Spend Your Age, and a Little More, for a Happy Retirement

Actuaries Institute develops Rule of Thumb for retirement spending that will help thousands of Australian retirees

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A group of Australian actuaries have devised a 'rule of thumb' to help retirees work out how much money they should draw out of their savings in retirement.

The simple, three-part rule was developed by five actuaries. The actuaries ran a range of complicated equations and dynamic programming calculations to help single retirees who have reached Age Pension eligibility age, and who are receiving a part or full Age Pension but who choose not to seek financial advice at retirement.

"The reality is that many people can have a better retirement if they have higher confidence that they are able to draw down a little bit more of their savings than the minimum required by the government," said Actuaries Institute President Nicolette Rubinsztein.

"Many retirees draw a bare minimum from their account-based pensions, or their savings, after they stop work," she said. "They can't afford to pay for professional advice from a planner, and they live frugal lives because they fear outliving their savings. But the 'rule of thumb' is simple and accurate and takes into consideration a retiree's asset base and age."

The members of the 'Rule of Thumb' Working Group are John De Ravin, Estelle Liu, Rein van Rooyen, Paul Scully and Shang Wu.

The starting point for the actuaries' work is a detailed calculation of the optimal drawdowns for single homeowner pensioners. 'Optimal' means drawdown designed to promote the best possible lifestyle but allowing for the risk that if the pensioner spends too much in the early years of retirement, they might reduce the amount available in their later years.

Initially, these calculations were performed for pensioners of different ages and different levels of assets (in bands of $20,000). The calculations allowed for the Age Pension that would be payable to a pensioner with reference to their assets. These calculations lead to detailed tables of optimal drawdown rates.

Having done these detailed calculations, the team of actuaries then produced some simplified guidance for pensioners who want an easy-to-follow rule. For many combinations of age and asset level, the simplified rules produce suggested rates of drawdown that are reasonably close to the optimal rate derived from the very detailed calculations.

The simplest 'rule of thumb' guide is that a single retiree should:

- draw down a baseline rate, as a percentage, that is the first digit of their age
- add 2% if their account balance is between $250,000 and $500,000
- the above is subject to meeting the statutory minimum drawdown rule.

For example, here's what a single retiree, who retires with a superannuation balance of $350,000, could drawdown. The rule of thumb suggests that a retiree aged 60 to 69, would draw down 8% of their savings: 6% representing their decennial age, plus an extra 2%. This means that their annual drawdown would be $28,000 (8% of $350,000).

A retiree with the same balance at age 70 to 79 would draw down 9% of their savings, and someone aged 80 to 89 would withdraw 10% of their savings.

"The majority of Australians are members of defined contribution superannuation schemes, and on retirement they apply the balance of their account to start an account-based pension," said John De Ravin, one of the authors of the research paper. "But it is very hard for retirees, who are generally risk averse, to work out how much of their savings they should live off at any point in time," he said.

"The federal Government has encouraged the industry to develop better products to help ensure retirees don't outlive their spending. But that's still a way off. In the meantime, we've taken a complicated set of equations and scenarios, and worked out what is a simple guideline that works."

Mr De Ravin said even if post-retirement products are developed, the current expectation is that typically, only 25% of someone's balance would be invested in an annuity. "If that is the case, then 75% of a typical retirement product will still require a decision by the retiree as to how much of their account-based pension component to draw down," he said.

The working group looked at various rules currently in use including Bengen's 4% rule, to "spend the income but not the capital", often used by self-managed super funds. "Each rule has its own limitations, and the biggest challenge from an Australian perspective is that none of these rules allows for the interaction with the Age Pension entitlements, which forms a significant component of most retirees' assets," said Mr De Ravin.

The authors developed a second set of recommendations, contained in a simple table, for retirees who are more engaged and actively manage their finances, and who want to optimise their drawdown rate; and a third set of ratios for financial planners.

These alternative recommendations use greater detail around ages and asset bases. For instance, the third set of recommendations allows financial planners to see recommended drawdown rates for each year of age from the age of 67 through to age 95, for seven different asset levels ranging from less than $200,000 to more than $700,000.

"Excellent techniques for computing optimal spending for individuals are available but these are complex," said Actuaries Institute Chief Executive, Elayne Grace. "It has not been possible to find drawdown rules that are simple and optimal for everyone," she said. "But the Working Group has developed a guide that could help Australians have a better retirement. All the rules respond to Age Pension testing parameters, which makes this work very important for a large number of Australians."

John De Ravin is available for interview. The paper can be viewed here.

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