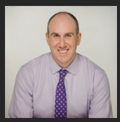
Why the 4% Rule Is Only a Starting Point for Retirement



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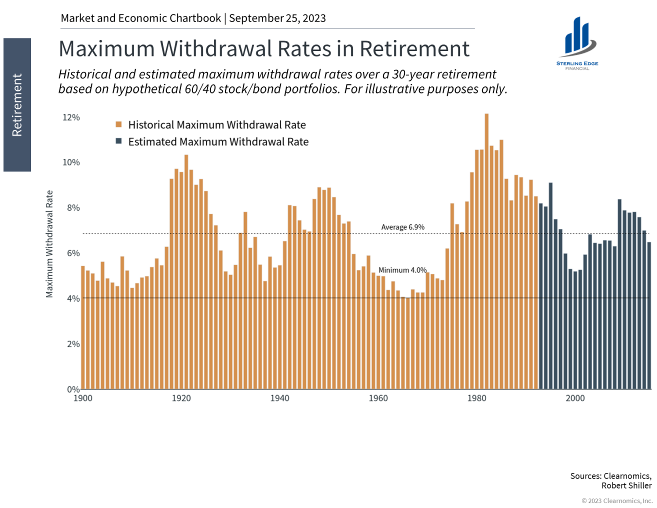
Planning for retirement has never been more important and yet so challenging. Given the difficult inflationary conditions of the past two years, the risk that worries most retirees continues to be outliving their savings. This is because, when it comes to markets and the economy, we can't control the timing of events - including day-to-day market swings and whether investors begin retirement in a bull or bear market. What we can control, however, is our own behavior by staying disciplined. Thus, while there are never any guarantees, history shows that having a sound financial plan that can adjust to changing conditions, accompanied by proper financial guidance, is the best way to minimize retirement risks. How can retirees continue to maintain peace of mind and their quality of life in today's environment?

Maximum withdrawal rates have varied over history

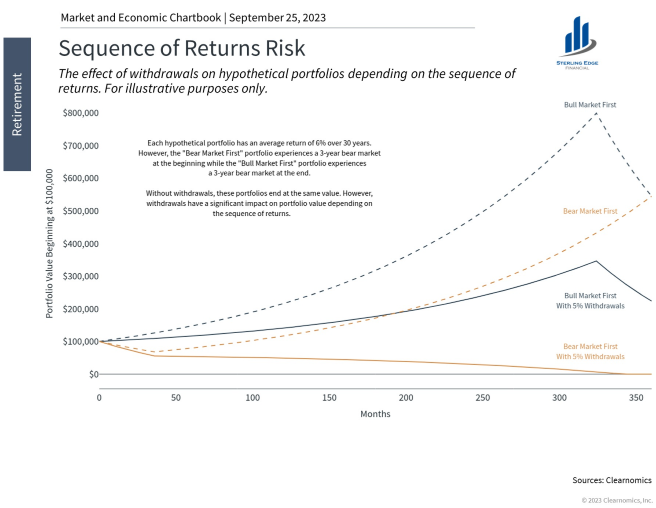


Two of the most important concepts when it comes to retirement and investment planning are "the 4% rule" and "sequence of returns risk." In simple terms, the 4% rule attempts to answer the question "how much can I withdraw from my portfolio each year over the course of my retirement?" This concept was coined by William Bengen who observed that, historically, a 4% annual withdrawal rate from a portfolio was "safe" in that retirees were unlikely to exhaust their savings over a 30-year retirement horizon, accounting for inflation. For this reason, this is also sometimes referred to as the "SAFEMAX rate."

How does the 4% rule hold up today? The accompanying chart shows the hypothetical "safe" withdrawal rates based on 60/40 stock/bond portfolios and inflation rates across historical 30-year periods as well as estimates for more recent years. These illustrative calculations show that only once in the 1960s did the maximum withdrawal rate fall as low as 4%. On average and with the benefit of hindsight, retirees would have been able to withdraw 6.9% each year without running out of funds. Of course, the safe withdrawal rate can vary dramatically from year to year, a fact that should not be surprising given how much market returns can change across a cycle. In general, this pattern is positive for retirees since it suggests that there is a historical basis for steady withdrawal rates of 4% or above.

However, there are several points to keep in mind. First, this depends heavily on sticking to an investment plan throughout the full period. Investors who would have overreacted to short-term market pullbacks would have failed to rebound alongside the market, negatively impacting their withdrawal rates later in retirement. This is why investing is as much about our own behavior as it is about market and economic events. Second, this analysis is oversimplified since it does not account for differences in portfolio construction and risk tolerance across individuals that are a critical part of real-life financial planning. After all, a 60/40 portfolio may be quite aggressive for many retirees, especially later in life.

The sequence of returns can dramatically impact the value of a retirement portfolio

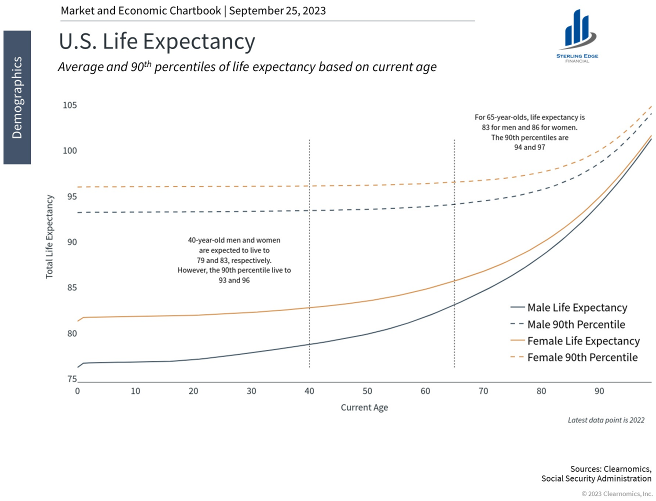


Finally, and most importantly, simple rules of thumb should be used with caution since they may not account for the sequence of returns, or the idea that the timing of bear and bull markets can dramatically impact the value of a portfolio when withdrawals are being made. Specifically, when the market is down early in retirement, withdrawing funds amounts to "selling low." Investors are then less able to take advantage of future bull markets and the wonders of compound interest over the remaining years. Conversely, withdrawing when the market is up ("selling high") allows the portfolio to maintain a higher value and compound faster, which then provides a cushion when the inevitable recession and bear market hits. Unfortunately, investors don't get to choose whether they begin with a bull or bear market - they need to adjust accordingly to the hand they are dealt.

Thus, the 4% rule is a helpful place to start but lacks the nuance that may be appropriate in balancing spending and risk throughout one's retirement. Understanding the various factors that affect withdrawal rates requires financial guidance, and adjusting to changing conditions requires a financial plan that is sensitive to the needs of retirees.

Life expectancy continues to rise

What simple rules of thumb also don't account for are increasing life expectancies. For instance, according to the Social Security Administration, 40-year-old men and women today have a life expectancy of 79 and 83, respectively, as shown in the accompanying chart. However, the 90th percentile could live well into their 90s. Similarly, men and women who are 65 years old today could live to 83 and 86, on average, while the 90th percentile could live to 94 and 97, respectively. The difference of a decade or longer, i.e. a retirement of 20 years vs 30 years, or 30 years vs 40 years, can have dramatic implications for investment portfolios and financial plans.



The prospect of living longer than expected is often referred to as “longevity risk.” This risk is asymmetric in that running out of funds is far worse for most households than leaving money behind to loved ones, charities, and more. This means that life expectancy is an important input to any financial plan. Ultimately, managing longevity risk is another reason why all individuals can benefit from professional financial advice.

The bottom line? While the 4% rule can act as a basic guide for investors in retirement, it unfortunately isn't enough. Investors should continue to stick to long-term investment and financial plans as they navigate this challenging market and economic environment.

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