

SECOND OPINION



## WILL THE REAL SAFE WITHDRAWAL RATE PLEASE STAND UP?

**Q:** The popular consensus suggests a 4% withdrawal rate from investments after retirement. My question is: 4% of what? Once I had all my assets with a financial adviser who charged a 1.5% advisory fee and invested in very expensive mutual funds - in the 1% to 2% range.

Now I've seen the light and invest myself (no advisory fee) in Vanguard funds with management fees in the 0.1% to 0.3% range. That's a net savings of about 3% a year. If we're saying 4% withdrawal rate from a bare-bones scheme, then are we saying only 1% from a professionally managed scheme?

Or conversely, if we're saying 4% from the professionally managed scheme, are we saying 7% from the bare-bones one? I'm not trying to put too fine a point on it, but the 3 percentage point fees make a huge difference. - R.E., Houston

**A:** You won't hear it from the expensive advisers, but your insight is right on. The 4% rule was derived from studies using raw indexes, so spending needs to be adjusted downward against high management expenses. Basically, they can have dinner or you, but not both.

Fortunately, you don't have to subtract it directly from the 4%. Instead, you run a survival study that subtracts the higher fees from the gross return. Then you shoot for the withdrawal rate that will give you the same survival odds.

You can experiment with this by using the retirement portfolio survival calculator at

[www.firecalc.com](http://www.firecalc.com). It allows you to construct portfolios with different asset classes and to set a management expense for the portfolio. Then it computes the survival odds at different withdrawal rates.

**Q:** I have read a significant amount of material regarding exchange-traded funds (ETFs). But I must be missing something because I fail to see the advantage of ETFs over traditional mutual funds, at least for the average "Joe Six-Pack" investor who should be interested in long-term investing and not in frequent trading.

For example, I (an average Joe Six-Pack investor) have funds invested in Vanguard's Total Stock Market Index. Vanguard has, I believe, a Total Stock Market ETF. Under what circumstances would it be advantageous for me to be invested in the ETFs rather than the traditional index mutual fund? I can't think of any. - J.L., Austin, Texas

**A:** The form of fund - mutual or exchange-traded - should be viewed as neutral with respect to trading. While it is possible to trade ETFs, it is not necessary.

Like mutual funds, they can be purchased to hold for the long term. To me, the biggest advantage of ETFs is that they are

an inexpensive way to hold index funds in any account you have, so they provide great flexibility.

Let me give you an example. If you have an account with Vanguard, you can choose between its index mutual funds or its exchange-traded index funds. For most people, it will be easier to choose the mutual funds.

But what do you do if you have an account elsewhere?

If you have an account at Fidelity, for instance, you could use its limited selection of index mutual funds. Then you fill out the remainder of the portfolio by purchasing exchange-traded funds at a commission cost that is lower than the commission cost of buying a mutual fund.

At other firms, there may be no free access to index mutual funds. In that case, you need to construct your portfolio using exchange-traded funds from firms such as Vanguard and iShares.

**Q:** With I bonds offering such small returns, particularly the small guaranteed interest rate, are they still a good investment for, say, 25% of a retirement portfolio? - M.C., by e-mail.

## SECOND OPINION

A: You may misunderstand the return on I Savings Bonds. The stated return is the extra yield you will receive over the rate of inflation. The rate for the current period (it will be reset for bonds issued in November) is only 1.30%. Combined with the low trailing inflation rate, the yield annualizes to 3.74%. That's a low return - but it can rise in the future if the inflation rate rises.

Over the last 80 years the yield on Treasury bills has been only 70 basis points (0.70%) over the annual rate of inflation - so I bonds are offering a premium over Treasury bills.

They also offer tax deferral and commission-free buying in amounts as low as \$50.

Needless to say, I preferred I Savings Bonds when they were yielding 3% over the rate of inflation - then they were a slam dunk. If your retirement funds are in tax-deferred accounts, you should consider buying a TIPS fund that will provide a higher premium over inflation.

(Questions about personal finance and investments may be sent by e-mail to [scott@scottburns.com](mailto:scott@scottburns.com) or by fax to

505-424-0938. Check the Web site: [www.scottburns.com](http://www.scottburns.com). Questions of general interest will be answered in future columns.)

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