Director of Retired Members

Withdrawal rates

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Planning for retirement is, in large part, a financial question. For some, it is the only question. Although this column regularly reviews the retirement benefits of city letter carriers, it intentionally avoids providing financial advice. Although this article will continue that tradition, it will discuss withdrawal rates.

Withdrawal rate is an important topic to address, so that those planning for retirement, or even those who have already retired, can have a ballpark understanding of how much money they can withdraw from their Thrift Savings Plan (TSP) for an indefinite horizon. Conversely, an understanding of withdrawal rates helps one understand how much they need to save up for retirement based on an expected budget.

One withdrawal method is often referred to as the 4 percent rule. It's fairly simple. The idea is that a retiree can withdraw 4 percent of their retirement account each year, year after year, and not run out of money. For example, if your TSP is $400,000, then the 4 percent rule says you could withdraw $16,000 per year ($1,333 per month) for the rest of your life. It is important to point out that nobody can predict the future and that there is always some risk with any withdrawal rate. To better understand the risk, we should look at the history of the 4 percent rule and how it was derived.

Prior to 1994, the adage was typically that one could withdraw 5 percent per year. One financial advisor decided to challenge this guidance and analyzed historical data of stock and bond returns over a 50-year period. William Bengen, the financial advisor, found that a 4 percent withdrawal rate would survive nearly every scenario, good and bad. This change to the guidance helps ensure retirees saved enough prior to retirement, and do not face a significant risk of outliving their savings. As the 4 percent rule was derived by analyzing historical data, we should be reminded that past performance does not dictate future performance. There is always some inherent risk.

There are many factors that could impact your nest egg and desired withdrawal rate, such as rising medical expenses and personal tax rates. The makeup of a portfolio also is vital. Is the portfolio allocated entirely in stocks or bonds or is it diversified? The 4 percent rule was derived using 60 percent equities and 40 percent bonds, but at a time when bonds had a higher return than they do now.

Of course, the performance of the market is a substantial factor. Keep in mind that the 4 percent rule is just general guidance. If the market is performing poorly, one might cut back on some expenses and withdraw less. Typically, if the market is performing poorly, there is an economic impact such as inflation or higher interest rates, which might make it easier to cut back as one waits for a better deal on non-essential items, such as travel and entertainment. Alternatively, if the market is overperforming, you might be able to spring for that luxury you've been dreaming about or helping the kids out, without serious long-term risk to your savings.

Some might go with a more conservative withdrawal rate of 3.5 percent. They might have personal factors, such as an expectation of living longer than average. The lower withdrawal rate increases the chances that the savings will last their lifetime. Others might want a lower withdrawal rate for a different reason, knowing that their savings will be passed on to a loved one. On the other hand, those with a shorter life expectancy might be more aggressive and opt for a 4.5 percent withdrawal rate to get the most out of retirement.

Fortunately, the TSP withdrawal options are flexible and can accommodate various goals. In particular, the TSP provides options for installments (automatic withdrawals), or partial distributions of a specified amount. There is no limit on the number of partial distributions, except that no more than one will be processed in a 30-day period. You can even make partial distributions while you are receiving installments. One approach might be to start with a conservative withdrawal rate in the form of installments, and if needed, supplement with a partial distribution or simply increasing the withdrawal rate. Be mindful that increasing your distribution may have an impact on your effective tax rate and/or Medicare premium.

Every person will have a deeply personal decision to make when it comes to withdrawing their retirement accounts. They may need to weigh their retirement goals, expenses, budget, risk tolerance and other benefits to help them determine how much to withdraw from their retirement accounts, or how much they can afford to. If you decide that a financial advisor is right for your situation, be sure to understand all of the costs and whether the advisor has a fiduciary duty to you. Bear in mind that the TSP's fees (expense ratio) can be hard to beat with the C Fund at 59 cents for every $1,000 invested.