What is a Safe Withdrawal Rate in Retirement? - Transcript

Tom Mullooly: Welcome to the Mullooly asset management podcast. This is episode number 247.

Brendan M: 24/7. 365, all day, all year.

Tom Mullooly: That's right. Podcast all the time at Mullooly asset management. So I am your, one of your hosts Tom Mullooly. I'm here with Brendan Mullooly and we are ready to talk about topics that are burning in everyone's brains.

Brendan M: Well, I don't know, this one seems to be all the time, maybe not just this week, but something that we hear a lot are people approaching retirement who have come to the realization that they need an actual plan to draw down their assets, like, like they don't just want to wing it, which is sensible. And I commend people for coming to the table to do that because there are certainly people out there that have investments and they just pull a random amount every year and hope that everything works out. Other people want to come in, get some clarity on what is sensible to withdraw, what that would mean for their future and what trajectory that puts them on in terms of not outliving their money. And that's something we help people with all the time.

Tom Mullooly: I'm amazed after all this time in the business that we talk to clients about making their required minimum distribution each year from their retirement accounts. And there's still a lot of unknown out there, and surprise, we'll talk to clients and say, we're going to make our first required minimum distribution this year. And some of the responses that we hear, I can't believe we have to do that. Why do we have to do that? That is most of the answers. We still get some people who just don't understand like I have to take everything out?

Brendan M: Yeah. There's a lot of anxiety involved with, with these RMD's and people will literally come to a meeting because they are so afraid of this thing that for whatever reason has been associated in their mind with pain or something that's scary and it's not that big a deal. It's something everybody has to do and it doesn't need to be, it's certainly not rocket science. People really want guidance when it comes to that, they want to make sure they don't screw it up. So I guess I understand that because the penalties are pretty steep for not taking your RMD. It doesn't need to be something that costs you sleep by any means.

Tom Mullooly: Yeah, and doesn't need to be complicated either.

Brendan M: No. There was a pretty good post, a couple of posts this week, but I'll start with one from Morningstar, our friend Christine Benz, who ...

Tom Mullooly: A friend of the firm.

Brendan M: We read all the time, was on Tim's podcast. That was a great episode of Living With Money.

Tom Mullooly: Yes it was.

Brendan M: She talked about, should your withdrawals mirror your RMDs? The beginning of the article about something that I didn't know, I mean I've looked at these tables that they use to determine the RMDs, but the RMD distribution period that is baked into that table is actually based upon your life expectancy plus ten years.

Tom Mullooly: Correct.

Brendan M: So these are very conservative numbers and that was kind of what sparked this topic for Christine in the sense that you could probably use these as a general guideline to taking distributions even before you are 70 and a half and taking required distribution.

Tom Mullooly: Right. And also it provides a good framework for how you should think about de-cumulating or distributing assets, not in a retirement account.

Brendan M: Yeah, exactly. You could use it across the board, on your entire net worth or investible assets to determine how much you can pull each year. And then you kind of have to parse out and from where. But I thought that that was interesting. And so that plus 10 years, what that really means is that while it is a burden in some people's eyes to have to take this money out of the account because they don't think they should have to, for whatever reason, the idea behind an IRA distribution is never to make somebody take it out at such a rate that they are going to outlive it.

Tom Mullooly: Right.

Brendan M: That is almost the antithesis of the schedule that they put together. Unless as some people in our industry have said, we're going to live to 140 or whatever, I've heard that retirement talk recently.

Tom Mullooly: You'll make it. I don’t know about me.

Brendan M: I don't know, we'll see, maybe, maybe not, but you know, if, if that were the case, then sure, maybe these RMDs are forcing something upon us that's going to make us outlive our money or something along those lines.

Also, nobody says, just as a side note, nobody says you have to spend your RMD just because you have to take it out of your IRA. Obviously there's slippage because you are sending some of that to the IRS.

Tom Mullooly: Right.

Brendan M: Which is the reason you're doing it, but nobody says if your RMD this year was 30 grand that you have to spend all 30. You could literally transfer it directly to another investment account and continue investing if you don't need the money.

Tom Mullooly: Which we do for many clients.

Brendan M: Yeah, we do.

Tom Mullooly: They don't want it, don't need it, and so they would rather just keep the investment's going. One other option, which I know we talked about at length in another podcast was, now individuals, if they don't want to take their distribution, they can actually donate it. You don't get the write off that you would making a typical donation, but you also don't have the taxable income that you would in taking a required minimum distribution.

Brendan M: So this is a charitable required minimum distribution.

Tom Mullooly: Correct.

Brendan M: Right. And you can do that up to $100,000 a year.

Tom Mullooly: Per year.

Brendan M: Which is nice. Yeah. So if you want to make a nice gift and not show as much taxable income, skip out a, stick it to the man, not give the government their cut, then that's great.

Tom Mullooly: There are ways to do this.

Brendan M: Yeah, yeah, absolutely.

Tom Mullooly: Totally. Again, totally getting further away from the topic. I'm really enjoying reading these articles about what the future's going to look like with a 70% income tax rate and what people can do to evade taxes. I am amazed at how many people are just sucked in by the concept of sticking it to the man, like you just said.

Brendan M: Yeah.

Tom Mullooly: Or, you know, finding some way to knock down their overall tax bill. There aren't a lot of loopholes anymore, there just aren't.

Brendan M: No. No there's not. But also I think, it's like an American pastime. It's like finding tax loopholes is like the most American thing out there. I think it's like Apple Pie and baseball. But also I think people get caught up in like what the top like people, that look at the top marginal tax rate as if that applies to like them or their situation, unless they make millions each year in taxable income. So probably not the case.

Tom Mullooly: Another topic for another podcast for another day.

Brendan M: Yeah.

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Brendan M: So anyway, the, but Christine was talking about in this piece on Morningstar about how this RMD style distribution, from your retirement account may be good. One of the biggest pros is that it is dynamic in nature. So it's not static. It's not a set dollar amount. One of the more common rules of thumb that people use for retirement distributions is just that, it's static. Yeah. And so it's the 4% rule, which involves taking in year one of retirement, 4% of your account balance and then taking an inflation adjusted same dollar amount in perpetuity, you know, for the rest of your retirement days. So static in that sense that you're getting an adjustment every year. You're getting a static dollar amount adjusted for inflation, but it's not accounting for reality. It's not accounting for what happens in between now and tomorrow. The future.

Tom Mullooly: Right.

Brendan M: So an example used in the article was that if you had a million dollar portfolio and you were going to use this 4% rule, your first year of distribution would be $40000. And that's, you know, obviously very simple as the surface, as it's 4% of your account. And that seems like a reasonable amount to withdrawn. No one's going to tell you you're crazy for doing that.

Tom Mullooly: But that's where the simplicity and ...

Brendan M: Right. So just to even not complicated that much, let's consider if during that first year the market goes down 30%. Okay? And you're invested in that. The next year you're ready for your distribution, you're going to follow the 4% rule. So you're going to take $41000 to adjust for inflation that year two distribution, considering what has happened in the market and your portfolio is now 6% withdrawal rate.

Tom Mullooly: So it's either stay with the 4% and now you're going to live on less, that's 28000.

Brendan M: Yup.

Tom Mullooly: Or continued to take out the same dollar amount. Now you're taking out a much bigger hunk.

Brendan M: Yeah. So, I mean, there are pros and cons. So one of the other pros about the RMD approach is that the static approach doesn't really have any adjustments for life expectancy either. And so like as you get older, you can afford to take higher percentages of your account out because you have a shorter life expectancy even if you're baking in an extra ten years, like IRS does with this required minimum distribution schedule.

Tom Mullooly: There's really no right answer in my opinion, for this. I think the main thing is to, you know, like we say in a lot of podcasts live beneath your means, that certainly helps a lot. But this was a very logical argument. This 4% rule, which caught fire 25 years ago because we had just come through a period even after the 1987 crash where stocks had averaged somewhere between, depending on where you draw the line, nine or 10% a year or 10 or 11% a year.

Brendan M: Before inflation.

Tom Mullooly: Right. Taking 4% seem like, oh, this is going to be an easy layup. The fund or the portfolio or the account will continue to grow. Even as we're taking distributions out. I'm going to retire now.

Brendan M: Yeah, I'll just live off of the interest or whatever. Not Interest, but you know, it makes intuitive sense. It's like, well, if my portfolio is going to make seven and I'm only going to take out four or five, then sure it sounds great, but that's why we run simulations that take into account the actual sequence of those returns that averages out to 7% so that you know, you can see the effect that that has because if you average 7% it doesn't mean you're going to get 7% every year.

So along the way to averaging 7% you might have a year where you lose 10% and you're taking a distribution from the account that further drops the value of and more. And then to make up for that ...

Tom Mullooly: If you don't have a 30% year, immediately after that, you're falling further and further behind.

Brendan M: Yes, and especially when these are early on in retirement where the portfolio still needs to last for another 20 to 30 years, and in many cases these days, and you string together two, three years, like 2000, 2001, 2002 where the market goes, does nothing. Then you can take the decade of the 2000's in the US stock market and you were, if you were taking distributions, you retired in 2000 and you're taking distributions for ten years. You were up down, sideways for a decade in the US stock part of your portfolio at least. And you were taking money out along the way and there was no growth. Really.

Tom Mullooly: None. Zero.

Brendan M: So tough.

Tom Mullooly: Yeah, it's amazing. And you know, we have a small sample size to kind of examine in our own backyard. We have clients who have retired over the years and they're not actually taking distributions, they're just letting all this money continue to compound. And we should probably do an entire podcast on this where we talk about clients that should be in the distribution phase of their lives, where the money's going out instead of coming in, but they're not, they're not distributing it, and then they call up and they say they have some big project that they have to do and that, I'm really sorry, I'm going to have to take, you know, $80000 out of this account to do something around the house or relocate or whatever. And they, they're almost apologetic, like they don't want to do it.

They don't want to touch this money.

But I guess they've gotten used to living a certain lifestyle where they don't need this money and now it's actually, okay, how are we going to pass this to the next generation?

Brendan M: Yeah, in some cases, but I also think there should be conversations about that because if somebody feels guilt over it touching their own money, then there's obviously an issue and a disconnect where they feel that they can't spend it for some reason, which is ridiculous. They should be spending it if they want to.

Tom Mullooly: They should be spending it, but a lot of them don't want to take it out of the market or out of their investment portfolio because they want this to grow in perpetuity. And you know ...

Brendan M: It depends on that with something Christine touched on. Like if you want to leave money to the next generation, then you know, using a set of rules like the RMD style for your distribution is great because it's a little on the conservative end of thing.

Tom Mullooly: Right.

Brendan M: Whereas a static number is going to be a little more aggressive and maybe better suited for somebody who is not interested in leaving money to the next generation or is in a situation where they don't have the ability to do that realistically.

The biggest con of that RMD style withdrawal strategy, I think is just that the cash flows are going to be irregular, which is tough to fit into a budget. And so if you actually are relying upon your portfolio to throw off income each year, it can be tough to plan when you aren't 100% rock solid on what the amount coming out is.

It can be harsh. Which is something that, uh, Andrew Miller wrote about this week on the Alpha architect blog. He was talking about these, the same topic of he was terming it flexible spending in retirement in terms of distributions.

And he kind of led with that, that these flexible spending things that people suggest where it's entirely based upon the value. Like you take last year's value like you did for an RMD on December 31st and you live off of that. Like you can, but you have to be prepared to ...

Tom Mullooly: Have less.

Brendan M: Yeah, have less. And so Andrew looked at something where instead of being all, all static or all flexible, it was kind of a mix of the two. And so he took two areas that at least in his practice, he's seen a lot as truly flexible spending where he looks at the categories of a car expenses, so people that are either buying a new car every handful of years or leasing or something. So whatever your car bill is for the year. In addition to that, he looked at travel and so travel and your car expenses and he created bands depending upon portfolio performance the year before of how much would be allocated towards each of these categories.

And so you kind of set a floor in terms of what you're willing to spend on that category or the bare minimum and you set a ceiling in terms of the maximum. If things are doing really well in the portfolio and so you, you have a moving scale in there in terms of what you're getting at least for those categories. Because I think you can afford to cut those in a year where the portfolio hasn't done well.

Tom Mullooly: You say we'll drive that car for one more year.

Brendan M: Right, like we're not going to get a new car or we're just like not going to go on vacation this year or we're going to go, I think his example is like going to go to six flags with the kids instead of Disney or something like that. Like you can make adjustments to account for that ...

Tom Mullooly: You can work your way around it.

Brendan M: But you can't just say like, all right, well I guess I'm going to spend half as much on groceries next year. I mean, sure there may be a little fat to trim there in terms of what you're buying week to week for food, but you still need food and so you can't just like chuck that out the window because stocks went down last year. You still have to eat.

Tom Mullooly: It's some of these extra things. Not necessarily that we would consider our extras, but yeah, you may not need to get a new car next year. Something like that.

Brendan M: One thing that he said too that I thought it was smart I agreed with is this 4% rule and how it's a really good set of guidelines for the accumulation phase in terms of as a rule of thumb to identify how much you need to have accumulated by the time you get to retirement. That's a good rule to follow.

Tom Mullooly: That is actually I think the best reason to have that rule is to, is to just say, okay, if I need to pull $60000 in income beyond social security or some other fixed income that I'm going to be getting, how much do I need to get? Accumulate? To get to that point.

Brendan M: Right, so to use it as just like a rule of thumb in terms of how much to save and how to roughly allocate your portfolio to get there by the time you're hoping to retire. Andrew likes it as a rule of thumb. I like it as a rule of thumb, not great for the actual income plan and I think that a lot of people, whether they come to us because they want a plan because they don't want to wing it and they want to make sure they don't outlive their money or they want to come to us for the opposite reason that we were discussing, which is they don't want to feel guilt about spending their money either. They want to know what is, what is okay to spend? Like, I want to leave $500000 to the kids, so what can I spend from this portfolio over time? Like what can I take from this and have it be okay.

Tom Mullooly: I think that's, like you alluded to earlier, I think that's an important discussion to have with clients as they're retiring or immediately after they retire because we've had conversations with clients in their late seventies and they couldn't spend this much money that they've accumulated, nice problem to have, but they've lived their life a certain way. They've been very frugal, they've been good savers and they always have their own one eye on how much things cost. And now to shift gears and become consumers, bigger consumers, it's a big shift, a big shift for them.

Brendan M: I think, again, like you're alluding to, it’s about the mindset. And so if they don't want to spend money from their portfolio because they can't even imagine a way to do it, then that's fine. But if somebody feels guilt over, like dipping into it for something above and beyond because they just don't know like, that it's completely okay to do so, then that's a problem. Like they should have a discussion about why it's not something to feel guilty over. There does not need to be guilt involved with that at all.

Tom Mullooly: it doesn't need to be guilt. But also I think the other thing that an advisor can provide is that they shouldn't worry. In addition to the guilt, there's the concern that hey I'm digging into my principle. I'm not sure that this is such a good move for me. And so unfortunately that's when we see a 74 year old person with a mortgage or home equity or some crazy loan that they had no business getting, and because they didn't want to touch their investment principle, just doesn't make sense.

Brendan M: Right.

Tom Mullooly: Well, thanks for tuning in and listening to episode 247, 24/7 Of the Mullooly asset management podcast, and we will catch you on the next episode.