Sustainable Spending Policies

By Jan Blakeley Holman, CIMA®, CFP®

We may not be able to control the direction of the markets or the rate of inflation, but we can control the amount of money we spend.

Once you decide that your client needs to supplement income by taking distributions from an investment portfolio, you need to choose a spending policy. A spending policy is the method for determining how much can be withdrawn from the investment portfolio on an annual basis without depleting the principal too quickly.

Spending Policies
There are two kinds of spending policies: the lifestyle spending policy and the endowment spending policy. Two key decisions determine which type of spending policy will be chosen:

- How much will be spent initially?
- How will the spending amount be increased or decreased?

Lifestyle Spending Policy
A lifestyle spending policy is calculated by identifying a percentage of the portfolio that is withdrawn to cover expenses, increased by a cost-of-living adjustment typically measured by the Consumer Price Index (CPI). This spending policy is referred to as a “lifestyle” policy because it is intended to provide the investor with a consistent standard of living that is indexed to inflation.

The lifestyle spending policy, although attractive because of its simplicity, is flawed in two important areas:

1. This policy does not tie the spending level of the performance to the value of the underlying investment portfolio.
2. Because the withdrawal rate is driven by the inflation rate, spending amounts may increase too rapidly during periods of high inflation, placing the portfolio at risk of premature depletion.

As a result, the lifestyle policy never requires your client to slow or reduce spending during extended bear markets when a portfolio may decline.

To understand how a lifestyle spending policy works, it’s helpful to look at a hypothetical client’s situation. Assume you have a client who has a $1-million portfolio and wants to begin taking distributions of 5 percent on January 1, 1973. During the following decade, annual inflation averaged 8.75 percent, and your client’s spending amount doubled from $50,000 to $108,632 (see figure 1).

For this client, high inflation was only half the story. Between 1973 and 1974, stock prices fell dramatically and the S&P 500 declined by approximately 37 percent.

The combination of high inflation and stock market losses caused this client’s investment portfolio to last just 21.5 years (see figure 2).

It may seem unfair to use an example that begins in 1973, during arguably one of the toughest investment periods in the past 80 years. So let’s look at how the lifestyle spending approach worked during a more moderate investment environment that began in 2000. In figure 3, the blue line shows the lifestyle spending rate from 1973 to 1985, a period during which inflation rose from 6.16 percent in 1973 to a high of 13.58 percent in 1980 and then declined to 3.55 percent in 1985.

The gold line shows the spending rate beginning in 2000 when the rate of inflation was 2.19 percent and ending in 2013 when the rate of inflation was 2.07 percent.

Figure 3 shows that, regardless of the rate of inflation, the lifestyle spending approach
creates a problem because the amount being spent increases every year, and because there is no relationship between the value of the underlying portfolio and the spending amount.

The client who began taking portfolio distributions in 2000 doesn’t have the same magnitude of the problem as the client who began taking distributions in 1973, because inflation was lower and grew at a much slower rate. Still, at the end of 14 years, withdrawals as a percentage of the portfolio for your 1973 client have increased to 39 percent, and withdrawals as a percentage of the portfolio for the 2000 client have increased to 23 percent. Figure 3 shows that both rates are at odds with the goal of a sustainable portfolio.

So, if the lifestyle spending policy isn’t the way to go, what approach can you take to help clients balance cash-flow needs with inflation, market fluctuation, and the desire to extend the longevity of their investment portfolios?

Consider an endowment spending policy.

**Endowment Spending Policy**

An endowment spending policy is a spending policy that’s used by some colleges and university endowments. Like individual investors, endowments are interested in preserving the value of their portfolios while spending at sustainable rates. Because endowments and individuals have similar goals, your clients can learn a great deal from this approach.

Unlike the lifestyle spending policy, which relies upon a flat annual withdrawal rate, the endowment spending policy factors in the current portfolio value and the prior year’s spending. When blended together, these two values determine the next year’s spending amount.

Having a percentage of the spending tied to the performance of the portfolio increases or decreases the spending amount in tandem with the value of the investment assets. The endowment policy is designed to lower the spending amount during bear markets, but this is done gradually, thereby allowing an investor time to adjust spending and stay on plan. Like university endowments, the endowment spending policy provides a balance between paying for current expenses and preserving assets to cover future operations.

To establish an endowment spending policy, you and your client must decide on two factors: the appropriate spending rate and the applicable smoothing rule, as described below.

**Spending Rate**

The spending rate is the percentage of the portfolio value used to determine your client’s annual spending. Much has been written by academics on the subject of sustainable spending rates, but today there seems to be a consensus that a rate somewhere between 4 percent and 5 percent maintains a prudent balance between providing a consistent distribution and giving the investment portfolio the opportunity to grow.

**Smoothing Rule**

The smoothing rule determines how quickly to increase or decrease your client’s annual spending amounts based on the portfolio’s investment performance. Selecting a 90/10 smoothing rule assumes that 90 percent of the spending amount will be based on the prior year’s spending and 10 percent will be based on the portfolio’s current valuation.
Table 1: Endowment Calculations on a Hypothetical Portfolio

<table>
<thead>
<tr>
<th>Account Status</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
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<tbody>
<tr>
<td>Hypothetical Portfolio Value (PV)</td>
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<td>$700,000</td>
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<tr>
<td>Spending Amount</td>
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<td>$51,940</td>
<td>$55,773</td>
<td>$55,822</td>
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<tr>
<td>Current Spending Rate (Amount/PV)</td>
<td>5.0%</td>
<td>6.5%</td>
<td>8.0%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Spending Calculations</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>90% of Prior Year Spending Amount</td>
<td>$45,000</td>
<td>$46,746</td>
<td>$50,196</td>
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<tr>
<td>10% of PV Times 5% Spending Rate</td>
<td>$4,000</td>
<td>$3,500</td>
<td>$4,000</td>
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<tr>
<td>Subtotal before Cost of Living Adjustment (COLA)</td>
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<td>$50,246</td>
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<tr>
<td>Prior Year CPI Increase</td>
<td>6%</td>
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<tr>
<td>Annual COLA</td>
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<tr>
<td>Increase / (Decrease) from Prior Year</td>
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<td>7.4%</td>
<td>0.1%</td>
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</tr>
</tbody>
</table>

*Not indicative of a particular investment. For illustration purposes only.*

Source: Thornburg Investment Management

Table 1 illustrates how a 90/10 smoothing rule affects the value of—and spending from—a hypothetical investment portfolio over a four-year period of high annual inflation. Assume that we begin with a $1-million portfolio and a 5-percent spending rate (a $50,000 distribution during the first year). Table 1 shows portfolio value on January 1 of each year and the annual spending calculations.

Note how the spending amount increases during the two-year bear market, but it does not keep pace with inflation because the underlying portfolio value does not warrant it. Your client’s willingness to choose an approach that reduces the spending amount when the investment portfolio is not performing well is the key to having a sustainable investment portfolio. Using an endowment policy assists in maintaining a reasonable current spending amount in both bear and bull markets.

Comparing Spending Policies: Lifestyle vs. Endowment

Returning to the example of the client who began taking investment portfolio distributions on January 1, 1973, it is possible to see the difference an endowment policy can make to the longevity of a long-term investment portfolio. Figure 4 shows a comparison of the annual spending amounts for the first 10 years of portfolio distributions from endowment and lifestyle policies.

Note how the endowment policy reins in the spending amount during this inflationary bear market. In fact, over the 10-year period the spending amount was lowered by almost $102,000 in aggregate (10 percent of the initial portfolio value), allowing this amount to remain invested in the portfolio for future periods. The reduced spending amount gave the portfolio time to grow, and as the assets increased in value, the investor could take advantage of improving market conditions.

The net effect of using an endowment policy for the investor who began distributions on January 1, 1973, is dramatic. Figure 2 compares the impact to the value of the hypothetical investment portfolio for the lifestyle and endowment policies. The lifestyle policy portfolio is exhausted in 21.5 years, but the endowment policy portfolio grows to $1.8 million during the same period.

If you choose an endowment spending policy, you and your client should expect that spending amounts may not keep pace with the cost of living unless the value of the underlying investment portfolio grows sufficiently to support the increases. At the same time, this approach provides access to two critical factors that contribute to the longevity of long-term investment portfolios: continued growth of assets and a spending policy that supports belt-tightening during bear markets.

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