Retirement Drawdown: Tips to Make the 4-Percent Rule Work

by Steve Vernon
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How much can you safely withdraw each year from your IRAs, 401ks, and retirement savings and minimize the odds of actuarial ruin (outliving your retirement savings)? My post last Monday discussed the four-percent rule as one strategy to help you prevent this fate. This post gives you tips on how to make the four-percent rule work, reflecting some of the refinements to it that I mentioned at the end of my prior post.

The four-percent rule was introduced in a landmark paper published by William Bengen in 1994. Earlier this year, Chris O'Flinn and Felix Schirripa published a significant update to Bengen's paper. The duo used Bengen's historical methodology but looked at all retirement periods beginning each month since 1926, substantially increasing the number of data points. They were able to reflect the investment experience up through June 2009, including the most recent meltdown. Here are a few key points and conclusions:

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For Retirement at Age 70 or Later

For all 20- and 25-year retirement periods, the four-percent rule reflected no instances of actuarial ruin with a portfolio invested 75 percent in stocks and 25 percent in bonds (a 75/25 portfolio). For a portfolio invested 50 percent in stocks and 50 percent in bonds (a 50/50 portfolio), there were no failures for 20-year retirements, and only a 2 percent failure rate for 25-year retirements.

Conclusion: The four-percent rule appears to be safe if you're retiring at age 70 or later, since a portfolio with a 25-year retirement goal would have very high odds of lasting until age 95 and later. I think targeting a retirement that lasts until age 95 is a reasonable goal.

For Retirement at Age 65

For all 30-year retirement periods, the four-percent rule failed only 4 percent of the time for a 75/25 portfolio, and 8 percent of the time for a 50/50 portfolio.

Conclusion: You could use the four-percent rule if you retire at age 65, but be ready to make mid-course adjustments under certain circumstances, as discussed below.

For Retirement Before Age 65

For 35-year retirements, the four-percent rule failed 8 percent of the time for a 75/25 portfolio, and 15 percent of the time for a 50/50 portfolio. For me, these failure rates are too high to guarantee peace of mind for retirements well before age 65.

Conclusion: I believe that 35 years is just too long to be withdrawing principal from your retirement accounts. Too much can go wrong during that long of a period. Instead, if you're retiring before age 65, I'd recommend living on just the interest and dividends of a portfolio balanced between stocks and bonds, at least until age 65 — and until age 70 would be even better. That strategy produces withdrawals of about 3 percent of your portfolio. I'd also suggest you work part time if you need additional income to meet your living expenses.

The O'Flinn/Schirripa paper also showed that the four-percent rule failed when there was high inflation and/or poor stock market returns early in a retirement period. Examples are retirements that started in the mid 1960s to the mid 1970s, and retirements that started before the significant stock market crashes during the Great Depression. Monday morning quarterbacks would give you this advice: Don't retire before the market crashes or before there's high inflation!

Mid-Course Adjustments Are Appropriate

More practical advice would be to make some mid-course adjustments if you encounter high inflation or poor investment returns during your retirement. Cut back on your principal withdrawals during these periods, so that you buy time to let your portfolio recover. And consider living on just the interest and dividends for awhile. This can mean tightening your belt on living expenses or finding some other source of income, such as by working. While these may not be desirable choices, they sure beat being broke in your eighties and nineties.

On the other hand, if you experience a favorable investment environment during the first five to ten years of retirement, you could reset your withdrawal amount to four percent of your portfolio at that time, if that would give you a higher withdrawal amount than rigidly sticking to your original withdrawal plan. It's entirely appropriate to make mid-course adjustments to your withdrawal strategy to reflect your ongoing investment and inflation experience — good or bad.

Don't Forget About Fees and Expenses!

The historical analyses prepared by Bengen and O'Flinn/Schirripa don't reflect investment management fees and expenses. If you're paying an advisor one percent of assets to manage your portfolio, you'll have a drag on your investment earnings, unless your advisor produces returns that exceed the historical averages, net of expenses. This is one more reason to be conservative in your initial withdrawal strategy, and then make mid-course adjustments as appropriate. In addition, consider using index funds with low fees that correlate well with the historical returns that the above papers were based on. If you need advice, pay your advisor an hourly rate instead of one percent of assets, to minimize the drag on your returns.

Determining a safe amount of withdrawals from your retirement savings is a critical decision we all have to make. That's why we're not done with this topic yet. Other methods have been floated out there to help you avoid actuarial ruin during your retirement years when you're withdrawing principal. For instance, some analysts suggest higher allocations to bonds. And the O'Flinn/Schirripa paper discusses the use of immediate annuities. I'll cover these strategies and more in future posts — stay tuned!

P.S. Don't forget — there are two other ways to generate retirement income from your IRAs and 401ks, as I've previously written about.

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For 30 year retirement periiod, the article discuses only 75/25 and 50/50 portfolios. Is there a portfolio with an optimum mix of stocks and bonds that provides minimum failure (even lower than 4 per cent) rate?

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Since your children won't have SS because their parents voted for politicians that refused to do anything but perform steal all you can now then your childern will need it.

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The bottom line is that most of these simple set-it-and -forget-it rules don't work when there are extraordinary times, and over 30 years or so there are guaranteed to be economic conditions that are way outside what you expect. Low interest rate periods, high inflation periods, stock and bond bubbles and crashes, probably all these things and more in a 30 year period.

The best you can do, especially if retiring early, is make sure your minimum cash burn requirements are as low as possible. That means absolutely no debt and maybe move where living is cheap. Then adjust spending each year to the results your investments achieve. This makes sure your money will last and also gives you a strong incentive to manage it actively.

I retired at 54 and adhere to this idea. I am now 60 and doing just fine despite financial crisis, stock crash and zero interest rates. I live very modestly and spend some time on my portfolio and keeping up with potential new opportunities nearly every day. That is my job now that I do not have any other. When my investments are doing poorly I cut back to near subsistence living, when doing better I can spend more. It helps that I live alone and so have sole control of my spending.

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If at age 62 I have 300K in 401(k) at 63 I retire with 344K (8% increase +20K contribution) I should be able to withdraw 8% for 5 years (no yearly increase) and still have 300K principal.

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If at age 62 I have 300K in 401(k) at 63 I retire with 344K (8% increase +20K contribution) I should be able to withdraw 8% for 5 years (no yearly increase) and still have 300K principal.

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I thought the 4% rule was designed generate income without having to touch principle (i.e. 7% return 3% inflation), in other words last forever. Fine if you want to leave a significant sum behind. I would like to see more writing on peoples retirement savings lasting a set period of time.

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Article does not take into account RMD

Replies (1)

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Another way to not run out of money in retirement is to invest in a highly diversified basket of closed-end mutual funds that have regular (monthly or quarterly) payouts of interest and capital gains that match actual market performance . Of course the actual payout will vary, but if you can live on the 3-8% returns that are typically available, you won't run out of money no matter how long you live.

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The problem is not people living longer. The problem is inflation since 1971 stealing people's hard-earned wealth.

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