What Happens to My Investments When I Retire?

Congratulations! Your retirement date is quickly approaching, perhaps you've just begun your retirement journey or you are well into your retirement years. As we meet with clients, we hear how this is not only a very exciting time, but it is also a time with many uncertainties including an anxiety about running out of money. In this paper, we offer perspective on your investment portfolios and what does happen when you retire. We acknowledge that we are only able to scratch the surface on a number of topics discussed in this paper and that each of your individual circumstances is different, but we hope you find this to be an informative overview of how your investment portfolio continues working for you when you are no longer working.

Humans have a hunter, gatherer innate sense that influences our thinking about our investments. We gather assets during our working years and worry whether or not our stash is large enough to get us through an unknowable period – the rest of our lifetime.

Emotionally, it is natural to think of our investments, savings and collections of assets, including real estate, Social Security and pension payments, as a pile of nuts needed to get us through a long, potentially cold winter. But unlike a squirrel that confidently settles in and awaits the spring, we often think of our retirement lives as an eternal financial winter. This can weigh heavy on our minds; fortunately, the reality is very different. Most of us will spend nearly a third of our lives in the post-employment phase and these years are consistently surveyed to be some of the most rewarding.

From a purely practical investment perspective, our investments don't care that we are retired, or that we will begin making monthly withdrawals soon. The real investment impact of funds that are withdrawn monthly to support retirement life is that those funds are simply not there to earn future market returns. Fortunately, the remaining portfolio continues to plod along as it always has moving up and down with the markets and providing income and appreciation to support our future monthly withdrawals

The question then becomes one of sustainability, which is where the comparison to a squirrel's activities do not apply to a carefully structured investment portfolio – a winter stash does not grow to provide for future needs. An investment portfolio has the potential to sustain our annual needs for a long period of time and can last well after our original investment is exhausted if withdrawal rates (the amount of money withdrawn from one's investment accounts during the year) are held close to the historical annual returns of 4% to 8%. Although future returns are not guaranteed and require an element of faith, few retirees over the past 60 years would have outlived their investments if mid-single digit withdrawal rates were observed.

Beyond future investment returns, sustainability is also dependent upon the other two unknowns: how long we (including our spouse) will live and our annual spending needs. Life expectancies have risen steadily over the past four generations and most of us will live longer than we think. Given today's long life expectancies and an uncertain spending and inflation outlook[*], our portfolio needs to continue generating income and delivering market appreciation for many years into the future. As such, our actual retirement date is a relatively minor event on life's investment calendar.

How Does Your Investment Portfolio Continue to "Work" in Retirement?

Maybe a better way to think of our accumulated retirement assets is that the assets behave like a replacement worker that takes over when you decide to retire. The combined sources of income represent a salary that, although it may not fully replace our working income, allows for a more relaxed retirement lifestyle.

With few exceptions, we believe the best course of action is to make few changes to a portfolio's risk level (or asset allocation) in the first few years of retirement given the long retirement horizon ahead. In fact, retirement, or the withdrawal phase of investing, is already built into our client investment allocations. Any needed changes are typically introduced well in advance of actual retirement, or if there is some other major life change.

Let's take a look at an example of why, for most clients, we maintain their current asset allocation.

Example "Hypothetical Investment Portfolio" details:

- Retirement portfolio assets of $1,000,000.
- Initial annual pre-tax withdrawals of 5% of the investment portfolio ($50,000 per year), or a monthly check of $4,167.
- A 2% increase in annual withdrawals to keep up with rising costs.
- To keep things simple and since tax rates vary by individual - no tax withholding.

The questions we are trying to share perspective on include:

- Should I move to a very conservative and less risky portfolio now that I'm retired?
- I hope to live a long life, and maybe even leave some to family and charities that I care about, will I have any money left to do that?
- Will I have a bit of cushion if I need extra money beyond my monthly checks?

What does the data show:

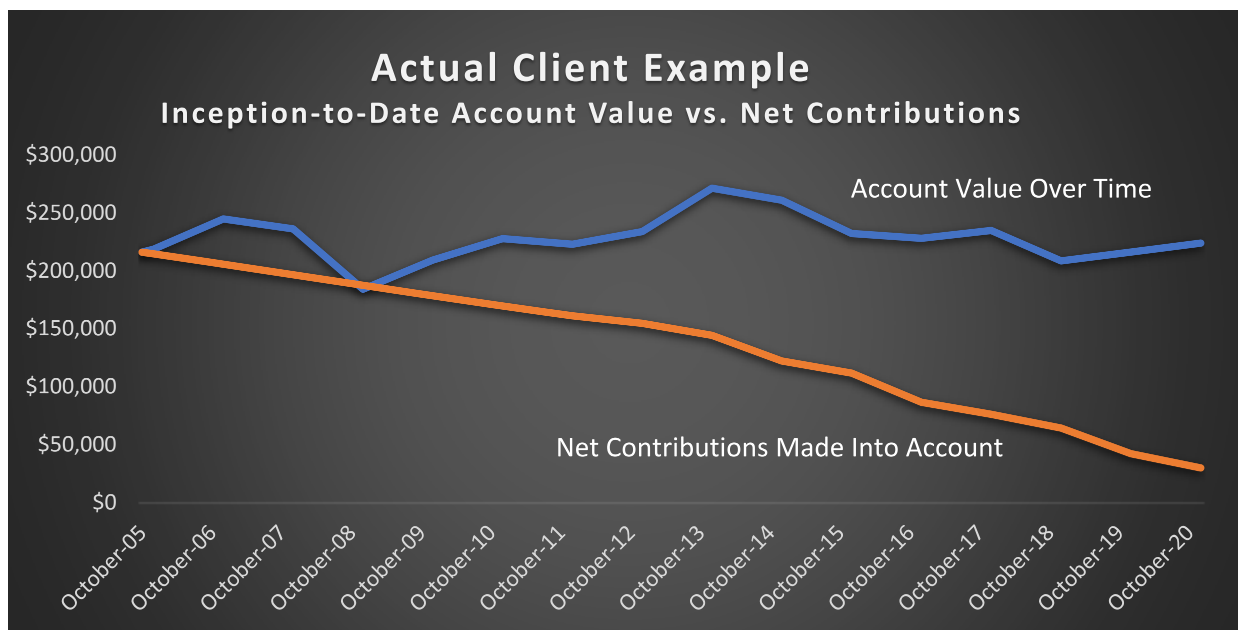
Portfolio Risk Level	Annual Return of Investments	Will My $1 Million in Retirement Assets Last 30 Years?
Less Risk	1%	18 Years and 3 Months
	2%	20 Years and 1 Month
	3%	22 Years and 5 Months
	4%	25 Years and 8 Months
	5%	Investment Balance Remaining after 30 Years = $56K
	6%	Investment Balance Remaining after 30 Years = $770K
	7%	Investment Balance Remaining after 30 Years = $1.8M
More Risk	8%	Investment Balance Remaining after 30 Years = $3.3M

Data provided is not representative of future results. Information provided is for illustrutive purposes only.

A quick review of the numbers in the table above highlights the power of investment returns and compounding over a long period of time. With a very conservative expected return of 1% for a hypothetical investment portfolio, the fund would be depleted after just 18 years. Increasing the annual investment return from 1% to 2%, 3%... all the way to 8%, it is clear just how powerful the extra investment return can be. As the expected return increases, the asset allocation has to work harder to achieve those desired returns and therefore it contains more stocks, fewer bonds, less cash and has more risk that can also lead to some uneasy negative return periods during retirement.

The example, while illustrative of the power of investment returns, is a simple example using a steady annual return. As we know, the timing of investment returns is unpredictable and returns can vary significantly from year to year. So, let's take a look at second example for an actual client that has taken regular monthly IRA withdrawals over the last 16 years – including four larger special payouts for expenses like new vehicles. It should be noted that the observed period included the 2008 financial crisis and the recent Pandemic market decline, two of the most severe market drops a retiree has faced in decades.

Since this client's retirement in 2005, the annual withdrawal rates have averaged about 5% (with the occasional larger withdrawal for the bigger purchases), yet, today, the client's portfolio is valued near the original investment value (the blue line) even though almost all of their original investment has been withdrawn (the orange line). While we provide only one actual client example in this paper, we have a number of other clients with similar experiences.



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How can this be when interest rates and portfolio yields have declined sharply over the observed period? No doubt, we have all been fortunate that the financial market has delivered very strong investment returns these past 10+ years, but there's more to it. The withdrawal process we employ is known as the "total return" approach and uses both income and capital appreciation to meet the client's withdrawal

needs. In other words, it does not matter where the money comes from for your monthly retirement distributions – bond income, stock dividends, or rising investment values. All that matters, is that the portfolio's investments created enough value to meet the client's withdrawal needs. This approach helps to keep your asset allocation and risk levels at appropriate amounts by lessening the reliance on any one part of your portfolio (i.e., income from your bonds or dividends from your stocks) to make your monthly withdrawal requirements.

Two additional observations may be helpful. The simple model discussed in the table that used steady annual returns has actually proven to be very accurate over time. As a result, we use the simple model to forecast client retirements. Over the past 40 years, very bad annual return periods have typically been followed by sharp recoveries that closed the gap quickly. The other benefit that is hidden in the "Total Return" approach's math is that monthly withdrawals are almost always being taken from the part of the portfolio that is above targeted levels (in other words, parts of the portfolio that have gone up in value). In a bad year for stocks, a disproportionate amount of the cash flow needs is taken from bonds which generally would have risen as a percent of the total portfolio. Another way to look at the mechanics of the Total Return Approach is that we use it as an opportunity to rebalance client portfolios, which is by design, a buy low, sell high methodology.

Your "Paychecks" Continue in Retirement

The final piece of the retirement withdrawal process is how your bank account interfaces with your investment accounts at Charles Schwab. The Charles Schwab account MoneyLink system is a direct deposit banking interface tool that allows you to set the date, frequency and amount of the deposits you want to make into your checking account from your investment accounts. The Schwab system also allows you to set both Federal and State tax withholding rates, which you can easily change as you progress throughout the year, if needed. With this MoneyLink system, retirement income will look and feel very similar to your employment paycheck. We can help you manage your deposit preferences or you can easily manage your preferences through the Schwab website: **Login | Charles Schwab**. Behind the scenes (before those paychecks are processed), we take care of ensuring that cash is available and rebalance your account every few months to raise the cash needed for withdrawals. The entire process is simple, systematic and secure.

Summary

Your retirement journey is a long one. There is always some anxiety before beginning any new journey, but you've worked hard to save and now it's time to let your investment portfolios work for you. Given the long retirement time horizon, we do not suggest changing your asset allocation immediately when you retire. It's important to annually revisit your cash flow needs and goals along the way, and make changes if necessary. We may have to "pay ourselves less" in those bad years for the stock market and then can also treat ourselves to more in our monthly retirement withdrawals in the good years. You should expect your well diversified investment portfolios, whether your Investment Policy Statement calls for 50% stocks / 50% bonds allocations or 80% stocks / 20% bond allocations, and all combinations in between, to plod along, in good years and bad years, and deliver income and market appreciation that helps make your retirement

financially sustainable. And those paychecks that you're accustomed to (now through Charles Schwab and their MoneyLink process) will continue well into the future.

*__Important footnote on spending and inflation__:

Spending in retirement is the one unknown for which we actually have the most control, but here too, there are uncertainties. Health care and inflation, two topics that are beyond the scope of this commentary, are two key threats to any retirement budget. The common human response, particularly in the past 30 years, has been to overestimate the burden of both variables. Retiree health insurance has never been more available and is increasingly subsidized. As for inflation, there is no financial metric that has a worse forecast history. Powerful market forces, which have included political upheavals, have kept inflation in check, particularly over longer periods. The current inflation surge too will be subjected to a forceful market response in time.

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