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Creating Dependable Retirement Distributions

One of our most frequently asked retirement questions is, "How much cash flow can be generated each year (or month) from a retirement "nest egg?" Our short answer — between 4% and 6% per year if you have a diversified portfolio with at least 50% in stock equities.

However, you must adjust these distribution rates regularly based on actual portfolio performance. When a portfolio grows by more than 6% (equal to the annual distribution rate) in one year, you can take a raise the following year. However, when you experience years (like 2007 and 2008) where the portfolio drops in value, you must lower your withdrawals to avoid running out of capital.

We use a simple procedure to regulate cash flows for charitable trusts. You can use this same process for virtually any retirement situation. The first step is to value the portfolio every year on December 31. The second step is to select a "payout rate," generally between 4% and 6% per year. The third step is to multiply the portfolio value by the payout rate to derive the distributions to be paid for the next year. This process is repeated every year. This all sounds very simple, but does it really work?

Let's look at a real example of a trust established July 7, 1998. (The names have been omitted for obvious reasons.) This trust has a 6% annual payout rate, although the payments to the trust beneficiary are made quarterly. Appreciated securities valued at $396,928 were deposited into the trust in July 1998. The chart below shows the distributions made to the beneficiary since the trust was established.

Year Beginning	Trust Market Value	6% Annual Distributions	Increase/ (Decrease)
July 7, 1998	$396,928	$ 11,843	
Jan 1, 1999	378,168	22,690	
Jan 1, 2000	420,217	25,213	$ 2,523
Jan 1, 2001	378,528	22,712	(2,501)
Jan 1, 2002	338,619	20,317	(2,395)
Jan 1, 2003	271,171	16,270	(4,047)
Jan 1, 2004	347,132	20,828	4,558
Jan 1, 2005	374,340	22,460	1,632
Jan 1, 2006	377,078	22,625	165
Jan 1, 2007	420,047	25,203	2,578
Jan 1, 2008	411,430	24,686	(517)
Jan 1, 2009	238,812	14,329	(10,357)
Jan 1, 2010	260,227	15,614	1,285
		Total $265,339	

For illustration purposes only. Past performance is no guarantee of future results. Principal value, share/bond prices and investment returns fluctuate with changes in market conditions, so that an investor's shares/bonds, when redeemed or sold, may be worth more or less than their original cost.

This trust was formed shortly before the decade called "The Lost Decade" for investors who focused on the S&P 500. This period included both the 3-year "dot.com implosion" at the start of the decade and the devastating credit meltdown that caused one of the deepest global recessions since the Depression. Despite these negative market conditions, the trust beneficiary will have received $265,339 in quarterly distributions by the end of 2010 and despite virtually no gains in the S&P during this period, the trust still has over 65% of the principal originally contributed. You will also note that the trust income rose six years while falling in five years. Most other decades have yielded greater percentages for rising years than this most recent decade.

How did this trust manage to survive and continue to make payouts to the trust beneficiary during such a negative time period for the equity markets?

- First, the trust maintained a broadly diversified portfolio that benefited from including value stocks, small stocks along with a healthy inclusion of international and emerging stocks.
- Second, the trust used a systematic, disciplined plan for distributions and adjusted the distributions each year to reflect the actual portfolio performance.
- Third, the trust maintained the same model portfolio until March 2009 when the beneficiary made the allocation more conservative, a change which did cost the trust some of the rebound it would have realized in 2009.

This example gives you a road map for creating cash flows from a retirement nest egg. Whether you are working with a rollover IRA, a taxable savings account or a charitable trust, we believe that the distribution method used by this charitable trust will continue to provide annual distributions without risking a complete depletion of capital. The keys to its success are as follows:

1. Develop a thoughtful, written investment plan built upon sound principals, such as the Three-Factor Model of Professors Eugene Fama and Kenneth French and the long-recognized tenets of Modern Portfolio Theory.
2. Set a realistic payout rate that your investment portfolio is able to support. This rate should be set below the expected return for the portfolio. We suggest no higher than 6% in most circumstances
3. Maintain discipline both in the investment strategy and in the payout system. Do not allow emotions of the market and the hype of the media disrupt your plan.
4. Monitor results and adjust payouts accordingly. You must always base distribution rates on the resources available.

Diversification does not assure a profit and does not protect against loss in declining markets.

If this retirement distribution plan sounds like a strategy you'd like to use, please contact us to help you implement it.