Vanguard

A dynamic approach to retirement spending

A new way to calculate retirement draws offers the best of, and helps to alleviate the challenges with, two traditional methods.

Spectrum of three spending strategies

Strategy	Method	Key characteristics
Dollar amount grown by inflation	Calculate a dollar amount in the first year; adjust it for inflation yearly.	Ignores market performance.
		Provides short-term spending stability.
		Long-term effect on the portfolio can be unpredictable.
Percentage of portfolio with ceiling and floor	Withdraw a specific percentage of the portfolio each year subject to upper and lower limits based on the prior year's spending.	Somewhat responsive to market performance.
		Spending may fluctuate in the short term but is held within limits.
		If the markets decline significantly, the portfolio's principal could fall far enough to require reductions in future spending beyond the floor.
Percentage of portfolio	Withdraw a specific percentage of the portfolio each year.	Highly responsive to market performance.
		Spending may fluctuate significantly in the short term.
		The portfolio is never depleted; however, long-term spending levels depend on market performance and investment strategy.

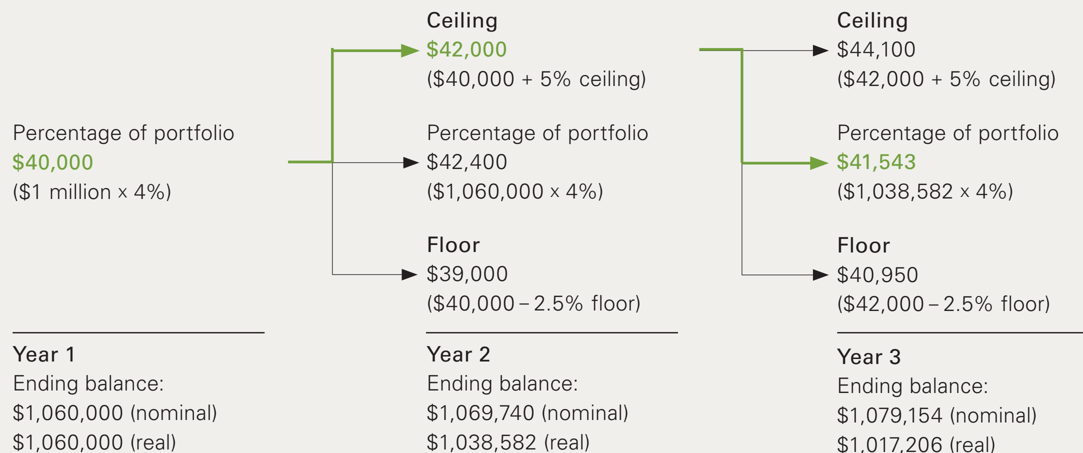
Note: For more information on guidelines on withdrawal rates, see A more dynamic approach to spending for investors in retirement (Jaconetti, Kinniry Jr., and DiJoseph, 2013).

Source: Vanguard.

- You are typically offered two choices to manage retirement savings to cover income needs. The first, a rule of thumb, is to limit annual spending to a specific percentage of your portfolio, typically 4%. The second is to choose a certain dollar amount that can support your lifestyle and then increase that amount annually by the rate of inflation. But each has drawbacks.
- The *percentage of portfolio* strategy can fluctuate dramatically during times of market turmoil. If you follow the *dollar amount grown by inflation* process, there is a chance that you will prematurely run out of money.
- Vanguard recommends a dynamic approach that combines both traditional methods with spending limits so withdrawals remain within a ceiling and a floor. This technique, called *percentage of portfolio with ceiling and floor*, keeps withdrawals within a maximum and minimum percentage increase or decrease, respectively, in real spending.

(continued on reverse)

Dynamic spending strategy example: Percentage of portfolio with ceiling and floor



Starting balance	$1 million
Spending rate	4%
Floor	2.5%
Ceiling	5%

Annual returns	
Year 1	10%
Year 2	5%
Year 3	5%

Annual inflation	3%
Cumulative inflation factor	
Year 1	1.0000
Year 2	1.0300
Year 3	1.0609

Important note: This hypothetical illustration does not represent the investment results of any particular portfolio. This figure shows a hypothetical three-year example of a spending strategy using the *percentage of portfolio with ceiling and floor* method. Here the Year 2 spending amount is constrained by the ceiling rule, while Year 3's spending amount is constrained by neither the ceiling nor the floor. The green lines are meant to emphasize which of the three calculated amounts would be used as each year's real spending withdrawal.

Source: Vanguard.

- *Percentage of portfolio with ceiling and floor* calls for you and your advisor to calculate each year's spending by taking a stated percentage of the prior year-end's portfolio balance. Your advisor would then calculate a ceiling and a floor by applying chosen percentages to the prior year's inflation-adjusted spending amount, such as a 5% ceiling and a 2.5% floor. The results are then compared. If the newly calculated spending amount exceeds the ceiling, you limit spending to the ceiling amount; if the calculated spending is below the floor, you increase spending to the floor amount.
- The strategy allows you to benefit from good markets by spending a portion of the gains. In addition, this method allows you to weather bad markets by having at least a minimum of cash available for spending needs while adjusting your withdrawals lower to preserve your portfolio.
- The ceiling and floor method helps you maintain income for basic expenses while allowing for more discretionary income if market returns are favorable. Talk with your advisor to see which method is best for you.

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All investments are subject to risk, including possible loss of principal. There is no assurance that any retirement spending plan will provide sufficient funds for your needs.

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