Focus on spending, not stocks mayhem

Worried about a plunging stock market that has hit every trading floor on the planet? Me, too.

But I've got a helpful idea. It is this: Simple decisions we make about our personal spending will have a greater impact on our long-term security and standard of living than anything we can say or do about the condition of the world and its markets.

That's a good thing to remember when you next waste time listening to the talking heads and prognosticators on TV. Their only function is to fill time between commercials.

Simple decisions about spending on your part, on the other hand, will do more to make your life better than anything those talking heads say. How do I know this? Easy. Declining markets are a scary opportunity if you are young and investing new money. Declining markets pose a danger only to retirees – to people who make regular distributions from their savings.

That difference – accumulating or distributing – changes the math of investing and introduces what is now known as the SWR question, for "safe withdrawal rate." I've been writing about this since 1995.

The original safe withdrawal rate research came from financial planner William Bengen. He tested portfolios and found that if you took 4 percent from your savings in your first year of retirement and increased the dollar amount of withdrawals by the inflation rate in every year after that, you had a 95 percent chance of having your portfolio survive for 30 years, while providing you with constant purchasing power.

Rivers of ink and centuries of computer time have been devoted to the idea since then. The withdrawal rate can be raised a bit if the portfolio holds more than just U.S. stocks and bonds. Diversification helps.

On the other hand, high stock valuations and low bond yields work to reduce the ini-

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tial safe withdrawal rate.

But those approaches have a defect. They assume that we stare reality in the face and never change our withdrawals. Never. In fact, people aren't like that. Life doesn't let us be. We adapt to change, and how we adapt affects our results. Those changes can save our butts – our lifetime spending butts – in a bear market.

Supporting evidence can be found in a nearly forgotten research paper that was part of that river of ink. In 2006, financial planners Jonathan Guyton and William Klinger added a new dimension to safe withdrawal rate studies. They extended some earlier work and explored how four "rules" could increase the initial withdrawal rate – but maintain portfolio survival and provide solid purchasing power throughout retirement.

Their answer: Follow a few rules, and withdrawal rates can be increased a bunch. With a portfolio of 80 percent equities, 20 percent bonds and cash, it was possible to have a starting withdrawal rate of 6.2 percent. Using the rules would have caused four cuts in annual distributions, seven freezes and eight increases in distributions. With a more common 65 percent equities, 35 percent bonds and cash portfolio, the withdrawal rate was lower, 5.6 percent.

Here are the rules.

First, avoid distributions from equities after a negative year, if possible. Second, increases in withdrawals to reflect inflation are capped at 6 percent. Third, withdrawal amounts are frozen after a negative total return year. Fourth, withdrawals can be increased by 10 percent in good years if the withdrawal rate would be more than 20 percent below the initial withdrawal rate.

There are two big messages here. One is that slight concessions to highly visible reality can boost initial spending rates from 4 percent to 6 percent. A 50 percent increase in spending is significant. To have the same effect on your Social Security benefits, you'd have to defer taking them by about six years.

To be as productive as these rules, your portfolio manager would have to increase your investment principal by nearly 50 percent to achieve the same spending increase.

Another message is subtler. You and I, as individuals, are the most powerful agents for our retirement futures. Follow simple rules, consistently, and we leave other alternatives in the dust. Most people have their hearts in their throats because the value of their retirement savings has fallen. In fact, we'd do better, and feel better, if we focused on managing the rate of our retirement spending.

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