

The 15-Minute Retirement Plan

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

One of the biggest risks an investor faces is running out of money in retirement. This can be a personal tragedy.

People can work their whole lives to accumulate enough wealth to make sure that they enjoy a comfortable retirement only to find they've come up short.

Sadly, many retirees often underestimate the length of time they will need their portfolio to provide for them and misjudge how much money they can safely withdraw during that time.

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



Carefully consider your time horizon.

You may live a lot longer than you think.

FACT: The human lifespan has increased steadily over the past few decades. The National Institute for Health (NIH) has shown that human life expectancy was 68.6 years in 1952. By 2006 that figure had risen to 77.85 years. Given the rapid advances in modern medicine and healthcare, there is every reason to believe this trend will continue.

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

The bottom line? Prepare to live a long time and make sure you have enough money to maintain your lifestyle.

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.

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

A common but incorrect assumption is that if equities have historically returned approximately 10% annualized over long time periods, then it is safe to withdraw 10% per year without ever drawing down the principal.

Nothing could be further from the truth!

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

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: markets are volatile, and taking 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!

¹Ibbotson *Financial Analyst* using S&P500 1926-2005= 10%

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

Understand the important trade-offs you may need to make.

We have included the following tables to show the various probabilities of success you can expect when taking different levels of withdrawals. The simulations were run using a Monte Carlo Bootstrap simulator.³

Scenario #1: The following table demonstrates the impact of taking annual withdrawals equal to **10%** 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	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, the probability that the assets will survive the entire time-horizon of 30 years is very low, as is the probability of growing the assets. Unfortunately, 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%, odds you will probably not want to 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%.

³Bootstrap re-sampling is a type of 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. Depending on where the emphasis lies, on growth of assets or survival of assets, either allocation might make sense.

Establish a primary objective.

Every investor has a unique personal and financial profile—growth objectives, withdrawal needs, time horizons and other factors can vary greatly.

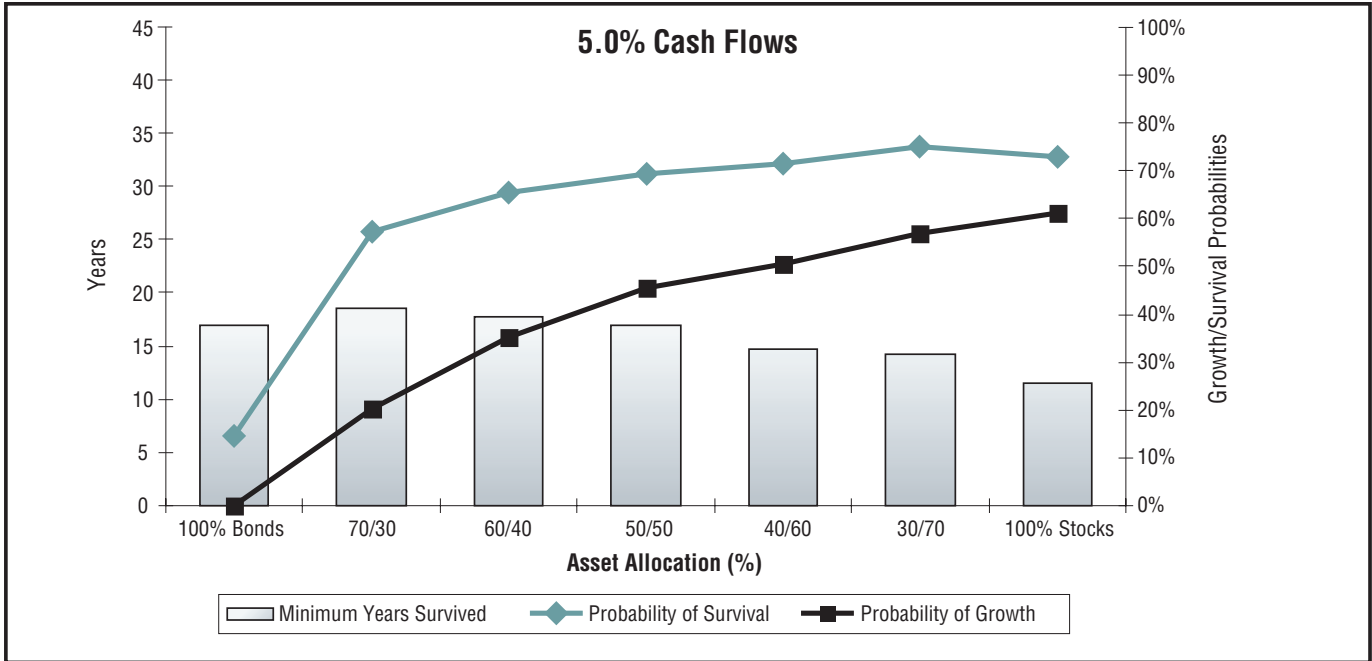
This unique mix of information should dictate how your portfolio is structured. It must first be carefully analyzed and then prioritized based on which goals are more important than others. Once individual priorities are determined, trade-offs should be addressed before determining optimal asset allocation and portfolio structure.

For example, withdrawals may be a priority for a particular investor based on fixed expenses over a set time period. But the difference between 5% and 6.5% annual withdrawals can have a material impact on the portfolio. Depleting assets at 6.5% annually can significantly reduce the likelihood of portfolio survival and growth over the established time horizon (regardless of the asset allocation mix).

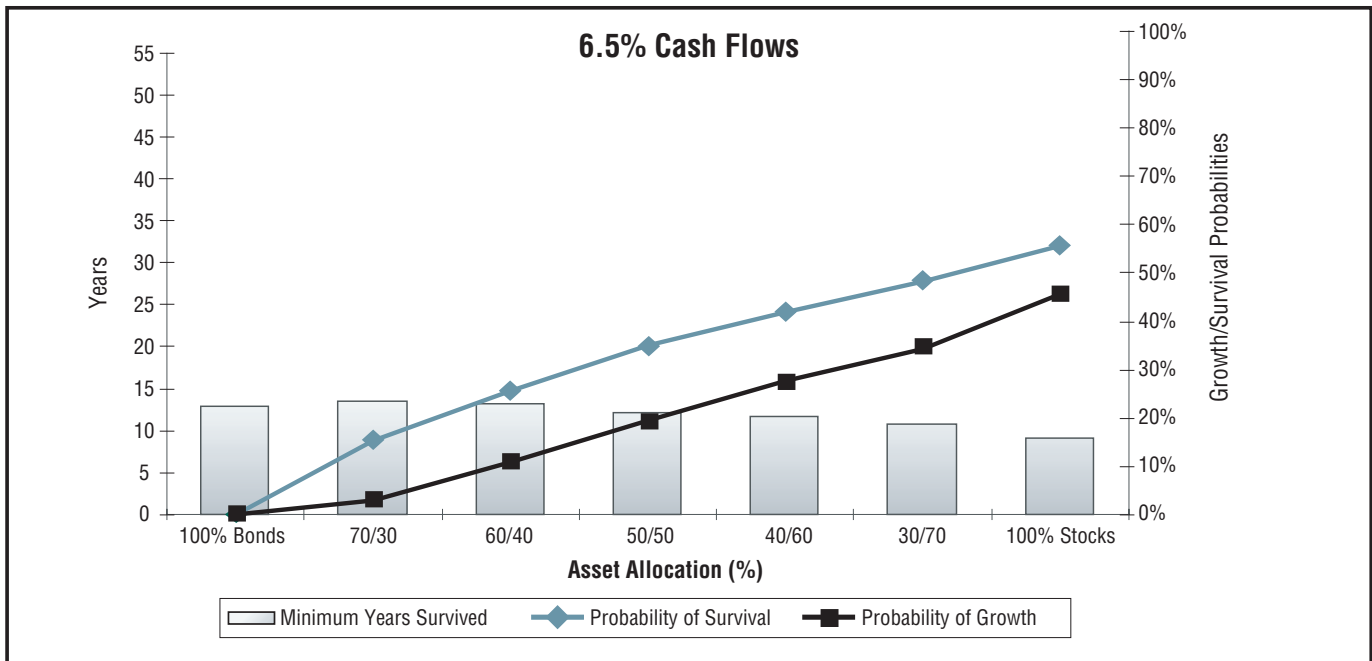
To improve the likelihood of meeting objectives, this investor would need to make some difficult choices. Reducing cash flow needs is one option to improve the chances of achieving goals. If this is not feasible, the investor may choose to weight equities heavily in their asset allocation mix. Higher historical returns associated with equity benchmarks relative to fixed income can improve the probability of growing the assets and securing high cash flow needs over time, albeit with higher levels of expected volatility and perhaps greater risk of portfolio failure in extreme circumstances.

But some investors may not be comfortable with shorter estimates of the minimum survival period—the worst case scenario—associated with equity-oriented portfolios. If this is the case, a more balanced allocation to fixed income relative to equities may improve the survival period. However, it may also reduce expected portfolio returns over time along with the probability of meeting stated objectives.

The graphs below visually illustrate this concept. The first shows distributions of 5% per year over a 35-year time horizon; the second shows distributions of 6.5% per year over the same period. The green and black lines represent the probabilities of survival and growth, respectively, while the bar graph represents the minimum years survived.



Based on Data from Monte Carlo simulation



Based on Data from Monte Carlo simulation

Plan for the survival of your portfolio.

Running out of money is one of the worst scenarios 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. As demonstrated, distributions of more than approximately 5-6% combined with a long time horizon can decrease the likelihood of portfolio survival.

Underestimating your time horizon can have similar devastating results. It is vitally important to set realistic expectations for your portfolio and time horizon. It is equally important to determine what market returns you need to make sure your financial needs are met well into the future.

A final word.

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

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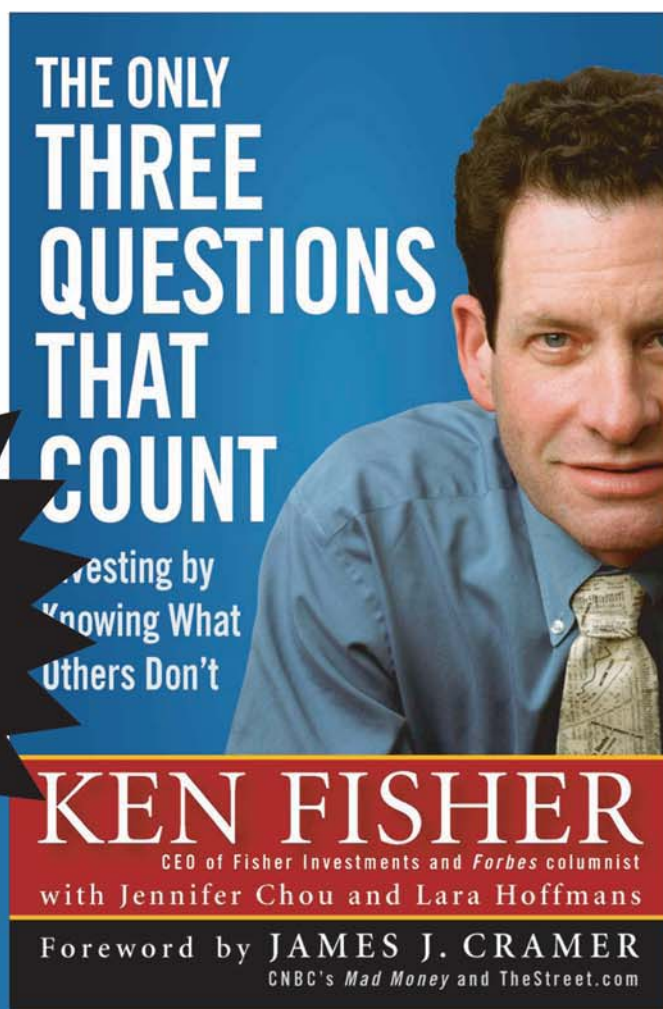
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