my mother's mental capacity continued to deteriorate, although she remained physically healthy for her age. By Thanksgiving she became so disoriented and confused that she agreed to "whatever we needed to do" for her to feel some relief. I immediately made arrangements for her to move to an assisted living facility that my sister had located some months earlier.

Currently, she has roughly $300,000 in her investment portfolio, 90% of which is still invested in equities. In addition, she has $66,000 in a revocable trust invested in money market instruments. And right now, I am making arrangements for the sale of the home, which is costing $600 per month to maintain, and there is virtually no chance that my mother will return to live there.

I believe that the quality of my mother's living facility is on par with the home she left and in keeping with the lifestyle she has experienced for the last forty years of her life. The cost of the facility runs just under $3,000 per month. Her pharmacy billing ranges between $250 and $300 per month. There is a proposed additional medication, which will cost about $150 per month. While the geriatric psychiatrist did not describe this medication as necessary, or even certain to improve her condition, I believe it will eventually be prescribed.

Currently her total living expenses are roughly $4,000 per month, and I am assuming that they will soon be on the order of $3,500 per month, after the sale of her home. Her Social Security income is $893, so her savings will need to provide her with the remaining $2,607 per month.

However, I have to believe that monthly living expenses will rise, with $4,000 to $5,000 possible over the coming few years. Her regimen of medications is designed to help control confusion and anxiety. Although she is deteriorating mentally, she seems to have very good healthcare and is physically strong for her age, so she may live on for several more years. As her needs for assistance in the daily routines of life increase, the facility where she lives will assess higher monthly rates.

Based on December 1998 asset information and assuming $5,000 per month expenses with zero investment performance, we can expect the assets to support my mother for 117 months. This level of living expense implies about $4,107 withdrawals per month when netted against Social Security income.

I expect to use the proceeds from selling the house to buy a laddered portfolio of U.S. Treasury securities, with $10,000 blocks maturing at three-month intervals. This will return us toward a more traditional elderly person's asset allocation and fund the withdrawals expected for now. To the extent that maturities, interest, and mutual fund distributions do not provide sufficient cash flow, I expect to use the practice of selling small portions of the equity mutual funds on a monthly or quarterly basis.

RISK/RETURN ISSUES

I do have some statistics to help illustrate the long-term risk relative to the long-term performance in this heavily equity-oriented portfolio. To do this, I examined five-year annualized rates of return, using various quarterly starting periods. The worst recent three-month performance for the portfolio was probably May 31 to August 31, 1998, when the portfolio was down 13.70%. The third calendar quarter of 1998 was almost as bad, with a drop of 12.31%. But these are short-term fluctuations and do not tell much of the story. The five-year calculations tell the more significant story:

Five-Year Periods	Annual Return (%)
03/31/93 to 03/31/98	19.8
06/30/93 to 06/30/98	16.6
09/30/93 to 09/30/98	12.9
06/30/94 to 06/30/99	19.0

While the five-year return did suffer with the market correction of 1998, it was not pulled to a drastically low level.

Maybe I have just been lucky in that the high equity allocation has not experienced disaster. If a pilot makes a flight, where his skills are marginal for the conditions, without a significant incident, has he demonstrated good flying skills? Even if he has a dangerous incident and recovers, he has probably not shown appropriate judgment.

THEORY VS. EXPERIENCE

In writing this article, it has not been my intention to detract from the excellent analytic works I have seen in this publication and others, relative to appropriate allocations and withdrawal rates in retirement portfolios. But I do think that when you are making decisions regarding the management of your retirement portfolio, it is important to consider some of the retirement lifestyle and family issues that arise in the real world, rather than focusing only on tax and estate planning issues.

Here is a brief summary of some of the more practical concerns I found based on my experience:

- Conventional wisdom has evolved since I began managing this portfolio. At the time, conventional wisdom held that a retired person should hold a large percentage of their portfolio in fixed-income instruments. We should be aware that some elements of the conventional wisdom of financial planning have not been well-tested by solid research or experience. It was fortunate that I included at least some equities. I did this by examining the specific case, and adapting the portfolio to that case, instead of mechanically following the conventional wisdom.
- My mother started with what some people would consider to be a very modest savings portfolio, but she was able to maintain her lifestyle over a very long-term time period. Part of this may have been due to pure luck—she was invested at a time of an unprecedented bull market. Nonetheless, it is important to recognize that the life expectancy of a 65 year old is over 25 years, and research shows that significant allocations to equities will tend to dramatically improve total return where the holding period is longer than 10 years.
- Withdrawal rates are useful for determining whether a person has adequate resources to support a lifestyle. However, to apply a rate as a fixed formula for actual spending is very difficult. For most people, spending is governed by wants and needs. It is useful to begin with an assessment using withdrawal rates, but as the retirement years play out, it becomes much more important to focus on the total resources available for retirement.
- For the fixed-income portion of my mother's portfolio, I preferred to use a laddered portfolio instead of fixed-income mutual funds. I like to buy and hold these securities to maturity. There are very few opportunities to improve total return by trading bonds. Since the primary purpose for fixed income in the portfolio is to increase stability instead of total return, a laddered maturity portfolio does that quite well at very low cost.
- The automatic withdrawals available through the brokerage account worked out well and saved time. Every time my mother had to write a check on the brokerage account, she went through an emotional event; when the transfers were automatic, she did not think about them so much.
- Healthcare and financial decisions at advanced ages are very hard, and they are very personal. My siblings have disagreed on several issues on this front, and the family stresses have been damaging. It is critically important that people establish durable powers of attorney for both financial matters and health care. Otherwise, there is a tendency to have "too many cooks in the kitchen." ✥