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Retirement Drawdown: Tips to Make the 4-Percent Rule Work

by Steve Vernon
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How much can you safely withdraw each year from your IRAs, 401ks, and retirement savings and minimize the odds of actuarial ruin (outliving your retirement savings)? My post last Monday discussed the four-percent rule as one strategy to help you prevent this fate. This post gives you tips on how to make the four-percent rule work, reflecting some of the refinements to it that I mentioned at the end of my prior post.

The four-percent rule was introduced in a landmark paper published by William Bengen in 1994. Earlier this year, Chris O'Flinn and Felix Schirripa published a significant update to Bengen's paper. The duo used Bengen's historical methodology but looked at all retirement periods beginning each month since 1926, substantially increasing the number of data points. They were able to reflect the investment experience up through June 2009, including the most recent meltdown. Here are a few key points and conclusions:

For Retirement at Age 70 or Later

For all 20- and 25-year retirement periods, the four-percent rule reflected no instances of actuarial ruin with a portfolio invested 75 percent in stocks and 25 percent in bonds (a 75/25 portfolio). For a portfolio invested 50 percent in stocks and 50 percent in bonds (a 50/50 portfolio), there were no failures for 20-year retirements, and only a 2 percent failure rate for 25-year retirements.

Conclusion: The four-percent rule appears to be safe if you're retiring at age 70 or later, since a portfolio with a 25-year retirement goal would have very high odds of lasting until age 95 and later. I think targeting a retirement that lasts until age 95 is a reasonable goal.

For Retirement at Age 65

For all 30-year retirement periods, the four-percent rule failed only 4 percent of the time for a 75/25 portfolio, and 8 percent of the time for a 50/50 portfolio.

Conclusion: You could use the four-percent rule if you retire at age 65, but be ready to make mid-course adjustments under certain circumstances, as discussed below.

For Retirement Before Age 65

For 35-year retirements, the four-percent rule failed 8 percent of the time for a 75/25 portfolio, and 15 percent of the time for a 50/50 portfolio. For me, these failure rates are too high to guarantee peace of mind for retirements well before age 65.

Conclusion: I believe that 35 years is just too long to be withdrawing principal from your retirement accounts. Too much can go wrong during that long of a period. Instead, if you're retiring before age 65, I'd recommend living on just the interest and dividends of a portfolio balanced between stocks and bonds, at least until age 65 — and until age 70 would be even better. That strategy produces withdrawals of about 3 percent of your portfolio. I'd also suggest you work part time if you need additional income to meet your living expenses.

The O'Flinn/Schirripa paper also showed that the four-percent rule failed when there was high inflation and/or poor stock market returns early in a retirement period. Examples are retirements that started in the mid 1960s to the mid 1970s, and retirements that started before the significant stock market crashes during the Great Depression. Monday morning quarterbacks would give you this advice: Don't retire before the market crashes or before there's high inflation!

Mid-Course Adjustments Are Appropriate

More practical advice would be to make some mid-course adjustments if you encounter high inflation or poor investment returns during your retirement. Cut back on your principal withdrawals during these periods, so that you buy time to let your portfolio recover. And consider living on just the interest and dividends for awhile. This can mean tightening your belt on living expenses or finding some other source of income, such as by working. While these may not be desirable choices, they sure beat being broke in your eighties and nineties.

On the other hand, if you experience a favorable investment environment during the first five to ten years of retirement, you could reset your withdrawal amount to four percent of your portfolio at that time, if that would give you a higher withdrawal amount than rigidly sticking to your original withdrawal plan. It's entirely appropriate to make mid-course adjustments to your withdrawal strategy to reflect your ongoing investment and inflation experience — good or bad.

Don't Forget About Fees and Expenses!

The historical analyses prepared by Bengen and O'Flinn/Schirripa don't reflect investment management fees and expenses. If you're paying an advisor one percent of assets to manage your portfolio, you'll have a drag on your investment earnings, unless your advisor produces returns that exceed the historical averages, net of expenses. This is one more reason to be conservative in your initial withdrawal strategy, and then make mid-course adjustments as appropriate. In addition, consider using index funds with low fees that correlate well with the historical returns that the above papers were based on. If you need advice, pay your advisor an hourly rate instead of one percent of assets, to minimize the drag on your returns.

Determining a safe amount of withdrawals from your retirement savings is a critical decision we all have to make. That's why we're not done with this topic yet. Other methods have been floated out there to help you avoid actuarial ruin during your retirement years when you're withdrawing principal. For instance, some analysts suggest higher allocations to bonds. And the O'Flinn/Schirripa paper discusses the use of immediate annuities