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The Basics Will you run out of money?

This may come as a shock: The amount you can spend in retirement each year, without running out of money, is far less than most people think -- no more than 3% to 4% of your savings a year.

By [Liz Pulliam Weston](#)

It's no secret that most Americans aren't saving enough for retirement. What's less discussed is the yawning chasm between what most workers *think* they'll need and the amount of money actually needed to produce an income that will last 30 or more years.

Consider these findings from a recent retirement confidence survey by the Employee Benefit Research Institute:

- 84% of workers say they're confident they'll have enough money to cover basic expenses in retirement, and 75% believe they'll be able to manage their money well enough not to outlive their funds.
- But less than one-third of those surveyed had actually tried to calculate how much they'll need. Only 26% of younger workers and 33% of those aged 40-59 had tried to do the math.
- Only 23% of those aged 40 to 59, and 17% of those over 60, said they have saved \$100,000 or more for retirement, while 13% of those aged 40 to 59, and 11% of those over 60, say they have saved nothing at all for retirement.

The crux of the problem is that the amount of money you can spend each year without running out of money is far less than most people think: no more than 3% to 4% a year.

Financial planners call this the "sustainable rate of withdrawal." And what it means to you and me is that we'll need a nest egg of at least \$1 million to get just \$40,000 in annual income.

A field fraught with uncertainty

Before you despair and cash out your retirement funds, however, it's important to know that these calculations assume you want to be nearly 100% certain of having enough money to last your lifetime. It's possible to take a higher percentage of income and still not run out, but you'll need to either 1) die quickly or 2) be a little bit lucky with your investments.

The table below shows the maximum withdrawal rate over various time periods and confidence levels.

Retirement withdrawal rates

| Payout Period | 10 Yrs | 20 Yrs | 30 Yrs | 40 Yrs |
|---------------|--------|--------|--------|--------|
| 100% Safe | 8.84% | 5.16% | 4.26% | 4.08% |

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| Journal of Financial Planning | 98% Safe | 9.00% | 5.32% | 4.40% | 4.12% |
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| | 90% Safe | 9.78% | 5.70% | 4.71% | 4.56% |

Source: Retire Early

While they provide an interesting illustration, the numbers in the table are way too precise. The more you know about retirement income calculations, the more you'll realize how fraught with uncertainty the whole field is.

Until the mid-1990s, calculating sustainable withdrawal rates was pretty much a guessing game. Many planners simply picked a figure somewhere below the expected rate of return on a portfolio. If the planner figured the client would earn an 11% average annual return -- about the norm for a stock portfolio -- he would subtract a 3% or so inflation rate and allow an 8% annual withdrawal rate, or perhaps slightly less if he were a conservative type.

That seemed a little too off-the-cuff for Bill Bengen, a financial planner in El Cajon, Calif. Bengen knew that there was no such thing as an "average" market, and suspected that withdrawal rates that seemed reasonable when based on averages would turn out to be too high when faced with real market conditions.

Bengen's research, using model portfolios and subjecting them to historic market conditions, proved his suspicions to be correct.

Run out of money in 20 years?

Depending on the portfolio's mix of stocks and bonds, Bengen found that even a 5% withdrawal rate -- adjusted each subsequent year for the inflation rate -- could cause someone to run out of money in 20 years. A 3% withdrawal rate from a balanced portfolio almost never did. His influential findings were published in a four-part series for the Journal of Financial Planning starting in 1994.

(Bengen also found that having a portfolio that was too heavily weighted in bonds was worse than one that went overboard with stocks. Bengen helped reinforce the idea that even risk-averse retirees should have at least 50% of their money in stocks in order to get enough long-term growth to overcome inflation and other portfolio-killers.)

Mutual fund giant T. Rowe Price later added to our understanding of sustainable withdrawal rates. T. Rowe demonstrated that too-high withdrawal rates early in retirement -- especially in bad markets -- could cause a retiree to run out of money decades too soon.

Need for income changes

Assuming consistent returns wasn't the only blunder planners made. More financial advisers now realize that spending patterns in retirement may not be constant, either. Instead of needing a steady income throughout, income needs

might spike, decline or take a U-shape.

For example, many retirees might need more money in the early years as they travel, indulge expensive hobbies or share their largesse with their children. At least half continue to save money in the early years, as well.

In the middle years, retirees may need less income as their wanderlust is sated and their health declines somewhat, leaving them less interested in leaving home. Spending might soar again in the last years, thanks to long-term care needs.

The longer you live, the more money you'll need

Then, of course, there are all the uncertainties of life expectancy. Once many planners figured their clients would die by age 85. Today, planning until age 95 or 100 -- or even later -- is becoming more common. Of course, the longer you live and spend in retirement, the more money you'll need.

Finally, there's the issue of expected returns. Obviously, no one can predict what the Dow will do next, and our historical context for guessing is pretty short -- the modern market is less than 100 years old, after all.

With all the unknowns, there's simply no way to say definitely how much you'll need to save or how long that money will last you. That doesn't mean you're helpless, however:

- **Don't fail to plan.** You can -- and should -- use retirement calculators like those included in Quicken or Money to give you a rough idea of how much you may need. People who have a plan for investing, and who stick to it, will be better off than those who leave their retirements to fate.
- **Don't underestimate the importance of guaranteed income.** Pensions and Social Security can reduce, perhaps significantly, how much you may need to save. Although traditional pensions are getting rarer and Social Security benefits may get trimmed, these sources will still exist for many workers. Others may be able to guarantee an income stream by using some of their retirement funds to buy an immediate annuity.
- **Don't despair.** I've previously mentioned Ralph Warner's excellent Nolo Press book, "Get a Life: You don't need \$1 million to retire well." Even if you can't save enough, you can help ensure a happy retirement by tending your health, your family, your relationships and your hobbies. Warner's research shows these factors are at least as important as money in determining how content you'll be in retirement.

Liz Pulliam Weston's column appears every Monday and Thursday, exclusively on MSN Money. She also answers reader questions in the [Your Money message board](#).

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