

Common Mistakes About Retirement Investments

How To Avoid Running Out of Money When You Need It Most

The worst nightmare of the retired investor is running out of money.

Investors often underestimate the length of time they will need their portfolio to provide for them and fail to factor in increases in the cash flow necessary to offset the effects of inflation.

They also often believe that they can safely take a higher percentage of their portfolio's value each year than is realistic.

Here are some factors to consider when planning for your own retirement



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Your Investment Time Horizon May Be Longer Than You Think.

Americans are living longer. The National Institute for Health (NIH) has shown that human life expectancy was 68.6 years in 1952. By 2006 that figure has risen to 77.85 years. Most experts expect this trend to continue.

The table below is the 2006 Internal Revenue Service life expectancy chart. It shows the average life expectancy of various ages.

Age	Life expectancy	Remainder of life expectancy	Age	Life expectancy	Remainder of life expectancy
51	84.3	33.3	71	87.3	16.3
52	84.3	32.3	72	87.5	15.5
53	84.4	31.4	73	87.8	14.8
54	84.5	30.5	74	88.1	14.1
55	84.6	29.6	75	88.4	13.4
56	84.7	28.7	76	88.7	12.7
57	84.9	27.9	77	89.1	12.1
58	85.0	27.0	78	89.4	11.4
59	85.1	26.1	79	89.8	10.8
60	85.2	25.2	80	90.2	10.2
61	85.4	24.4	81	90.7	9.7
62	85.5	23.5	82	91.1	9.1
63	85.7	22.7	83	91.6	8.6
64	85.8	21.8	84	92.1	8.1
65	86.0	21.0	85	92.6	7.6
66	86.2	20.2	86	93.1	7.1
67	86.4	19.4	87	93.7	6.7
68	86.6	18.6	88	94.3	6.3
69	86.8	17.8	89	94.9	5.9
70	87.0	17.0	90	95.5	5.5

Plan cash distributions conservatively.

Investors often have unrealistic expectations about how much money they will be able to safely withdraw annually from their portfolio.

Many investors believe that since equities have historically returned approximately 10% annualized over long periods, then it is safe to withdraw 10% per year.

This kind of thinking can lead to disaster.

While equities have historically returned 10% annualized,¹ the real return on investment is closer to 7%. This is due to the rate of inflation, which historically has been approximately 3%, annualized.²

In addition, the 10% long-term rate of return includes long time periods of high returns, such as 1985-2000, and long time periods of low returns, such as 1965-1985. A high withdrawal rate during periods of low returns could deplete assets quickly.

Inflation will also affect the size of the withdrawals an investor needs to take over time. Due to the compounding effects of inflation, a person who needs \$50,000 in 2005 to cover their annual living expenses would need approximately \$92,000 in 2025 and \$125,000 in 2035, to maintain the same purchasing power.

Another important factor: bear markets. A 10% withdrawal in a year when the market declines could substantially decrease the probability of meeting financial objectives. For example, if your portfolio is down 20% and you take a 10% distribution the same year, you will need about a 39% gain the following year just to get back to even. Some bear markets have had total declines of 40% - 50% stretching over 2-3 years. Obviously, 10% withdrawals under such conditions would virtually deplete the portfolio's value.

¹Ibbotson *Financial Analyst* using S&P 500 1926-2005 = 10%

²Based on U.S. Bureau of Labor Statistics Consumer Price Index. Source: Globalfindata

Historical Withdrawal Rates and Their Impact on Portfolio Values.

Scenario #1: The following table demonstrates the impact of taking annual withdraws equal to **10%** of the beginning portfolio value from \$1,000,000 portfolio over a 30-year time horizon and adjusting for inflation.

\$1,000,000 starting value over 30-year time horizon	10% Cash Flow		
	50% Stocks/50% Bonds	70% Stocks/30% Bonds	100% Stocks
Probability of ending balance above initial investment	0.0%	5.7%	17.7%
Probability of asset survival over specified time horizon	1.4%	10.3%	23.6%
Average years survived	14.8	16.4	18.2
Minimum years survived	7.9	7.3	6.1
Median terminal value	\$0	\$0	\$0

In this scenario, there is no asset allocation that comes with a high probability of success (working under these assumptions). A portfolio comprised of 100% equities will produce the highest probability of asset survival. That probability is only 23.6%, one that the average investor could not accept.

Scenario #2: The following table demonstrates the impact of taking annual withdrawals equal to **7%** of the beginning portfolio value from a \$1,000,000 portfolio over a 30-year time horizon and adjusting for inflation.

\$1,000,000 starting value over 30-year time horizon	7% Cash Flow		
	50% Stocks/50% Bonds	70% Stocks/30% Bonds	100% Stocks
Probability of ending balance above initial investment	14.7%	28.7%	40.9%
Probability of asset survival over specified time horizon	34.1%	46.1%	52.6%
Average years survived	23.8	24.4	24.2
Minimum years survived	11.3	10.2	8.7
Median terminal value	\$0	\$0	\$186,554

The probability of asset survival, as well as growth, significantly improves by lowering withdrawals to 7%. But even with a 100% equity allocation, the probability of not running out of money is still only 52.6%. Once again, a bad bet for investors who need income over a long period of time.

The data is based on a Monte Carlo simulation, a technique which allows for random sampling of historical stock, bond and cash returns while incorporating historical inflation. This statistical method is non-linear and allows for the assignment of probabilities to various outcomes. All values are expressed in today's dollars. Investments in securities involve the risk of loss and no assurance can be given that these returns will be achieved.

Scenario #3: The following table demonstrates the impact of taking annual withdrawals equal to **5%** of the beginning portfolio value from a \$1,000,000 portfolio over a 30-year time horizon and adjusting for inflation.

\$1,000,000 starting value over 30-year time horizon	5% Cash Flow		
	50% Stocks/50% Bonds	70% Stocks/30% Bonds	100% Stocks
Probability of ending balance above initial investment	42.8%	56.7%	62.1%
Probability of asset survival over specified time horizon	78.3%	80.4%	77.7%
Average years survived	28.7	28.6	27.9
Minimum years survived	17.0	14.0	11.2
Median terminal value	\$789,021	\$1,367,745	\$2,183,967

Historically, a more sustainable level of withdrawals is ~5% and below. By lowering withdrawals to 5%, the probabilities for survival and growth greatly improve.

As you can see, the probability of asset survival is highest at a 70% equity, 30% fixed income allocation. The highest probability of growth is with 100% invested in equities. Even so, there have been historical periods where this has been a bad allocation as is evidenced by the minimum years survived of 11.2. Even at 5%, some market scenarios have played havoc with investor expectations.

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Plan for the survival of your portfolio.

Running out of money is the worst nightmare an individual can face during retirement.

Time horizon, withdrawal amounts, and asset allocation need to be considered together when constructing a plan for the future. For most investors, distributions of more than approximately 5-6% combined with a long-time horizon result in portfolio shrinkage and/or reduced income.

Underestimating your time horizon can have devastating results. It is vitally important to set realistic expectations for your portfolio and time horizon. Returns from the stock market are not predictable over time horizons of 5-15 years, and may not correspond to the returns of recent times..

A final word.

We hope you've found real value in the information we've just provided.

Now we'd like to invite you to find out how Alpha Investment Management can help *you* build a secure financial future. Call Alpha at 513-621-9400 and ask to speak with Dr. Jerry Minton who can tell you more about our unique money management services. We'd be delighted to assist you.

Past performance is no guarantee of future results. Investments in securities involve the risk of loss.