The Best Life

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How to Build the Best Retirement Spending Plan

Despite widespread spending and investment standards, specific decisions should fit your needs.

Retirement experts have long advocated a conservative approach to spending down retirement assets. That's to ensure people don't outlive their funds. The most common rate recommended is 4 percent a year, although rates from 3 percent to as much as 5 percent and even 6 percent are sometimes considered appropriate, depending on individual circumstances. In the real world, however, there are wild variations when it comes to how people spend their money.

Research on the spend-down patterns of retirees leaves much to be desired. Fidelity Investments says its 18 million customers spend down their assets at a rate slightly above 4 percent. But that's an aggregate average that masks large variations in behavior. And even at Fidelity, which beats the drum of retirement planning loudly and regularly, only 20 to 25 percent of those 18 million customers have ever completed a retirement plan, let alone followed its recommendations.

At the National Bureau of Economic Research, economists James Poterba, Steven Venti, and David A. Wise have performed many retirement studies over the years. Before 401(k)s, IRAs, and other self-directed retirement accounts began replacing traditional pensions, most people depended on the regular streams of income produced by pensions and Social Security. Individual decisions did not play a big role in retirement income.

Now, of course, it's all about individual decisions. The three economists say that both their own research and their review of other studies show that people use their retirement assets as a piggy bank: They tend to break in only during emergencies and other shocks, such as divorce, the death of a spouse, or a serious health problem. Home equity, traditionally a retirement funding source, is used for such emergencies but is otherwise not tapped (in other words, it's regarded as a personal rainy-day fund).

Ditto for 401(k) and IRA assets. According to the economists, less than one quarter of all account holders withdraw assets from these accounts before they are forced to take a minimum distribution at age 70½. And in later years, people take out less money than the accounts have earned. Even at advanced ages—up to the early 90s—people preserved their retirement assets. "Personal retirement plan assets, like home equity, seem to be husbanded in retirement—at least by many households."

The accumulation of retirement assets is interrupted by two major events: a change in family status and a change in health. People who experience a divorce or the death of a spouse also experience a big financial shock that can reduce their retirement funds for the rest of their lives. Two may not live quite as cheaply as one, but couples fare much better in retirement than singles.

Major health events are another significant factor that drives people to break into their nest eggs. The association between health and retirement assets "is striking," the economists found. People in the bottom 20 percent of the population in terms of health had median assets that were only half of those of people in the top 20 percent when the research period began in 1994. When it ended 12 years later, the least-healthy group had only one third the retirement assets of the healthiest group.

Joan Bloom, a Fidelity executive, said the economists' findings were not surprising. If anything, they reinforce the need to plan. "Nobody likes to plan, particularly around money," she says. "It can be intimidating. It can be overwhelming. But the value in going through the pain of planning is that you really do understand what you can do." She emphasizes that planning is not a one-day-per-year exercise, but something that must be more fluid. "You need to be constantly looking at what you're doing. It needs to be adjusted on an ongoing basis." And that 4 percent drawdown rate? Forget it, she says. "A static drawdown rate is not the right way to think about it. Your investing strategy has to be more dynamic."

Central to that investing strategy, Fidelity advises, should be identifying what it calls a "target income mix." Much like a target asset mix helps to diversity assets and better manage investment risk, a target income mix can help diversify income streams to manage your income risk in the drawdown phase of investing. Different types of income-producing investments have different types of properties, Fidelity says, and mixing these components can help to build an "all weather" portfolio that provides income in various market scenarios. Fidelity's approach is to develop a target income mix with stocks, bonds, and short-term investments that are augmented with annuities. However, since each investor's situation is unique, there's no one mix that's right for everyone.

Bloom says people should calculate their fixed expenses—mortgage, property taxes, utilities, insurance, and the like—and fund them with assets that produce guaranteed income streams. This can include Social Security, interest income from bonds, and annuities. Discretionary spending should be approached with a more diverse portfolio. Stocks historically have produced higher returns than other asset classes, but they are riskier holdings. Using stocks to fund part of your discretionary spending makes sense. You'll probably experience solid gains, but if you don't, you can cut your discretionary spending. It's also important not to underspend, she notes. What's the virtue of hoarding assets, she asks, if it means you don't make trips to visit your family?