How to Invest and Draw-Down Accumulated Wealth in Retirement? A Utility-Based Analysis*

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In comparison to their parents, Baby Boomers face a different challenge regarding retirement security, in that they are the first generation where retirement wealth was accumulated primarily in personal retirement accounts. As their nest eggs will not automatically be annuitized, Baby Boomers confront the important question of how they should invest and draw-down their accumulated wealth over the rest of their lives. The present paper analyzes this question from the perspective of a utility maximizing individual. Specifically, we propose *and* analyze a model with internal habit formation and stochastic differential utility, and derive the resulting portfolio and draw-down strategy in closed-form. We show that the agent adjusts both the level and future growth rates of consumption after a wealth shock. As a result, in contrast to many popular portfolio and draw-down strategies, the year-on-year volatility of consumption is less than the year-on-year volatility of wealth. We also show that the welfare losses due to various popular investment and draw-down strategies can be large, especially if the individual is subject to a large degree of internal habit formation.

Keywords: investment strategy, draw-down strategy, internal habit formation, stochastic differential utility

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