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Road to Retirement: Does the 4% withdrawal rate still apply?

By **CHARLIE FARRELL** | cfarrell@northstarinvest.com | Special to The Denver Post
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If you are retired or close to it, you've probably heard about the 4% withdrawal rule. That rule roughly says that if you withdraw 4% of your retirement portfolio every year, you won't run out of money over a typical 30-year retirement.

So does that rule still apply in an era of record-low interest rates and wild stock market returns? It's an important question because your retirement lifestyle is primarily determined by your withdrawal rate — not how much you have saved. And the withdrawal rate will be determined by future returns.

Let's say you have saved $1 million for retirement. If a safe withdrawal rate is 4%, then you are living off $40,000 a year. But if a safe withdrawal rate is 6%, then you can live off $60,000 per year. It's the same amount of savings, but the withdrawal rate determines how you'll live. So what drives the withdrawal rate? It's your future returns that determine how much you can actually live on.

If you retire and you earn 8% on your money for the next 30 years, then you can afford to withdraw 6%. There are historical periods that averaged over 8% on balanced portfolios of stocks and bonds. For those lucky enough to have retired during one of those periods, they could have lived off of 6%. But if you only earn 3% on your money, and you take out 6%, you'll run out of money in about 23 years, and that's assuming we have no inflation. If we have inflation of just 1.5%, then you would be out of money in about 19 years.

To get a sense of how much you can withdraw, you have to make some estimates of future returns for stocks, bonds and inflation. Those are the three big inputs that will determine your lifestyle in retirement. How do we know if you'll earn 8% or 3%? We don't know, but you can make some reasonable assumptions based on what's currently happening in markets and then plan accordingly.

The 4% withdrawal rate comes from studying the history of stocks, bonds and inflation for about the past 100 years. Over that time frame, stocks returned about 10% annualized and U.S. Treasury bonds returned a little over 5%. If you had a portfolio that was simply half stocks and half bonds, your expected return would have been about 7.5%, and would have been enough to support a 4% withdrawal rate, adjusted each year for inflation.

Now there are many subtleties to this data. For instance, not all periods produced these returns. These are average returns over 100 years. But hypothetically even the worst periods historically provided enough return to live off 4% for about 30 years.

So will this 4% rule roughly hold up going forward? It's not so clear these days because financial market returns are running way below their long-term averages, and we still have some inflation. That combination of factors will make it harder to live on 4%.

Over the last 20 years, the total return for the S&P 500 stock index is about 5% annualized, or about half of its long-term average. Today, bond interest rates are under 2%, also less than half of their long-term averages. If you have a portfolio that is 50% stocks and 50% bonds, and the stocks produce 5% going forward and the bonds produce 2%, your expected return is about 3.5% for your portfolio.

If you earn 3.5% a year and take out 4%, with 1.5% inflation, you should be alright. You'll be spending down your principal, but after 30 years you should still have about 30% of your money left, which is a reasonable cushion.

Thus, it looks like the 4% rule should still hold even in a period of lower returns. Unfortunately, it's not quite that simple. You'll have to monitor things closely because with such low returns, there is little margin for error. For instance, let's say all this government spending unleashes some inflation, and instead of inflation at 1.5%, it goes to 3%. Under that scenario, you'd run out of money in 27 years. Or, while stocks might produce 5% going forward for the next 30 years, the returns from stocks tend to be very volatile. If you retire and the first several years of returns for stocks are negative or flat, that will increase the risk you'll run out of money in less than 30 years.

This means if you are planning on living on 4%, you don't want to simply "set it and forget it," or you may wake up 20 years from now and realize you don't have enough to support yourself. Here are a couple rules of thumb to help you navigate this uncertainly.

First, get your cost of living down as low as you can. This gives you flexibility to drop your distribution rate below 4% in a tough market and to manage inflation better. If you have fewer fixed expenses, then if we have inflation, you won't have to increase your distributions as much to pay your bills.

Second, if your portfolio value falls more than 20% below what you started with because of a bear market, then you should work pretty hard to reduce your distributions. Even going from 4% to 3% for a few years can make a big difference.

Third, if we have years of big stock market gains, consider “banking” some of those gains to use for future distributions. As we have seen the last few years, we can have big gains, but then they can be gone a month or two later. Investors are often reluctant to sell stocks when markets are up because they don’t want to pay taxes or miss out on future returns. But in retirement, you are going to be spending the money, so if you have a chance to sell some things when prices are favorable, it’s probably smart to build a reservoir for the inevitable lean years.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.