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Should Retirees Avoid Investing Too Much in Stocks?

No, this is not the first softball question to a new contestant in "Who Wants to be a Millionaire?" nor is it a trick question. Anyone knows it is dangerous to put all the eggs into one basket. But the danger is magnified for retirees who are no longer just accumulating assets, but taking money out of their savings to maintain their desired quality of life. In this issue of *Trusted Advisor*, I thought it would be valuable to let the numbers speak for themselves, and to explain why, I suspect, so many homes have gone up for sale in my neighborhood (more of that later).

A typical do-it-yourself retirement planning program, you know, one of those you can play with on the internet or purchase in a box a Costco, will ask the retiree to enter an assumed rate of return for his/her funds during the retirement years. It is only human to look back at the past for a notion as to how much one can expect to earn on one's savings. If you had done this at the end of 1999, you'd find that the stock market, for example, had generated an annual average return of 18.20%.

A hypothetical couple, the Bradens retired in late 1999 to a lovely new home overlooking a green wildlife preserve. They had $300,000 in Tom's 401K, and plan to roll this over to a self-managed IRA account at a trustworthy brokerage firm, where they plan to invest. Both Tom and Susan receive pensions and will take Social Security at age 65. Given the cost of their upper middle class lifestyle, they figure they'll need to take out about $25,000 each year from Tom's IRA. Tom shows Susan how they would have fared had the IRA been invested in stocks (the Standard & Poor's 500 Index of large capitalization companies) and they had begun their program ten years earlier:

1990 through 1999

Year	Beginning Balance	-	Beginning of Year Withdrawal	x	1+Rate of Return	=	Ending Balance
1990	$ 300,000	-	$ 25,000	x	0.968	=	$ 266,200
1991	$ 266,200	-	$ 25,000	x	1.305	=	$ 314,766
1992	$ 314,766	-	$ 25,000	x	1.077	=	$ 312,078
1993	$ 312,078	-	$ 25,000	x	1.100	=	$ 315,786
1994	$ 315,786	-	$ 25,000	x	1.013	=	$ 294,566
1995	$ 294,566	-	$ 25,000	x	1.374	=	$ 370,384
1996	$ 370,384	-	$ 25,000	x	1.231	=	$ 425,167
1997	$ 425,167	-	$ 25,000	x	1.334	=	$ 533,823
1998	$ 533,823	-	$ 25,000	x	1.286	=	$ 654,347
1999	$ 654,347	-	$ 25,000	x	1.210	=	**$ 761,509**

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Wow! They see this history and wonder why they both kept working for so long. If they'd just retired ten years ago and invested in stocks, their money would have more than doubled and they would have lived very comfortably the whole time!

TABLE 2

Year	Beginning Balance	-	Beginning of Year Withdrawal	x	1+Rate of Return	=	Ending Balance
1	$300,000	-	$25,000	x	1.100	=	$302,500
2	$302,500	-	$25,000	x	1.100	=	$305,250
3	$305,250	-	$25,000	x	1.100	=	$308,275
4	$308,275	-	$25,000	x	1.100	=	$311,603
5	$311,603	-	$25,000	x	1.100	=	$315,263
6	$315,263	-	$25,000	x	1.100	=	$319,289
7	$319,289	-	$25,000	x	1.100	=	$323,718
8	$323,718	-	$25,000	x	1.100	=	$328,590
9	$328,590	-	$25,000	x	1.100	=	$333,949
10	$333,949	-	$25,000	x	1.100	=	**$339,844**

But being reasonable people, Tom and Susan know there can be some bad years in the market, therefore it's best to use a much more conservative growth assumption for the future –just in case. 10% appears to be a reasonable figure, as it is often quoted as the long term growth rate for stocks. Even if they only earn 10% they plan to withdraw less than 10% of the original balance each year, so Tom's IRA should grow. Here's their reasonable estimate of how things will go in retirement:
<See table 2>

Let's say Tom and Susan invested Tom's IRA in mainstream stocks starting in 2000. Here's what their first three years have looked like: **<See table 3>**

TABLE 3

Year	Beginning Balance	-	Beginning of Year Withdrawal	x	1+Rate of Return	=	Ending Balance
2000	$300,000	-	$ 25,000	x	0.909	=	$249,975
2001	$249,975	-	$ 25,000	x	0.881	=	$198,203
2002	$198,203	-	$ 25,000	x	0.779	=	**$134,925**

Not exactly what "reasonable" investing was expected to produce!

What do you suppose the Bradens would have to earn to return Tom's IRA to about the $340,000 target at the end of year ten?

It's possible that stocks will return to the assumed 10% annual growth rate for the remaining 7 years. But a little back of the envelope mathematics will tell you this return will not even cover the annual $25,000 withdrawals. How about an annual return of 20%? What do you think the odds are for that sort of run over the next seven years? How likely is it that the Bradens will stay 100% invested in common stocks after their recent experience? Well, here's the result if this aggressive approach were successful:, and the Gods of Wall Street give back 20% per year net of fees and commissions: **<See table 4>**

TABLE 4

Year	Beginning Balance	-	Beginning of Year Withdrawal	x	1+Rate of Return	=	Ending Balance
2000	$300,000	-	$ 25,000	x	0.909	=	$249,975
2001	$249,975	-	$ 25,000	x	0.881	=	$198,203
2002	$198,203	-	$ 25,000	x	0.779	=	$134,925
2003	*$134,925*	-	*$ 25,000*	*x*	*1.200*	=	*$131,910*
2004	*$131,910*	-	*$ 25,000*	*x*	*1.200*	=	*$128,292*
2005	*$128,292*	-	*$ 25,000*	*x*	*1.200*	=	*$123,951*
2006	*$123,951*	-	*$ 25,000*	*x*	*1.200*	=	*$118,741*
2007	*$118,741*	-	*$ 25,000*	*x*	*1.200*	=	*$112,489*
2008	*$112,489*	-	*$ 25,000*	*x*	*1.200*	=	*$104,987*
2009	*$104,987*	-	*$ 25,000*	*x*	*1.200*	=	***$ 95,984***

This is not a pretty picture. In point of fact, the Bradens would need to earn an average annual return of 32.5% for the remaining 7 years just to arrive at their original 10% average return target balance! Not even Hillary Clinton did that well in the commodity futures market ! It's safe to say this couple will be forever behind the 8 ball.

There are two important lessons retirees can derive from this hypothetical but highly possible story:

- Don't bet it all on the stock market, even the big name stocks of the S&P 500.
- Average return assumptions can be highly deceiving. It is crucial not to take big losses, especially after you begin withdrawing funds from your savings.

The Bradens do have one saving grace in their otherwise nightmarish financial picture: they own their own home in California, where residential real estate values have soared at the same time the stock market has bled. They may be able to sell their home and move to a less expensive area, safely investing their profit and or eliminating the cost of their mortgage.

Personally, I've never met a newly retired couple who wish to make a forced move from their home for financial reasons. The Braden's story although fictional, is not unheard of. In fact I'm guessing it may explain why no less than five homes have suddenly gone up for sale (in mid-winter) on our short street of about 30 homes. You see, my wife Eileen and I, since we have no children, live in a community of mostly retirees, a quiet, safe, gated community. The average age is about 65, by my reckoning. And while I can't prove it, I suspect that a few of those "for sale" signs are the direct result of a tragic over commitment to the stock market and the stark mathematics presented above.

Our job as responsible financial advisors is to prevent our clients from making ill-informed decisions that may result in irreversible damage to their finances and their way of life. If you know of a friend, family member or business associate who may need financial advice, we welcome inquiries.

Gary E. Miller

(Footnotes)

[1] Stocks, Bonds, Bills and Inflation, Annual Yearbook, Copyright 2001 Ibbotsen Associates

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