How to Make Your Savings Outlive You

It's the great retirement debate: How much can retirees spend each year without running out of money before they run out of breath?

This is a tough one, because there's so much uncertainty. You don't know how long you'll live, what the inflation rate will be and what investment returns you'll earn. Still, many financial experts have settled on a 4% withdrawal rate, meaning you spend 4% of your portfolio's value in the first year of retirement and thereafter step up your annual withdrawals with inflation.

Seem reasonable? Laurence Siegel and M. Barton Waring don't think so—and they're gentlemen worth listening to. Mr. Siegel is director of research for the CFA Institute Research Foundation. Mr. Waring is the retired chief investment officer for investment policy and strategy at Barclays Global Investors. They have a working paper on the topic that they're currently circulating.

Their key point: You shouldn't expect a fixed-income stream from risky investments. "For retirees who think they might live to age 90 or so, 4% isn't a bad number to start with," Mr. Siegel says. "But if you don't adjust it to your portfolio's changing market value, you can get in trouble very quickly."

Adjusting annually: Want a predictable stream of retirement income? You could live off savings early in retirement while delaying Social Security until age 70, so thereafter you have a healthy stream of inflation-indexed income. For additional lifetime income, you could use any remaining savings to buy immediate-fixed annuities, preferably those that pay income that rises with inflation.

Alternatively, to generate a predictable stream of inflation-adjusted income, you might live off a ladder of inflation-indexed Treasury bonds with different maturities. Today, the longest-dated inflation-indexed Treasury matures in 30 years. You'd need a backup plan if you lived longer than that.

But what if you don't like these strategies—and prefer to own some mix of stocks and bonds? Forget settling on a spending rate when you first retire and then sticking with it for the rest of your retirement.

Instead, Messrs. Siegel and Waring propose what they call an "annually recalculated virtual annuity." The idea is to recalculate how much you can spend each year by taking your year-end portfolio value and figuring out how much you can spend over your remaining lifespan, assuming the current level of real interest rates.

The annual calculation would result in year-to-year fluctuations in your income. "In your working life, it's not unusual for your income to vary, and you have to adjust your spending," Mr. Siegel points out. "In retired life, you have to do the same. Certain expenses are inflexible, like property taxes. You should structure your life so that not all of your spending is that inflexible."

During your working life, it's not unusual to adjust your spending for changes in income. The same thing is true in retirement.

For most folks, the "annually recalculated virtual annuity" would involve a daunting calculation, though Mr. Siegel says the problem could easily be solved with a simple phone app. Until that app exists, what's the alternative? Suppose you believe you'll live 20 more years. You might simply spend 1/20th of your portfolio's current value in the first year, 1/19th in the second year and so on.

That wouldn't be ideal, Mr. Siegel says, because you would likely end up short-changing the early years of your retirement. "It back-ends the spending a lot, because you're assuming you aren't getting any sort of real investment return," he notes.

Living long: That still leaves another thorny issue: What if you live longer than expected? Mr. Siegel suggests devoting 75% of your savings to the annually recalculated virtual annuity and use that strategy to carry you through to age 85.

What about the other 25%? That would be your financial backstop should you live beyond 85. Mr. Siegel says you might use part of this money to buy deferred-income annuities, sometimes known as longevity insurance.

With these annuities, you hand over a chunk of money to an insurer and, in return, receive income for life starting at a future date—assuming you live that long. For every $100 invested in a deferred-income annuity at age 65, a man could get perhaps $37 a year starting at age 85 and a woman might receive $33.

Mr. Siegel notes that insurance companies can go bankrupt, so you might purchase annuities from multiple insurers. Indeed, because of the bankruptcy risk, he suggests investing just half of the 25% in annuities—and keeping the other half in a conventional mix of stocks and bonds.

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