Retirement Rules of Thumb

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You may have heard of the 4% rule in retirement; basically it means that you should be able to safely take out and spend 4% of your retirement portfolio in the first year of retirement, and then increase that dollar amount by the inflation rate for the next 30 years, and you should be able to count on that income no matter what the markets do.

Notice all the 'shoulds' here. This 'rule' was formulated by a financial planner named Bill Bengen back in the mid-1990s when he became curious about Money Magazine's advice that retirees could take 10% out of their portfolios each year, because, at that time, stocks had generated an average 10% return since the mid-1920s. Bengen pulled out his spreadsheet and assumed a $1 million retirement, and began taking out ten percent each year starting in 1926—and the portfolio ran out of money during the Great Depression. He iteratively tried a lot of other amounts and formulas, and came up with the 4% amount inflated thereafter because that portfolio distribution not only survived the awful markets of the Great Depression, but also the stagflation era that included the 1974 and 1975 stock market downturns.

The reason you can't sustain the same distribution as the markets is simple: you're taking money out of the portfolio every year, and in bear markets (particularly severe ones) the portfolio amount is declining by the downturn plus your distribution. The next year you have to pay out a larger percentage of the portfolio, which will generate less return going forward, and you can bet there will be another bear market in there somewhere. Because markets are erratic, you have to reduce what you take out to account for the uncertainty.

The problem with the 4% 'rule' is that if you don't encounter a Great Depression or stagflation, and particularly if you get a nice sequence of market returns in the early years of retirement, following through on the safe withdrawal rate means you will end up with a huge pot at the end of retirement—and maybe some regrets that you didn't spend some of it earlier.

There are other issues that make a 'set it and forget it' policy less-than-ideal. One is that if much of your retirement income comes from Social Security and/or a pension, then you are much less reliant on the markets—and you can probably take out more from the portfolio side of your wealth. If all your income comes from an investment portfolio, then market movements become proportionately more impactful.

And the 4% ‘rule’ doesn’t account for taxes. The most astute retirees have their retirement assets in different tax buckets: a Roth IRA (no taxes on distributions), a traditional IRA (full income tax rate on distributions) and a taxable account (taxed each year on distributions, but generally only taxed on capital gains when stocks or ETFs are sold for income). Experienced financial planners can control the tax bite by taking a certain amount from each—and by keeping income below certain thresholds, they can reduce Medicare IRMAA surcharges as well.

This suggests that the best approach to determining retirement income is to set a reasonable retirement budget and re-evaluate every year. If the markets go up, great! You might be able to go on a nice trip. If the markets go down, that’s a year where you can tighten your belt. If you’re willing to be flexible, then the ‘rule’ can go up to 5.5% to 7%. This also lets a retiree spend more in the early, more vigorous years of retirement when we get the most out of our travel time, and less in later years when our preference is to stay home and enjoy a good book.

Source:

https://www.investopedia.com/terms/f/four-percent-rule.asp

If you have any questions about this article or want to discuss your family finances, investment portfolio, or financial planning advice, please call on me anytime at my number (215) 325-1595 or you can click here to schedule a meeting.

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