

Indexing Works Even Better In Retirement

By Paul Keck - Monday, 11 February 2008

What is a subject like retirement doing on the Index Universe website? Well, there is a strong connection as you will discover in a moment.

Some of you may already be in retirement and many others are on the landing approach. After many years in the workforce, you've finally made it. And now you look forward to enjoying the rewards of your working years.

All your life you've saved and invested in order to create a pool of money that you could later draw on for comfortable living without employment income.

In retirement, the process of paying for retirement gets reversed. You are now going to pay yourself from that accumulated pool. And since the pool is no longer funded, how you maintain it and withdraw from it will have a dramatic effect on how well and how long you can pay yourself.

Looking Ahead

Yes, your retirement can be wonderful, but it could also be something else entirely.

Retirees today face tough opposition to the comfortable life because of rapidly increasing costs of essentials like food, medical care, and energy to heat your home and fuel your car. More than ever you will need to manage your retirement assets as efficiently as possible. That means no excessive losses due to costs, incorrect asset allocations, bad investment choices or poor diversification.

You need to make sure that you maximize your investment returns against the risk you take. And then you have to make sure those returns end up in your pocket. Losses due to inefficient investing can be substantial.

Let's just take a quick look at one of the biggest inefficiencies: costs. As William Bernstein wrote in his classic book "The Four Pillars of Investing":

"Make no mistake about it, you are engaged in a brutal zero-sum contest with the financial industry.--every penny of commissions, fees, and transactional cost they extract is irretrievably lost to you."

Rules Of Thumb

There is a general rule that a safe withdrawal rate in retirement is 4 percent of assets. But that is *supposed to* include expenses and taxes.

As an example, if you have a retirement portfolio of \$800,000, 4 percent would be \$32,000 per year. But if you are paying for high-cost funds and advisor fees, your costs could easily be 2 percent per year. That's 2 percent on the entire portfolio. Two percent is \$16,000 per year or 50% as much as you are withdrawing for yourself.

Sixteen thousand *each year* you don't get to spend. Sixteen thousand dollars lost. There is no chance that any advisor is going to remind you of this. And that goes on even when your portfolio is losing money. Yes, you can do much better, and you need to do better.

As the great individual investor advocate and founder of Vanguard, John Bogle, puts it: *"The great irony of investing, then, is not only that you don't get what you pay for. The reality is quite the opposite: You get precisely what you don't pay for. So if you pay for nothing, you get everything."*

Minding Costs

The following examples demonstrate why cost efficiency is far more important than just capturing more of what you've earned. Cost management is vital to survival.

The first example comes from a discussion of this issue by financial expert John Norstad, who looked into the probability of an investor's portfolio lasting 30 years. He estimated that in a particular case of an individual investor at one point, investing in a portfolio with a 100 basis point expense ratio (1%), the failure rate is at about 47% (i.e., that person not reaching their goals).

By comparison, someone with a portfolio of 20 basis points (0.2%) would face a failure rate of around 25%.

Quite a difference. And even though Norstad was only talking about one particular instance, the broader warning such estimates bring is sobering.

And here is how columnist Walter Updegrave in Money magazine handicapped the race:

Expense Ratio (Annualized As A % Of Assets)	Odds Of Savings Running Out Early
1.5%	31%
1.0%	23%
0.5%	16%
0.25%	13%

Note: Assumes 7% expected annual return before expenses, initial withdrawal of 4%, which is increased 3% annually for inflation.

Now, getting back to what all this has to do with index funds and ETFs: Because of their inherently low costs, index funds and ETFs are obvious choices for stopping a good portion of your assets from getting lost on the way to your pocket.

In other words, you automatically get a big increase in your investing efficiency. But the advantages of index funds and ETFs only begin here. They are also highly efficient in several other ways that provide needed advantages to retirees.

We will begin to examine these advantages next time.

Paul Keck is a retired engineer and an investor advocate for retirees. This is the first of a series of columns he's writing for IndexUniverse.com about indexing in retirement.