SUSTAINABLE WITHDRAWAL RATE– IS 3.3% THE NEW 4%?

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"Why the sustainability of the conventional 4% withdrawal rate is in question, here is how to best counter a lower return environment."

When it comes to determining what is a sustainable withdrawal rate, many researchers are questioning whether the traditional 4% rule can continue to be relied upon. Before we can evaluate the factors impacting this, as well as consider potential courses of action, we must first determine what a sustainable withdrawal rate means.

A sustainable withdrawal rate is *the percentage of your invested assets that you can spend each year without running out of money before reaching the end of your life*. The "4% sustainable withdrawal 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 30 years. 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.*

The sustainable withdrawal rate was last written in the March 2018 MAM Monthly Commentary. However, now that many analysts have been speculating the traditional 4% rule may need refinement, we believe it is a good time to revisit this important concept. A report released in November of 2021 from Morningstar stated that retirees should spend no more than 3.3% of their income in their first year of retirement if they want to make their money last 30 years. Two of most significant risks to the traditional 4% rule are:

1. **Low-Yield Environment:** Bond yields are currently as low as they have been in any environment in the last 70 years. This could prove problematic to the 4% rule, as Morningstar Investment Management's 30-year inflation-adjusted return for investment-grade bonds is -0.11%.

2. **Above-Average Stock Valuations:** While there are a number of ways to value the S&P 500, the price/earnings ratio is the industry standard and most common. The price/earnings ratio measures the price investors pay for a dollar of corporate earnings. Using recently reported earnings, at the beginning of 2022, the S&P 500's P/E ratio was calculated at 23.88, which was significantly higher than the 17.35 average over the past 20 years. Morningstar Investment Management's 30-year inflation-adjusted return forecast for U.S. large-cap stocks is 2.74%

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While the low-yield environment and above-average stock valuations are the two most impactful drivers behind the new 3.3% sustainable withdrawal rate estimates, it is also important to understand potential courses of action to mitigate the impact of a lower return environment. Examples of actions pre-retirees and retirees could take to offset a potential lower sustainable withdrawal rate include:

- **Working Longer:** This is often the most impactful option. Reducing the number of years in which you need to make your money last in retirement has a significant financial benefit. However, it is often the least desired option as well.
- **Delaying Social Security:** By waiting longer to start collecting, you increase your monthly benefit, which then reduces the needed withdrawal amount. The biggest financial risk in retirement is living a long life and outliving your money. Delaying Social Security until age 70 helps offset this risk, known as "longevity risk."
- **Withdrawing From Accounts in a Tax Efficient Manner:** While this a strategy that should always be implemented, in a period of lower returns, minimizing taxes will be especially beneficial.

Devising a Sustainable Withdrawal Program – The optimal solution is understanding that there isn't one single solution, but rather an array of steps to collectively take.

- **Understanding Sequence Risk:** The sequence of returns throughout a retirement period matter. The first few years of retirement are critical to the overall success of the sustainable withdrawal program. For example, individuals who retired in late 2000 or 2007, retired right before the onset of a major bear market. This caused the withdrawals during those early bear market years to have a significantly larger negative impact on the overall health of the portfolio. The most impactful ways to offset sequence risk are creating a 3-year bucket and employing variable withdrawal systems.
- **Creating a 3-Year Bucket:** For clients who are receiving periodic distribution from their portfolios, we typically set aside 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 cover 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 correct runs its course.
- **Employing Variable Withdrawal Systems:** Taking less of a withdrawal in down markets and more in good ones can significantly enlarge both starting and total lifetime withdrawals. Additionally, reducing expenses during a market downturn also reduces the amount of distribution needed from your portfolio(s).

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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:
    - Medicare Planning– Eileen Hamm of Superior LTC Planning Services, Inc.
    - Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.

Portfolio Specific Actions to Counter a Lower Return Environment – When evaluating the 30-year inflation-adjusted return forecast for investment grade bonds and U.S. large-cap stocks, the value of diversification and alternative assets grows significantly.

- **Diversifying Your Portfolio:** Most of the research related to sustainable withdrawal rates has been based on a portfolio made up of only stocks and bonds. Adding alternative assets to a portfolio can improve the risk-adjusted returns. When Bengen added a third asset class, small-company U.S. stocks, he raised the acceptable withdrawal rate to 4.5%. Additionally alternative assets like real estate provide significant portfolio value due to their lack of correlation with stocks and bonds.
- **Increasing International Stocks and International Bonds Exposure:** Adding international stocks and international bonds adds diversification to a portfolio. Additionally, international stocks have lagged U.S. stocks significantly over the last 13 years (i.e., since the end of the Financial Crisis). At some point, this trend will reverse and international stocks will have a period of outperformance.
- **Adding More Equities, Especially Dividend-Paying Stocks:** As individuals go through retirement and their life expectancies become shorter, it makes sense to reduce equity exposure and be more conservative with their retirement portfolios. However, for those with a 15-year or longer life expectancy, portfolio growth is critical so that future-year distributions can be increased for inflation. Additionally, dividend-paying equities can provide significant value in a portfolio during retirement.

In Summary: We are likely entering a lower return environment for the foreseeable future. We believe that factoring in the steps we take in managing portfolios, along with the recommendations above, our clients will be well positioned to enjoy a financially-secure retirement even if 3.3% is the new 4%.

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