

The Descent: Asset Decumulation After Retirement

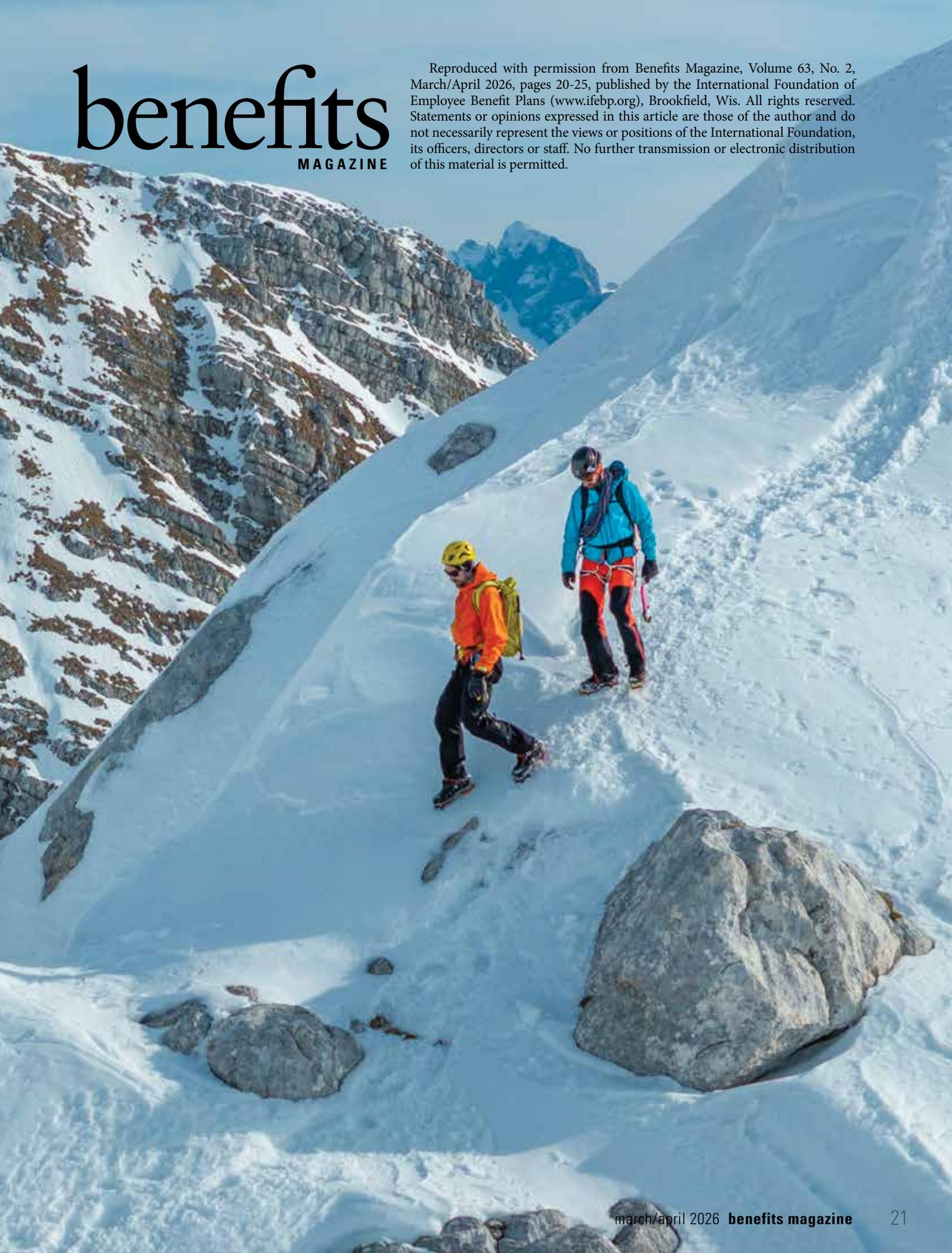
by | **Richard J. Hudson**

Managing withdrawals and sustaining income during retirement poses risks that are often greater than those encountered while saving for retirement. The hiking analogy used in this article may help plan participants—especially those nearing retirement—understand the risks as well as mitigation strategies.

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In a March 2024 *Benefits Magazine* article, I discussed the ways that defined contribution (DC) plan participants can approach accumulating wealth for retirement and what they should be aware of about types of investments, risks in investing and fees. I compared the idea to hiking up a mountain: a long, steady climb that requires endurance, discipline and planning. But once the summit is reached, the journey is only half over.

Once you have reached the summit and are ready to retire, you begin the descent and start to spend down your retirement savings. The descent is much more dangerous and fraught with risks, so planning is imperative. After the exertion of climbing up the mountain, you will be tired, the air may be thinner, your balance is less certain, and every step downward must be measured carefully. A misstep can lead to severe consequences. Likewise, in retirement, managing withdrawals and sustaining income poses risks that are greater than those encountered while accumulating wealth. This article explores the risks and strategies of decumulation through the metaphor of descending the mountain.

The Risks of the Descent

Any misstep on the way down the trail can cause harm, so planning the descent is critical. Yet most people don't spend much time planning for this part of the journey and lack an understanding of all the risks they face.

Longevity Risk: The Long Trail Down

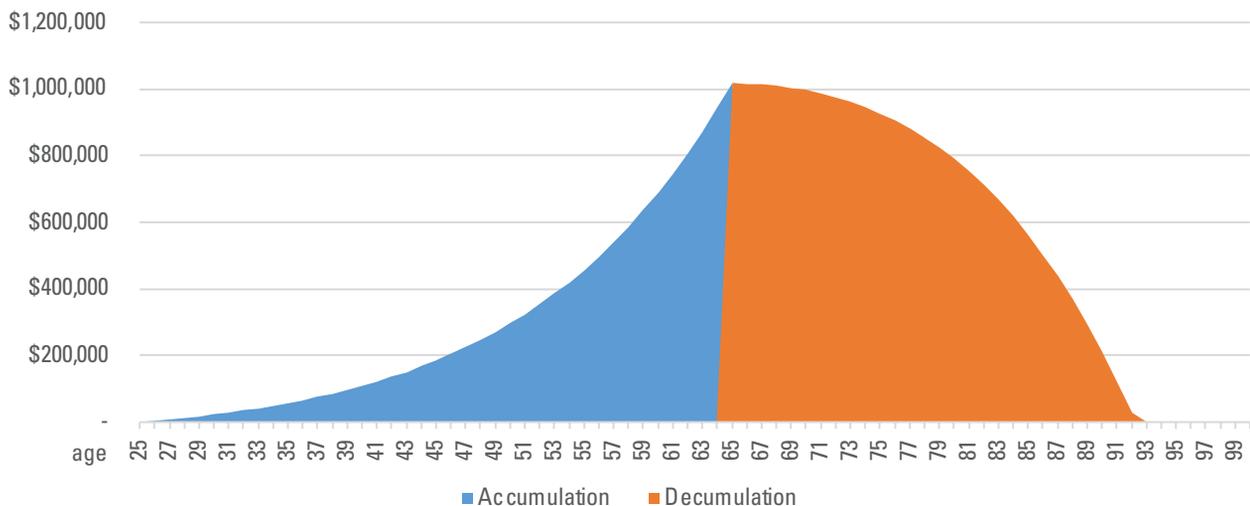
Longevity risk is the possibility that you will live longer than expected and outlast your savings. Just as a hiker may underestimate the length of the trail down a mountain and may run out of daylight, making the hike more treacherous, retirees often underestimate their life expectancy. Advances in medical care and healthier lifestyles mean that many retirees will live into their late 80s or 90s, requiring their money to last much longer than many plan. If resources are not adequately stretched, the danger of running out of income becomes very real.

As an example, the median life expectancy for a 65-year-old is about 20 years, so many people might plan to have enough money to last to age 85. However, median life expectancy means that among 1,000 65-year-olds, 500 will die before age 85 and the rest will die after age 85. Having enough money to live to age 85 is not very meaningful if you are the one who lives to 95. This is like coming to a fork in the trail and not knowing where the two trails lead. One direction will safely get you back to the bottom before dark, and the other will not. You have a 50/50 chance of choosing correctly.

As shown in Figure 1, the hike (saving for retirement) starts with a moderate incline but gradually steepens as you approach the pinnacle because of compounding returns. As you begin your descent, the trail again starts off relatively flat but steepens quickly because compounding inflation on expenses

FIGURE 1

Buildup and Drawdown of a Retirement Portfolio



Source: Author's calculations.

combined with the drawdown of the principal amount of the retirement nest egg leads to a rapid decline in assets.

Sequence-of>Returns Risk: Slippery Slopes

Sequence-of-returns risk occurs when negative investment returns happen early in retirement. This is like encountering a steep, slippery section of trail just after beginning the descent. The chance of falling is higher, and the consequences are severe. If you are withdrawing from your portfolio during a downturn, you lock in losses and reduce the principal from which future growth can occur. Even if markets recover, the portfolio may never fully rebound.

Figure 2 looks at what happens to a retiree if they suffer early losses in their retirement portfolio. The blue line represents a retirement portfolio assuming a steady 7.0% rate of return annually. The red line represents a volatile return scenario that averages 7.0% over the 15-year period. The steady return scenario did not go bankrupt, but the volatile return scenario hit bankruptcy in 12 years.

Negative Cash Flow in Retirement Plans: Running Low on Supplies

Negative cash flow refers to more money leaving a retirement account than going into it, which occurs when you retire and stop saving. After retirement, your savings are

takeaways

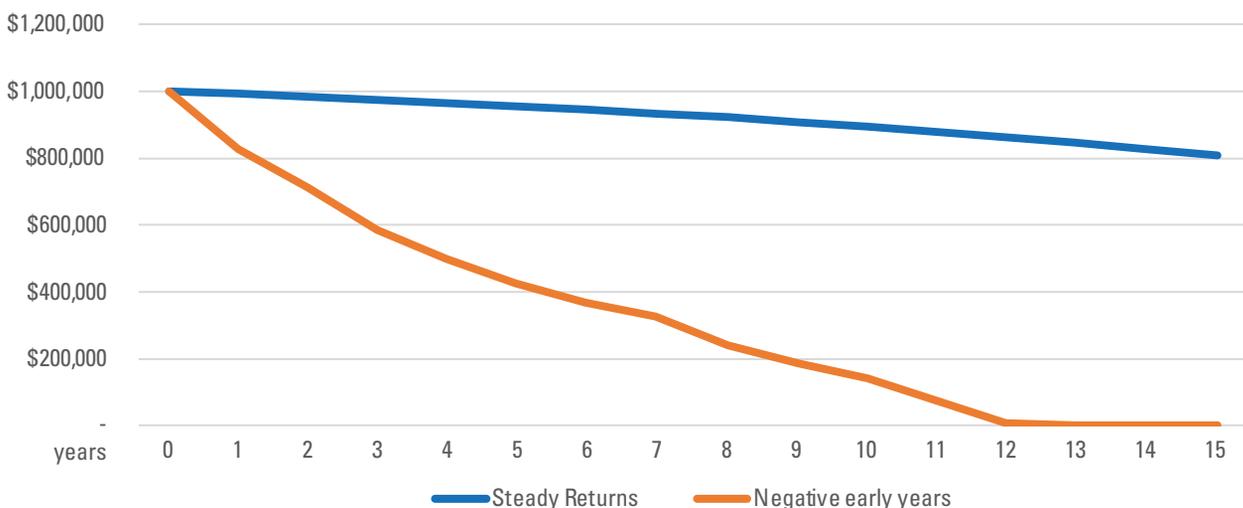
- You must carefully manage the spend down of your defined contribution (DC) retirement plan accounts to ensure that you have enough income to last throughout retirement. This process is often called decumulation.
- In addition to understanding your life expectancy, you need to understand your living expenses and plan your financial needs to avoid using too much income early in retirement.
- Investment-related risks for decumulation include negative investment returns occurring early in retirement—referred to as sequence-of-returns risk—and holding too much in illiquid assets.
- Strategies for mitigating risks include making systematic withdrawals and purchasing annuities with a portion of your portfolio. You should also make sure to plan for optimal sequencing of withdrawals from taxable, tax-deferred and Roth accounts to minimize your tax burden and preserve wealth.
- Diversifying your investments across asset classes protects you against risks in a specific asset category.

used to cover expenses, and you begin to draw down your account. This is like a hiker running low on food or water during the descent. If you use too much of your supplies early in the descent, you won't have enough to finish the hike.

You must be very prudent in understanding your living expenses and planning out your financial needs. You also

FIGURE 2

Sequence-of>Returns Risk: How Volatility Impacts a Retirement Portfolio



Source: Author's calculations.

must protect yourself from being forced to liquidate assets during a market downturn. There are several ways to do this, which may include buying some types of insurance annuities or allocating assets into different buckets to cover short- and midterm expenses and leaving some assets invested in equities to attain long-term growth.

Liquidity Risk: Navigating Loose Rocks

Liquidity risk arises when individuals lack easily accessible resources to meet obligations. For retirees, this may mean holding too much in illiquid assets, such as real estate, leaving them vulnerable when unexpected expenses arise. If this occurs, you may be forced to sell the illiquid asset at severe discounts to raise money to cover current expenses. This type of forced liquidation results in financial strain to the retirement portfolio and will cause significant losses that may have been avoidable with proper planning.

Safety Gear for Individual Retirees

Now that you're aware of the risks, you can begin to consider strategies for mitigating those risks. You may want to use multiple strategies. Choosing the right approach requires developing a financial plan and identifying your biggest risks. Strategies include the following.

Systematic Withdrawals: Measured Steps

Systematic withdrawal rules provide a framework for pacing retirement spending. The 4% rule, for example, suggests withdrawing 4% of the initial portfolio balance each year, adjusted for inflation. While this approach offers simplicity, it

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may be too rigid in volatile markets. You may need to adopt dynamic withdrawal strategies, adjusting spending based on portfolio performance. The 4% rule is also somewhat antiquated, since it was developed decades ago when interest rates were higher and people did not live as long. A 3% rate is probably more appropriate during these times, but any steps you take should be taken carefully and with some guidance.

However, simple strategies like the 3% rule can collapse when markets are volatile during your retirement years. So, building in some flexibility to allow you to withdraw less money if needed is an important step in your retirement planning process. An example is the bucket strategy mentioned later in this article.

Lifetime Income Products: Securing Ropes

Annuities can serve as financial safety ropes. They provide guaranteed income streams for life, reducing uncertainty and protecting against the risk of outliving savings. By converting part of a portfolio into a predictable cash flow, you can establish a foundation of security.

The cost of the annuity is dependent on several items. Most important is the current interest rate, your age and when annuity payments will begin. The table below considers a 65-year-old who elects to take \$100,000 of their retirement portfolio to purchase an annuity. The annuity payments will begin at age 75, 80 or 85. The interest rate is 3.0% in the first scenario and 5.0% in the second scenario.

As the table shows, higher interest rates lead to higher benefit amounts, and deferring the annuity starting date can dramatically increase the amount of the benefit due to the mortality risk.

One possible strategy is to layer annuity start dates so that, if you live longer, your total annuity payment will increase to help relieve the financial pressure of inflation during your retirement years.

TABLE

Sample Annuity Benefits

Interest Rate		3.00%	5.00%
Current Age	Age Annuity Starts	Monthly Annuity Benefit	Monthly Annuity Benefit
65	75	\$1,300	\$1,800
65	80	\$2,300	\$3,400
65	85	\$4,800	\$7,600

Another consideration is when to purchase the annuities. During the years 2010-2020, interest rates were very low and the expense of purchasing annuities was very high, making them less practical. Annuities are a more reasonable option when interest rates are higher. As you approach retirement age, you may want to consider looking into the cost of annuities and watch the interest rate environment to see when the best opportunity arises to purchase.

Social Security also provides lifetime income as well as some inflation protection. Determining the best time to commence receiving your Social Security benefits is not always a simple process. Claiming benefits early (before reaching your full retirement age) results in a lower monthly benefit, which may impact you negatively if you live a long time. Deferring the start date increases the benefit, but you may receive lower total benefits depending on how long you live. Understanding the implications of receiving the benefit early or deferring to a later date is another important step in your retirement planning process.

Tax-Efficient Withdrawal Sequencing: Choosing the Right Path

The order in which you withdraw from taxable, tax-deferred and Roth accounts can significantly affect lifetime tax liability. Strategic sequencing allows you to smooth taxable income across retirement years, minimizing tax burdens and preserving more wealth for the journey.

This is another area where proper planning can result in favorable outcomes, and not considering this during the planning process can lead to financial losses. You should always consult with a tax professional to understand the tax consequences of different retirement accounts and to determine the best path forward when liquidating the accounts to cover living expenses.

Note, you must make required minimum distributions (RMDs) from retirement accounts under Internal Revenue Service (IRS) rules. However, there is no RMD for Roth accounts.

Diversification and Bucketing: Taking Rest Stops Along the Way

Diversification across asset classes protects you against concentrated risks in a specific asset category. Another important consideration is how cash flow and living expenses can be impacted during economic downturns and how to protect yourself against forced liquidation

bio



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during depressed markets. This can be accomplished with a *bucket strategy*.

This strategy sets aside investments in cash or bonds for near-term expenses while keeping equities for long-term growth. During depressed markets, you use the cash and bond investments to cover expenses and allow equity investments to remain invested without having to sell them. When equity markets recover, you can then replenish the cash and bond investments. This would be like having periodic rest stops during the hike down the mountain and waiting for markets to normalize before you rebalance and continue down the mountain.

A retiree with \$1 million in assets might allocate \$100,000 to cash (two years of expenses), \$300,000 to bonds (five to seven years of expenses) and \$600,000 to equities for long-term growth. In a bear market where the value of equities falls 20%, the retiree can draw from cash and bonds, avoiding equity sales and giving the portfolio time to recover. In years where the equity markets are doing well, the retiree can pull gains from the equity investments and leave the cash and bond portfolios intact.

Conclusion

Determining how to spend your assets during retirement is just as important (if not more) than the decisions you made during the accumulation phase. You must be aware of the risks and strategies for addressing them.

Planning is essential to understand your expenses and how your income sources will be used to cover these expenses in retirement. After you construct a basic plan, it is also crucial to develop contingency plans to deal with unplanned expenses.

Taking these steps will help ensure that your path is smoother and more predictable. 🎯