Worth

Risk & Reward: Strategy

Sustainable Spending

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Most would assume that any individual with a net worth of $500 million can spend with impunity. After all, if properly invested, this base amount will yield more than enough income to support even the most lavish lifestyle.

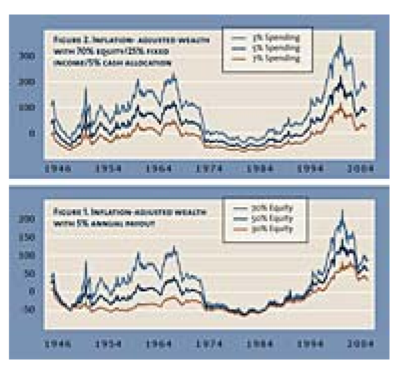
Or will it?

In light of meager returns on most asset classes, many financial advisors now caution that their clients need to scrutinize their rate of spending as carefully as the performance of their portfolios. "I don’t care if a client has a million dollars in net worth, a hundred million or a billion net worth, you have to look at their outflows," says Tom Zanecchia, president of Denver-based Wealth Management Consultants. He adds, "More often than not, as people acquire more wealth they are not in fact richer, because their spending goes up more than their wealth has."

TOP VIEW: Experts caution that affluent families’ rate of spending should be analyzed with the same rigor as the performance of their portfolios. Single-digit equity market returns will affect the spending rates that fixed pools of assets can sustain. Advisors say that now is a crucial time for those living off such pools to determine if their current rate of spending will ultimately erode their overall wealth.

According to a recent study by JPMorgan Private Bank, *Wealth Preservation: The Rate at Which You Spend Matters–Even More Than Your Asset Allocation*, an investor who lives purely off a fixed pool of assets and annually spends just 5 percent of his net wealth has a one-in-three chance of suffering a 20 percent reduction in his real wealth over the course of two decades. "Over the long haul, we would say that spending is more important than, or as important as, asset allocation," says Tricia Stewart, author of the report and managing director with JPMorgan Private Bank in New York. "And we would recommend that our clients maintain their spending at about an annual 3 percent or 4 percent level," she adds. "You can’t be spending 5 percent or 7 percent of a fixed pool of assets every year and still expect to meet your lifestyle goals."

Stewart and her team have concluded that equity market volatility and the expectation of single-digit returns for the foreseeable future will affect the spending rates that fixed pools of assets can sustain. Now, they argue, is the crucial time for those living off such pools to determine if their current rate of spending is eroding their real, overall wealth.



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To illustrate the problem, the bank’s analysts looked at how equity and fixed income market returns affected the performance of a fixed investment pool on an inflation-adjusted basis, assuming a rate of withdrawal of 5 percent per year, from 1926 through 2004. Contrary to popular opinion, they found that the way a portfolio is split between equities and fixed income makes very little difference to long-term wealth preservation. Figure 1 illustrates the annual performance of three different portfolios: a 70 percent allocation to equities, a 50 percent allocation and, finally, a 30 percent allocation.

In the context of a 20-year time frame (a typical investment horizon for a private client that would include, for example, the inflationary 1970s, when equity markets underperformed), the portfolios' asset allocation had practically no effect on dampening wealth erosion. All three portfolios would have lost around 50 percent of their value. "We found that although asset allocation clearly helps you in a bull market, it doesn't bail you out when markets are performing poorly," Stewart says. "The amount the investor had in equities was, within reason, almost irrelevant, as long as he had some sort of mix."

JPMorgan extended the analysis to look at what would happen to a static portfolio with a 70 percent allocation to equities with hypothetical annual spending (withdrawal) rates of 3 percent, 5 percent and 7 percent over the same time period. Figure 2 shows how even small variations in the spending rate leads to more pronounced differences in portfolio value compared to different asset allocations. Their conclusion is clear: Asset allocation cannot compensate for spending blindly.

"If we look at a 20-year time period that includes the early 1970s, then with a 3 percent withdrawal rate you would have lost about a third of your purchasing power, whereas with a 7 percent rate you would have lost almost 70 percent of your purchasing power," says Stewart, adding that the analysis therefore suggests that an optimal annual spending level is around 3 to 4 percent. With a very conservative 3 percent spending level, the analysis suggests that the probability of experiencing a 20 percent loss over a 20-year period is less than 10 percent. At the other extreme, a spending level of 7 percent applied to a portfolio with a 30 percent allocation to equities will almost certainly lose at least 20 percent of its value within 20 years.

Models of Restraint

The computing power available today allows many private banks and wealth advisors to create tailor-made models to help manage spending and other liabilities, as well as assets. "We start on the spending side and work toward the asset allocation," says Joe Leone, wealth manager with Chatham, N.J.-based RegentAtlantic Capital.

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A typical model, for example, would take into account income, returns on existing investments and average annual outflows. Some sophisticated mathematical modeling can determine, with a certain probability, the chances of experiencing a serious loss of wealth within a certain time period, given the historical performance of various investment markets. "Once we determine the spending level versus income and investment returns equation, then we can pick an asset allocation that provides a way to meet those spending goals with the least amount of risk," Leone explains.

"We do extensive modeling on spending," explains Daniel Dunn, a New York—based wealth advisor with the Merrill Lynch Private Banking and Investment Group. "Our software uses over 1,000 different modeling simulations to give the client a probability, based on the current asset allocation, of what the chances are that he will keep his net worth intact."

The most difficult part of the process, Leone says, is actually sitting down to work out how much an individual spends. "Sometimes that exercise is difficult for the client, but also enlightening," he explains. "The second hurdle is, if we recommend putting restraints on spending, we must determine where [to place those restraints]. We re-run the model every couple of years and factor in any changes to their income, expenses or goals, and that way we try to encourage them to stick to it."

Perhaps the biggest challenge for any affluent individual is considering the prospect that he is spending too much. It may come as a shock to a family with a $100 million portfolio that it can only safely spend $3 million to $4 million a year–on consumption, gifts, philanthropic endeavors and lifestyle–without eroding the value of that portfolio. Advisors often find this is a difficult truth for their clients to face. "That is not an easy conversation to have," Stewart says.

Most advisors will recommend only spending a fixed percentage of a static pool of funds per year, which means when markets go down, investors automatically reduce spending to cushion the blow. However, few individuals look at their spending patterns in this manner; most want to maintain the same lifestyle from year to year. "The reality is that individuals spend dollars, they don't spend percentages," Stewart says. "But I think you have to at least be conscious of what that fixed dollar amount represents as a percentage of your portfolio, because if it creeps up, then you may have to reevaluate what you're doing."

John Ferry is an Edinburgh, UK-based journalist who specializes in writing about financial markets and investments.