

The 4% Rule

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“Devising a Sustainable Withdrawal Program – there is no one simple solution ... but rather an array of steps that you can take. ”

McCarthy Asset Management, Inc. is an independent, fee-only investment advisory firm that has been helping people invest wisely for over fifteen years. Our mission is to help you better understand and improve your financial situation. We specialize in Retirement Planning, Portfolio management and Tax Planning.



The 4% Sustainable Withdrawal Rule is one of the most widely used “rules of thumb” in retirement planning. It is very useful as it serves as a rough guide to determine how much someone needs to save up for a financially comfortable retirement and then, once retired, how much they can spend per year without depleting their savings. The rule states:

Withdrawing 4% of your portfolio in the first year of retirement and then withdrawing the same amount adjusted for inflation each year thereafter will result in a high probability of your retirement savings lasting 30 years or more.

For example, an investor who has accumulated a portfolio worth \$1 million, and who is faced with 3% annual inflation, should be able to withdraw \$40,000 the first year of retirement, \$41,200 the second (i.e. \$40,000 increased by 3%), \$42,436 the third and so on, without fear of depleting their funds.

This rule was first introduced in a 1994 [study by William P. Bengen](#), in which he stated that for a portfolio comprised of 50% stocks and 50% intermediate-term treasuries, a 4% annual withdrawal rate is sustainable for a minimum of 30 years. [In his 2006 book, Conserving Client Portfolios During Retirement](#), Bengen further discussed the concept of the safe maximum withdrawal rate, which would allow for 30 years of withdrawals without depleting savings. This finding was later confirmed and expanded upon in [studies by other academics](#) to account for different asset allocations, time horizons and historical periods. In the recent years, though, the rule has come under fire and received [a lot of attention in the financial press](#).

Problems with the 4% Rule:

- **Low-Yield Environment and Above-Average Stock Values:** Most research done on sustainable withdrawal rates uses historical data and assumes the same expected return on each asset class year-after-year. This is a reasonable assumption when the stock market is fairly valued and bond yields are at or above their long-term averages. This is not a realistic assumption in today’s environment of low bond yields and [high stock market valuations](#).

- Factor in the aging population and the slow economic growth, and the 4% rule begins to look too aggressive for the current environment. A [recent Morningstar study](#) suggests that a **4% withdrawal rate provides only a 48.2% probability of assets lasting for 30 years.** The same study found that a **2.98% rate can result in a 90% probability of the money lasting that long.**
- **Sequence of Returns Matters:** Intuitively, most people understand that if they retired in late 2000 or 2007, right before the onset of a major bear market, the withdrawals during those early bear market years had a much bigger negative impact on the overall health of their portfolio. This concept is known as [sequence risk](#). This concept was discussed further in a recent [MarketWatch article](#).

Devising a Sustainable Withdrawal Program – there is no one simple solution to sustaining portfolio withdrawals during retirement, but rather an array of steps that you can take. Here are some of them:

- **Create a Cushion:** For clients who are receiving periodic distributions from their portfolios, we set aside typically 3 years' worth of withdrawals in a conservative bond fund. As long as stock prices are not depressed, we replenish this conservative fund at least every six months when we reposition portfolios. The benefit of using this technique is that when a bear market starts and stock prices drop precipitously, we do not need to sell any equities for at least three years to sustain portfolio withdrawals. Given that the duration of the average bear market since the Great Depression has been 18 months, we should have enough held in the conservative bond fund to allow the rest of the portfolio to recover as the market correction runs its course.
- **Be Flexible:** Recall that the first few years of retirement are critical to the overall success of the sustainable withdrawal program. Reducing expenses during a market downturn will allow you to temporarily reduce the distributions from your account(s).
- **Adjust Your Expectations:**
 1. **Reduce The Certainty:** Certainties do not exist in the world of financial planning. As much as we would like to have a 100% certainty plan, many financial planners suggest that 80% probability is an acceptable level of success for a financial plan. Furthermore, a significant downside with a 100% certainty plan is that the retiree is living on less than they could safely withdraw. Unless leaving a large estate is a very important goal, the retiree would be foregoing expenditures that are affordable. In these cases, it may make sense to spend more if it results in a higher quality of life while still minimizing the risk of running out of money.
 2. **Retire Later:** If the probability of success (i.e. the likelihood of not outliving your assets) is lower than what you are comfortable with, consider working longer or saving more.
 3. **Assume Shorter Length of Retirement:** A 30-year withdrawal time horizon may be longer than is likely for many who retires at 65. Consider your family history of longevity and your health when making your plan.

Our Services

Investment Management Services:

- MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.

Financial Planning Services:

- The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.
- "Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- Tax Return Preparation
- Income Tax Projections
- Tax Minimization Ideas
- Tax Authority Representation

Other Services: MAM has retained several outside experts, whose services are available at no cost to our clients:

- Long Term Care Planning— Allen Hamm of Superior LTC Planning Services, Inc.

- **Diversify Your Portfolio:** Most of the research that has been done on sustainable withdrawal rates has been based on a portfolio made up of just stocks and bonds. Adding alternative assets to a portfolio can improve the risk-adjusted returns, and therefore increase the sustainable withdrawal rate. Bengen's initial study used only two asset classes (large-company U.S. stocks and intermediate-term U.S. government bonds). When Bengen added a third asset class, small-company U.S. stocks, he raised the acceptable withdrawal rate to 4.5%.
- **International stocks and international bonds** add diversification to a portfolio. In addition, alternative assets can add other asset classes that reduce the volatility of a portfolio without sacrificing returns. Currently we are investing in Master Limited Partnerships as an alternative asset. In the past we have also used commodities and REITs as alternative assets. As other alternative assets become more attractive, we are likely to add them to portfolios.
- **Add More Equities, Especially Dividend-Paying Stocks:** As people age and their life expectancies become shorter, it makes sense to be more conservative with their retirement portfolios. For those with a 15-year or longer life expectancy, though, portfolio growth is critical so that future-year distributions can be increased for inflation. Particularly in the early phase of retirement, a portfolio should be more heavily weighted toward equities and less toward bonds. Dividend-paying equities can play a particularly important role here.
- **Work with a Planner-** According to a [recent article in a Financial Planning Magazine](#), working with an advisor who can help you implement an appropriate Total Wealth Asset Allocation, Tax Efficiency, Dynamic Withdrawal Strategies, Annuity Planning and Liability-relative Optimization, can add the equivalent of a 1.82% annual arithmetic return to your portfolio, translating to almost 29% more that clients can spend in retirement.

In addition to our expertise at MAM, we have purchased financial tools that help our clients plan for a worry-free retirement. Please contact us if you would like to discuss your retirement plan with us or have us prepare a Retirement Analysis for you.