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The 4 percent rule no longer applies for most retirees

What exactly is the 4 percent rule? It's a rule of thumb used to determine the amount of funds to withdraw from a retirement account each year.

The 4 percent rule seeks to provide a steady stream of money to the retiree, while also keeping an account balance that will allow those funds to be withdrawn throughout the person's retirement years. It's considered to be a “safe” rate, with the withdrawals consisting primarily of interest and dividends.

While the withdraw rate is kept constant, it can be increased to keep pace with inflation. It sounds great in theory. However, that rule is broken, new research shows that this rule doesn't work for retirees in today's low-rate environment.

Technology has come a long way since the 1990s, when the 4 percent rule was first introduced. There is an emerging class of services from tech-savvy investment managers that provide dynamic withdrawal rates using algorithms that look at market performance, balance and terms of portfolio, all of which work together to ensure you won't run out of money, he said.

But with the era of low interest rates nearing its nine-year anniversary, that old approach is no longer working well—unless you are among the wealthy, or at least have more than enough socked away for later life.

Households that have accumulated considerable wealth may use the 4 percent rule as a conservative yardstick. For most households, however, the rule is simply an opening bid. Retirement readiness is too complex to be codified by a simple rule of thumb."
Part of the problem with the 4 percent rule is that it was developed in the 1990s, when interest rates were significantly higher. Retirees with their savings in safe instruments such as bonds and annuities were getting more income than retirees today do with similar assets.

Another problem, though one with a positive side as well, is that life expectancies have increased. Americans are living longer after they stop working, which means their savings have to last longer. A man reaching age 65 in 1970 could expect to live 13 more years, but by 2011 that figure was 18 years. A woman's life expectancy at age 65 rose from 17 years in 1970 to 20 years in 2011 (the most recent year for which such data is available from the Centers for Disease Control).

Wealthy households do not have to worry as much about these issues since they are more likely to have accumulated more than enough money to support themselves in retirement.

But those with less savings have less of a margin for error.

Behavioral trends describe another problem as well: the so-called sequence of consumption problem. The 4 percent rule expects people to draw down their money in a mostly linear pattern, but life is not linear. Retirees commonly spend more money—much of it discretionary—when they first retire, either because they don't know what they should be spending or because they are enjoying long-awaited activities such as travel.

Spending tapers off in the middle of retirement, and then non-discretionary spending picks up later on, perhaps because of health-care needs. But households who overspent in the early years can wind up in a bind at that point.

Using historical interest rate averages, a retiree drawing down savings for a 30-year retirement using the 4 percent rule had only a 6 percent chance of running out. But using interest rate levels from January 2013 retirees' savings would grow so slowly that the chance of failure rose to 57 percent. The 4 percent rule cannot be treated as a safe initial withdrawal rate in today's low interest rate environment.
Models to help investors and their advisors understand how prepared they are for retirement. Developing tools that mass market investors can use to determine how to draw down their savings. The approach has to be much more personalized. Retirees need to keep assets dedicated to their retirement needs invested in lower-risk assets such as bonds and annuities. On top of those funds is discretionary money. That is the only money to invest in anything with meaningful risk, like the stock market.

As for drawdowns, "an actuarial view of the length of the plan remaining," or a calculation of how long a retirees money has to last. Look at retirees current balance net of recent market performance, and from there you can calculate how much is safe to draw down for a given time period. If you do the household math, then you have a better sense of how much risk you are taking and whether it's a good idea.