In Part-1, we explored mistakes investors make due to bad advice, flawed research, and emotional distress. In Part-2, we continue the journey into a world of COVID and possible economic fallout, much remains unknown. Retirees, and those planning to retire, possess little financial bandwidth for error.

> *Retirement is not the end of the road. It is the beginning of the open highway."*

Today, retirees face a tremendous challenge: How to generate predictable cash flow with real interest rates on fixed-income investments such as bonds, at zero or negative. As a result, the willingness to take on greater stock market exposure has increased. Unfortunately, current valuations portend to low future returns for stocks. Furthermore, in the case of a massive correction or bear cycle, older investors don't have the luxury of time to recover from significant investment losses. Due to the lingering effects of COVID, retirees are susceptible to unforeseen economic shocks. No longer career-earners, they are unable to replenish investment coffers in the case of adverse events. If you're in retirement or planning to be, please consider our Part 2 of the mistakes.

Risk #1: The 4% Portfolio Withdrawal Rule is Full of Nasty Surprises.

At our Right Lane Retirement Class, we discuss how the lifeblood of retirement is a dependable, predictable stream of income. To suggest, investors can *consistently* withdraw a **FIXED** percentage every year from **VARIABLE** portfolio assets such as stocks is borderline fantasy. At the least, it's unrealistic. Many retirees should be open-minded to annuities. After all, Social Security is an annuity. Single-premium immediate and deferred products with income riders also provide *lifetime guaranteed* income. Naturally, stocks can pay dividends, but there's nothing guaranteed or dependable about them, primarily through times of economic distress.

Bierwith and Bengen Undertake Groundbreaking Research.

In 1994, Larry Bierwith and later William Bengen researched a way for retirees to spend for thirty years with the reasonable assurance their money would last. They modeled a four percent first-year withdrawal followed by inflation-adjusted withdrawals in subsequent years. Subsequently, a four-percent withdrawal was considered safe as long as a portfolio maintained between fifty and seventy-five percent stocks. Retirees today cannot expect to hold 75% of their portfolios in stocks and adequately sustain bear market losses. Frankly, with the current Shiller PE at 32X, it's not practical for even younger investors to maintain an aggressive allocation to stocks unless a strict sell or rebalancing discipline is employed.

Is the 4% Rule Realistic in Today's Environment?

In a recent interview with ThinkAdvisor, Professor of retirement income at The American College Wade Pfau, weighed in on the topic of withdrawals during the COVID-19 crisis. One of the leading academics in the financial field, Wade believes the stubbornly popular tenet is in peril. In that interview with Jane Wolman Rusoff dated April 14, 2020, he stated:

> I did some updates in mid-March; and for an investor taking a moderate amount of risk, I put out 2.4% as my equivalent of the 4% rule. That?s still about the same today.

Just like that, the holy *4% Withdrawal Rule* is cut in half. As of this writing, the stock market has recovered, but that doesn't mean investor portfolios have followed a similar path. Keep in mind; academics have questioned the rule for years. In 2008, Jason S. Scott, Nobel-prize winner William F. Sharpe, and John G. Watson revisited it in a paper titled "*The 4% Rule - At What Price?"* In the paper, the authors comment:

> *"We have argued that the major flaw of the 4% is its attempt to support non-volatile spending with volatile investing."*

As a result of a bear market and 20-40% stock losses, how comfortable would you be to stick with the rule? Perhaps you'd reduce future withdrawals to compensate or return to work to prevent further erosion of your nest egg.

A Practical Approach to Portfolio Withdrawals.

Retirees require flexible, customized approaches to portfolio withdrawals. I created general guidelines to jump-start the thought process. Naturally, a strategy should be customized for your situation.

1. Consider a *baseline* annual withdrawal rate. A rate you can stick with *regardless of portfolio volatility*. From experience, I found 2% to be a realistic starting point.
2. For every 1%, the portfolio *increases* in value, trim profits, and place the proceeds in cash or spend them (*with a modification*). For example, let's say a portfolio increases by 6% for the year. A half-percent for each 1% above the baseline (2%), is 2%. Add the 2% to the base rate to establish a 4% withdrawal rate the following year. Maintain the remaining 2% as a cash buffer for future distribution needs.
3. With every 1%, the portfolio *decreases*, limit the following year's withdrawals to the baseline or plan not to exceed an *additional 1%.* If losses are 6%, adjust portfolio withdrawals the next year to 3%, or stick with the baseline.
4. Undergo a distribution checkup every three years. Calculate cumulative net gains minus withdrawals and other costs. In the case of surplus *(more gains than withdrawals)*, by all means, go ahead and spend it. Enjoy. Take that trip. Buy that car. Whatever. Use this time also to assess current trends in inflation, taxes, and fees.

Risk # 2: Retirees: Reset The Inflation Expectation.

Inflation is unique to each household. An assortment of calculation methods exist; only a few are applied. Intuitively, inflation should differ for an urban wage earner vs. an older, retired American. The Experimental Consumer Price Index for Americans 62 Years of Age and Older exists for that purpose. The [CPI-E] attaches more significant weightings to medical expenses and housing. The share of expenditures on medical care is double that of the CPI-U or W populations. Yet, CPI-E is ignored. Why? Because it would likely result in a budget-prohibitive COLA for Social Security benefits. Studies show that implementation of CPI-E would result in a 4% greater benefit than currently provided under CPI-W. For that reason, the Social Security Administration uses CPI-W to calculate cost-of-living adjustments for retirement benefits. There's no reason to believe they'll change it anytime soon, if ever.

Deflation Now. Inflation Later.

Currently, economic conditions are deflationary. Due to COVID, I fear imminent price pressures on premiums for healthcare and long-term care costs. As we age, it's tough to avoid rising healthcare expenses. Medicare, Medigap, and supplemental Part D Drug Coverage cover a majority of a retiree's healthcare costs. Even so, inflation has been running close to 6% for Medicare and healthcare insurance premiums. And that's before COVID. Also, many retirees are ill-prepared for long-term care expenditures. Generally, long-term care is assistance with activities of daily living like eating and bathing. Medicare does not cover most long-term care costs.

How will Inflation Erode your Retirement?

> ***At RIA, we use an annual inflation factor of 4.5% for additional healthcare expenses (depending on current health of the client), and cost of long-term care. Within three years, I would not be surprised to employ a rate close to or exceeding, 7%.***

Inflation is a shapeshifter, a ghost, and on occasion, a boogeyman. Inflation can increase one year, fall the next. It all depends on a household's unique spending needs. At RIA, we study inflation trends. As a result, we believe the ongoing cost burden of COVID, along with the rise of global trade barriers and supply chain disruptions, may generate inflationary spikes perhaps not witnessed in over 40 years. The craft of withdrawals in retirement, along with inflation adjustments, is just as much art as science. Financial plans are as individual as the people who bring the numbers to life! Financial professionals are sometimes wary of the 'art' part, but it doesn't change the fact that every analysis is a leap of faith. Remember, a financial plan is a comprehensive, educated guess about future outcomes. No plan is perfect. As a result, a systematic withdrawal strategy requires monitoring and adjustment. COVID inflation is another variable that may impact future cash flow.

Risk #3: An Emotional Response to Portfolio Positions is Dangerous to Wealth.

In the face of accommodative Central Bank policies, which border on reckless, the emotional state of investors is one of unadulterated greed. 'Twenty-one-year-old college students think they're 'market mavens." They feverishly trade on platforms such as Robinhood and consider themselves geniuses when the true hero is accommodative monetary policy. Novice investors conduct little fundamental research and employ narratives, stories, word-of-mouth to buy stocks blindly. The masses are blindly seduced by a Federal Reserve that supports the tailwind in risk assets.

It Bodes a Question: Are Investors Rational? Yes. *And No.*

A human's rationality is bounded. Cognitive abilities are limited and emotional biases, plentiful. As a result, few recognize their deficiencies and depend on mental shortcuts to rise above the overload of information. In a market that only goes higher, investment decisions have become full-on ' *System 1.'* As illustrated in Eugene Higgins Professor of Psychology Emeritus at Princeton, Daniel Kahneman's bestseller - Thinking Fast, And Slow, human brains operate on two systems. Consider *System 1* the brain on auto-pilot. Fast, emotional, incredibly efficient, but fraught with error. *System 2* is the slow, logical, deliberate operator. The one that seeks homework disdains immediate gratification and relishes the long term. The Fed' easy cash' machine has short-circuited our *System 2.*

How To Control Your Emotions:

1. *Steer clear of financial television*. Financial news is a System 1 overload. Financial news junkies (me included) find it tough to step away from CNBC. Over the years, I've learned to be an outsider and a casual observer. I listen to what reporters say and how they say it to understand how a retail investor would interpret the so-called news. It's fair to watch and generate ideas, but it's another to trade based on stories blindly.
2. *Establish a PHR*. A 'Personal Hurdle Rate' is the return necessary to meet financial milestones. An investor with a PHR focuses on the portfolio sufficient return to fulfill goals. Focus is diverted from some arbitrary benchmark like the S&P 500. A holistic financial plan is necessary to determine a PHR. A plan will also help investors understand the portfolio risk taken for a given level of reward.
3. *Avoid the 'Christmas lights' investment method*. Investors focus on gains and losses tracked in their brokerage accounts. In their minds, winners are green, and losers red. *Red and green, just like Christmas lights!* To the System 1 brain, green is always good. Red equals bad, but is it? To diversify properly, an astute investor owns investments that react differently to overall market conditions. For example, when the stock market environment is risk-on, bonds go red. Risk-averse conditions cause bonds to go green; stocks go red. Before selling what's 'in the red,' activate your System 2. Do homework, ask questions. Keep in mind, gains and losses do not calculate overall performance or total return. For the most part, the system is designed to help investors get a handle on the tax consequences of liquidation.

The headwind to returns has just begun.

With interest rates lower for longer and stock valuations extended, retiree income remains a challenge. The headwinds have begun. Since early 2018, the RIA planning team has communicated our concerns. Mistakes can make a challenging situation worse. With objective guidance and planning, you can avoid them.