
DANIEL GOLDIE, CFA, CFP®
dgoldie@bamadvisor.com
650.566.1121


DIRK GILLIARD
dgilliard@bamadvisor.com
650.566.1111

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The purpose of saving and investing is to accumulate assets for future goals. The ultimate long-term goal for most of us is to be able to enjoy a safe and comfortable retirement. One of the key decisions we make when we enter the distribution phase of our lives—the time when we are withdrawing money from our portfolio rather than adding to it—is how to safely make these withdrawals while preserving the purchasing power of our assets for the remainder of our lives.

The challenge of not outliving our money is relatively new because it is only in recent decades that average life expectancies have increased well beyond the normal retirement age. In fact, most of us should plan on living longer than statistical averages given our favorable economic status compared to most.

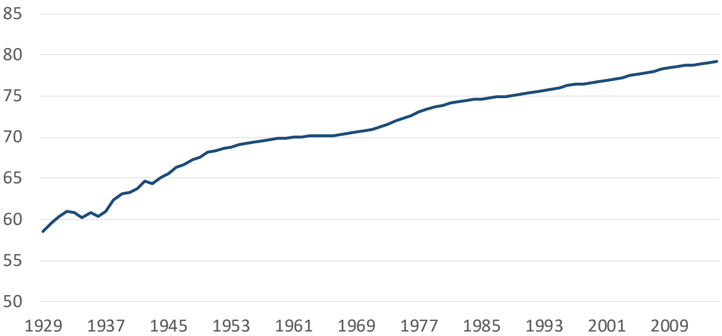
According to two academics in the UK, Lynda Gratton and Andrew Scott, this challenge is only going to get worse because every future generation is expected to live about 10 years longer than the one before it. Therefore, the younger you are, the longer you'll need your money to last in retirement. In fact, Gratton and Scott believe that the current way we live, work and retire will have to dramatically change to adapt to much longer lives in the future.

Today's longer retirement time horizons means that we have to be especially careful about spending too much, especially in the early years of retirement. One way to think about it we have found helpful is to view yourself as an endowment fund or private foundation serving your family's benefit. Endowments and foundations have a long history of managing assets to meet long-term spending needs from which we can learn.

The earliest endowments date back to 12th century Europe and belonged to religious organizations that owned land. As land values increased, so did the ability to increase spending. The earliest spending policies were income-only and served as the model for modern endowment spending policies, which have become more sophisticated.

In modern times, endowments invest in diversified portfolios with multiple asset classes for total return, not just income. Total-return investing views portfolio growth not just from fixed income instruments but also from dividends and stock appreciation. Most endowments withdraw a specified percentage of their portfolio each year using a smoothing method to determine each year's withdrawal rate, rather than withdrawing only the income earned that year. Instead of basing spending on a current year's value, smoothing methods reduce the volatility in spending.

U.S. Life Expectancy at Birth
1929-2015



Source: ourwoldindata.org

Prior to the early 2000s, most endowments used a moving-average smoothing method to determine withdrawals. For example, they would spend a percentage of the rolling 3-year or 5-year average value of their portfolio. If markets went up during the measurement period, their spending would increase

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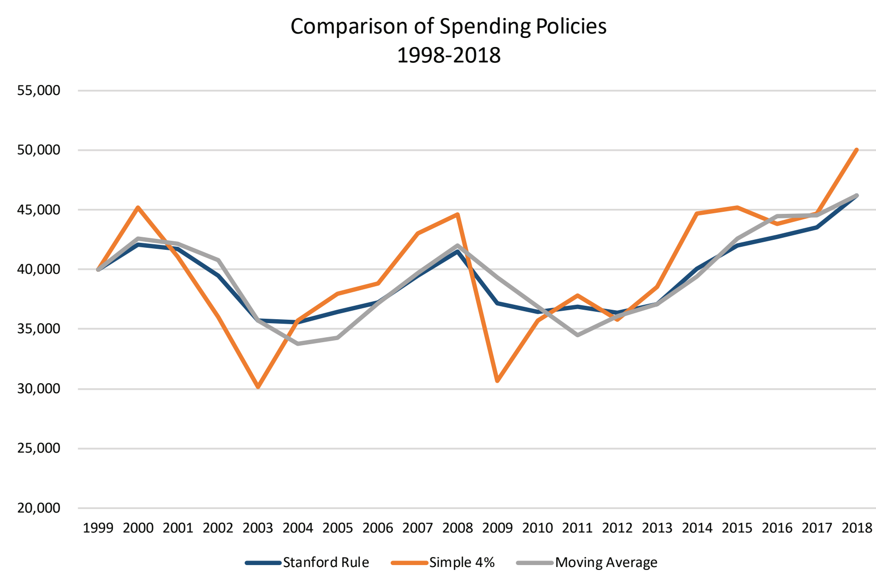
but at a slower rate (and vice-versa in a declining market).

After the early 2000s, hybrid policies were introduced to further stabilize spending. Hybrid policies take into consideration the prior year's spending to stabilize spending and the current market value to preserve assets. The difference between hybrid policies and earlier smoothing models was the flexibility to prioritize one goal over the other depending on the endowment's needs.

You can follow these methods with your own retirement savings. The chart below uses historical data to compare how three common withdrawal policies would have worked for the 20 years ending in 2018 assuming $1,000,000 invested 45% in the S&P 500 Index, 25% in MSCI EAFE Index, and 30% in Barclay's 1-3 Year US Gov't Bond Index. In this example we use a 4% starting withdrawal rate—we recommend that client's use a target withdrawal rate no higher than 4%.

The simple method of taking 4% of the portfolio's value each year caused the withdrawal amount to fluctuate significantly year to year. Using this method in our example, income fell from approximately $45,000 to $30,000 two times before finally rising to $50,000 in the final year. It can be hard to stomach a one-third drop in income, especially if your fixed expenses are a large part of your family's spending pattern.



One alternative is the smoothing method, which uses a 3-year moving average of the portfolio's value. It is still subject to market volatility but has smaller swings because the market values are averaged over three years.

The hybrid method illustrated is that used by Stanford's endowment fund. This method follows what is known as the Stanford Rule, in which each withdrawal is equal to 60% of the prior year's withdrawal plus 40% of the current spending policy (4% of the current market value in this example). The Stanford Rule resulted in the highest ending market value of the three methods and the least volatility of income. Yale, MIT and other schools use a similar method.

Let us know if you would like to discuss how this might apply to your situation.

As always, thank you for you continued trust and confidence.

Warm regards,

Dan　　　　　　Dirk

Daniel C. Goldie　　　　　　Dirk G. Gilliard

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