



Retirement Spending: Reviewing the 4% Rule

In 1994, William Bergen concluded in a study that retirees could safely spend four percent (4%) annually from their retirement assets, adjusting the annual spending amount upward to account for inflation. Based upon the assumptions Bergen made, he determined that a retiree would be able to fund his or her retirement for up to 30 years, without running out of money. However, the financial environment has changed significantly since Bergen conducted his study. As a result, this “4% rule of thumb” has been called into question by several recent studies. In fact, Bergen himself agrees that it is time to take another look at some of the conclusions reached in his study.

One of the criticisms of the 4% rule is that it is too simplistic. Is it reasonable to assume that this simple rule could potentially answer the very complex question every retiree needs to solve: how much money do I need to retire? The world is constantly changing. Retirees are retiring at different ages and under widely varying financial circumstances. The financial environment today is quite unlike that of twenty or thirty years ago. Retirees know far too well the impact that low interest rates have had on their ability to generate income in retirement without taking on significant additional risk. These factors lead many financial advisors to question the efficacy of the 4% rule.

Morningstar, along with Texas Tech University and The American College, recently conducted a study in an attempt to test the 4% rule under current financial conditions. The study examined the impact of a 4% withdrawal rate, adjusted annually for inflation, on an assumed 60% stock, 40% bond portfolio. This study concluded that a retiree has only a 48.2% probability of not running out of money after 30 years, as the study noted, slightly less than a flip of a coin. What caused such a drastic difference in result compared to the study completed by Bergen? The Morningstar study factored in the current low interest rate environment and its impact on retirees. The study also



PROFESSIONAL OPINION

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assumed that current interest rates, at some point, would return to their long-term averages. While the study made a few other adjustments, the major difference in the conclusions reached by the two studies was largely caused by taking into consideration the current low interest rate environment and the impact this has on future expected returns.

Additional recent studies have similarly concluded that accepting a 4% withdrawal rate, adjusted for inflation, as a safe withdrawal rate in retirement is unwise. Retirees need to consider several factors in determining a reasonable withdrawal rate. Some of the more significant factors are:

1) **Long-Term Goals** - Your long-term goals have a significant impact on what a reasonable withdrawal rate would be in retirement. A retiree whose goal is to not run out of funds in retirement would have a significantly different withdrawal rate than a retiree who desired to leave a significant inheritance to heirs.

2) **Life Expectancy** - While a retiree can't determine exactly how long he or she is going to live, life expectancy should be considered when determining what constitutes a reasonable withdrawal rate during retirement. Retirees also need to understand that planning for average life expectancy is insufficient, as 50% of retirees can be expected to survive beyond this period.

3) **Inflation** - Inflation needs to be monitored as it will have a significant impact on future spending power. This is especially true for retirees, as many live off a “fixed income.”

4) **Financial Environment at Time of Retirement** - The financial environment that exists at the time of retirement can have a material impact on determining a safe with-

drawal rate. A lower withdrawal rate should be considered if you retire at a time when the stock market has had a significant run and valuations are stretched. Conversely, if retirement occurs after a bear market and valuations are inexpensive, a higher withdrawal rate could be considered. The main point retirees need to keep in mind is, valuations matter.

5) **Sequencing of Returns** - Sequencing of returns is one of the most important factors in determining whether or not a retiree will meet his or her goals in retirement. Investment returns in the early years of retirement have a far greater impact on the likelihood of success than returns in later years. If you consider retirees who retired in 2000 or 2008, just prior to the beginning of a bear market, their safe withdrawal rate in retirement was impacted significantly based solely upon the sequencing of returns. If a retiree faces subpar investment returns in the early years of retirement, it is imperative that the retiree review the retirement plan and be willing to adjust it as needed.

With so many unknowns (life expectancy, future investment returns, inflation, etc.), relying on a one-size-fits-all 4% withdrawal rate in retirement has proven to be too simplistic. The 4% rule should be viewed as a guideline, and not as a hard and fast “rule of thumb.” Several factors need to be considered in determining a retiree's safe withdrawal rate. Most importantly, retirees need to continually monitor their retirement plans and be willing to adjust them as needed, when things don't go as planned. There will always be bumps along the way, but a flexible plan will go a long way to insure that retirees are able to lead a rewarding and financially secure retirement.

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