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RETIREMENT

4% Rule for Retirement Withdrawals Is Golden No More

By EILENE ZIMMERMAN MAY 14, 2013

ONE thing most retirees want to avoid is outliving their money. Since the mid-1990s many of them have relied on a staple of retirement planning known as the 4 percent rule to avoid that. Although the name says 4 percent, the rule is that if retirees withdraw 4.5 percent of their savings every year, adjusted for inflation, their nest egg should last 30 years, the length of time generally used for retirement planning.

That percentage was calculated at a time when portfolios were earning about 8 percent. Not so anymore. Today portfolios generally earn much less, about 3.5 percent to 4 percent, and stocks are high-priced, which is linked historically to below-average future performance. Many financial advisers are rejecting the 4 percent rule as out of touch with present realities.

The rule was created in 1993 by Bill Bengen, owner of Bengen Financial Services in San Diego, who examined every 30-year retirement period since 1926, reconstructing market conditions and inflation. He identified 1969 as the worst year for retirees because a combination of low returns and high inflation had eroded the value of savings. Using that as his worst case, Mr. Bengen tested different withdrawal percentages to see which one would allow savings to last 30 years. At first 4 percent worked, he says, based on a portfolio with a 60/40 split between large-cap stocks and intermediate-term government bonds. After research, Mr. Bengen decided to add small-cap stocks to the mix and revised his recommendation to 4.5 percent. The 4 percent name, however, stuck.

Michael Finke, a professor in the department of personal financial planning at Texas Tech University in Lubbock, is a co-author of a paper critical of the rule, "The 4 Percent Rule Is Not Safe in a Low-Yield World." He says Mr. Bengen's rule doesn't acknowledge the new economic reality of prolonged low returns. "There haven't been any historical periods that look like today," Mr. Finke said. "We've never had an extended period where rates of returns on bonds have been so low and valuation on stocks so high."

Strict application of the rule also does not factor in how important returns are in the early years of retirement, something known as the sequence of returns. "The first years of returns have an outsize impact on your retirement savings sustainability," Mr. Finke said. He used an example of $500,000 in savings earning zero for the first five years of retirement. Applying the 4 percent rule (that is, 4.5 percent), you will withdraw $22,500 a year. At the end of five years, your portfolio is left with $387,500. If returns go up, they are being earned on a smaller amount of savings than if you had gotten positive returns those first five years or had withdrawn less, Mr. Finke said. "You have less money to use to earn money for the next 25 years."

High inflation early in retirement can have a similar impact, especially if earnings are also low. Taking out more money just to keep up with the rising cost of living will accelerate the depletion of savings, Mr. Finke said. Although the inflation rate today is 1.5 percent, historically it has been about 5 percent, he said.

Many advisers recommend maximizing earnings by moving away from the 60 /40 portfolio allocation on which the 4 percent rule is based, says Jay Wertz, director of wealth advisory services at Johnson Investment Counsel, a wealth management firm in Cincinnati: As interest rates have fallen and stayed low, "earning 2 to 3 percent on 40 percent of your assets for the next several decades doesn't really make sense."

Retirees wanting more certainty in the future might consider investing in a deferred income annuity, Mr. Finke said. Deferred income annuities pay a yearly income that kicks in later in life — usually starting about age 80 or 85. Rather than an investment, Mr. Finke says, it is essentially "an insurance product you buy so that you won't run out of money in old age."

Steve Vernon, a retirement consultant with the Institutional Retirement Income Council and author of "Money for Life: Turn Your IRA and 401(k) Into a Lifetime Retirement Paycheck," advises investing up to half of retirement savings in an immediate fixed annuity, which starts payouts when you retire. The annual income usually ranges from 5 to 6 percent of the amount paid for the annuity, and those payouts, together with Social Security, should be used to cover basic living expenses, he said, and "the remainder of savings should be invested and systematically withdrawn to cover everything else." Another option is a managed payout fund, especially for people who do not want to actively manage their money. These funds, offered by Vanguard and Schwab among others, invest savings for you and send out a check each month that is a combination of investment income and a return of principal.

Because it is based on how much the investments earn, the payout can vary, Mr. Vernon said. Some funds have target dates when they will end, and others aim to pay indefinitely. (They can even be inherited.) But none come with payment guarantees. If the market goes south, the money in a managed payout fund can run out prematurely. It also can be withdrawn at any time.

Mr. Bengen still feels his rule is a good benchmark, but advises clients to spend more conservatively. When he first came up with the 4 percent rule, "people said, 'How can anyone live on so little?' Now they are saying it's too high. I think it's a lot to ask people who have saved their whole lives to live on 3 percent." But Mr. Wertz says the 4.5 percent withdrawal rate may really be too high, especially for those heavily invested in bonds. Those retirees "are likely to fail miserably using the 4 percent rule," he says. "They aren't generating the returns to fuel it."

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