

# Systematic Withdrawal Plans (SWP)



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LEHIGH VALLEY  
INVESTMENT GROUP

The simplest method for constructing a retirement income plan is generally called a Systematic Withdrawal Plan, or SWP (pronounced “SWiP”).

The idea is simple and elegant: start with a mass of capital that is invested and earning interest, then withdraw a specified dollar amount every year (month) or withdraw a percentage of the total each year that is less than the amount earned by the account, and voila! The goal is to have an unending stream of income that emanates from a base of principal that never depletes. Sounds perfect!

In many cases, it is perfect. There are many folks who can live happily using a system like this. At present, about 45-50% of all retirees are using this approach to satisfy their income needs in retirement. And the vast majority of financial institutions have developed significant technology to support this kind of distribution strategy from their investment portfolios. As an example, a portfolio of mutual funds is particularly well suited to this approach.

A simple example shows why this approach might be appealing. Let’s assume we have a teacher preparing to retire. If he taught in the Pennsylvania public schools, our teacher will have access to one of the very best pensions in the United States. Let’s say he will get \$4,200 per month for the rest of his life. Further, he is entitled to Social Security benefits starting at \$1,100 per month and his wife will get \$600 per month for her Social Security benefit.

On day one of his retirement, our teacher friend will have a guaranteed income stream of \$5,900 per month. That’s \$70,800 per year! Now, let’s presume that he has done some budgeting and he realizes that he really wants \$84,000 per year for his retirement.

Based on this example, he needs an extra \$1,100 per month (or \$13,200 per year) to meet his retirement income goal. If he and his wife have accumulated \$500,000 of their own savings prior to retirement, this goal is very achievable. In fact, this situation is perfectly suited for a SWP approach. Starting with \$500,000 invested at a conservative 4%, his portfolio should produce \$20,000 per year in income. This \$20,000 is more than adequate to support his need for \$13,200. In fact, not only does it supply his supplemental income, but it also adds another \$6,800 (the difference between what he earned and what he used) to his nest egg for next year. In the following year, he would be starting off with a portfolio of \$506,800 on which to earn 4%.



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In situations where a retiree has a significant, financially strong pension and a Social Security check to boot, a systematic withdrawal plan often works well.



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As long as the accumulated savings are significant and the supplemental income needs are modest, the simplicity and predictability of a SWP is perfectly adequate.

Of course, one size does not fit all. There are, however, risks in adopting this strategy and there are clearly situations where a SWP exposes the retiree to the probability of running out of money before they themselves run out. Obviously, these risks must be understood and addressed.

One risk is a timing risk; the “optimal” time to retire and to begin withdrawing funds on a regular basis can be a roll of the dice. If you retired and began withdrawing funds in 1996 and rode the wave of the technology boom, you had a much more enjoyable (and profitable) ride than a colleague in similar financial circumstances who started her withdrawals in March of 2000. A similar dichotomy exists today between retirees who unluckily began withdrawals in late 2006 at the beginning of the financial crisis versus their colleagues who were lucky enough to begin retirement in March 2009 when the crisis bottomed out.

There is a more fundamental risk at play as well. The inexorable grinding of inflation against the purchasing power of your income creates a problem no matter what your income situation is. Since it costs more money to live tomorrow than it did today, the income you start drawing from your investments this year will have to be larger next year, and the year after that, and the year after that, and so on. While this may not seem so important, it really is.

Let's look at a common example that many pre-retirees cite as their “income plan.” The numbers may be different for each person, but the basic concept is the same. A prospective retiree comes to see me, and he states that by his calculations he needs \$40,000 per year of income to supplement his and his wife's Social Security. He feels he is in good shape since he has amassed an impressive \$500,000 in assets and his 25-year track record of investments has averaged 8% per year. He rightly figures that 8% earned on \$500,000 is \$40,000 and he therefore has reached his income target.

In the sense that he will be able to generate \$40,000 of income in the first year of his retirement, he is correct. But in the broad context of a 20 to 30-year retirement for him and his wife, however, he is terribly wrong. The chart on the next page shows why: inflation. If our retiree friend does in fact begin withdrawing \$40,000 in his first year, he will have withdrawn the entire earnings of his fund. When, in the second year, we adjust for 4% inflation, he must now withdraw \$41,600 to live the same way he did in the first year. Because he is withdrawing all the earnings, the principal value does not grow. Therefore, the \$41,600 withdrawal in the second year represents more than the 8% earnings we assume he will make in that year.

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## The Ravages of Inflation

Year	Starting Capital	Annual Income	Remaining Capital	Growth at 8%
1	\$500,000	\$40,000	\$460,000	\$36,800
2	\$496,800	\$41,600	\$455,200	\$36,416
3	\$491,616	\$43,264	\$448,352	\$35,868
4	\$484,220	\$44,995	\$439,226	\$35,138
5	\$474,364	\$46,794	\$427,569	\$34,206
6	\$461,775	\$48,666	\$413,109	\$33,049
7	\$446,157	\$50,613	\$395,545	\$31,644
8	\$427,188	\$52,637	\$374,551	\$29,964
9	\$404,515	\$54,743	\$349,772	\$27,982
10	\$377,754	\$56,932	\$320,822	\$25,666
11	\$346,487	\$59,210	\$287,278	\$22,982
12	\$310,260	\$61,578	\$248,682	\$19,895
13	\$268,576	\$64,041	\$204,535	\$16,363
14	\$220,898	\$66,603	\$154,295	\$12,344
15	\$166,638	\$69,267	\$97,371	\$7,790
16	\$105,161	\$72,038	\$33,123	\$2,650
17	\$35,773	\$74,919	(\$39,146)	(\$3,132)

Starting with \$500,000 and taking \$40,000 in annual income, annually indexed at 4%, and growing the remaining principal at 8%, would leave you bankrupt in 17 years.

This example is hypothetical and no specific investment is used. Your results will vary.

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What is important to take away is that over time, inflation creates an ever-downward cycle that ends in disaster by year 17. That's a problem!

And to spare you added pain and suffering, I did not even factor in income taxes in this example. I'm afraid that the IRS will not be so accommodating. Further still, this example is highly improbable since it assumes that the portfolio will return 8% every year. The reality is that portfolios that do return 8% on average over time almost never make 8% in a given year. So, you can't even depend on that!

In summary, there are some situations which lend themselves well to SWPs and some that are at more risk of failure. In general, sophisticated research using Monte Carlo simulation has shown that a retiree can confidently start an inflation-protected SWP of 3-4% or less per year provided that he/she stays invested in a prudent portfolio of equities and bonds. There is a "high probability" of success for the retiree even if the withdrawal lasts for 25-30 years.

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