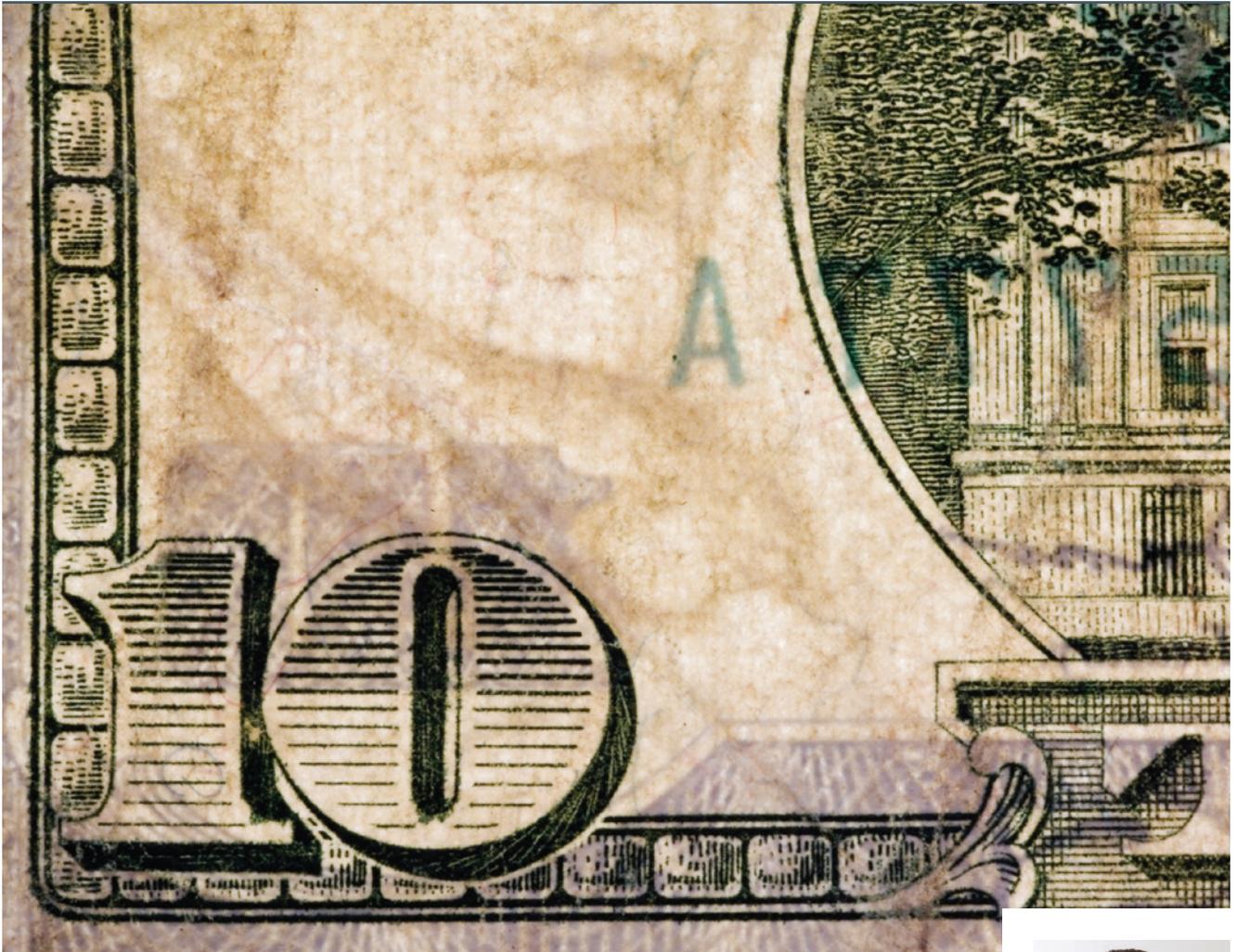


RETIREMENT

Planning Retirement in a Rising Tax Environment / 46 /



Ten Reasons Why the 4 Percent Rule Is Too Simplistic

By Wade D. Pfau, Ph.D., CFA

Help your clients plan for their retirement by considering the bigger picture.

WILLIAM BENGEN'S SEMINAL STUDY in the October 1994 *Journal of Financial Planning*, "Determining Withdrawal Rates Using Historical Data," helped usher in the modern era of retirement withdrawal rate research by codifying the importance of sequence of returns risk. The problem he set up is simple: A new retiree makes plans for withdrawing some inflation-adjusted amount from his or her savings at the end of each year for a 30-year retirement period.



Wade D. Pfau, Ph.D. is a professor of retirement income in the new Ph.D. program in financial services and retirement planning at The American College. He is also an active blogger on retirement research and was a 2012 selectee for the InvestmentNews Power 20.

Wade.Pfau@wcinput.com

RETIREMENT

What is the highest withdrawal amount as a percentage of retirement date assets that, with inflation adjustments, will be sustainable for the full 30 years? He found that with a 50/50 asset allocation to stocks and bonds, the worst-case scenario experienced in U.S. history was a 1966 retiree who could have withdrawn, at most, 4.15 percent. It is from these origins that the idea of the 4 percent safe withdrawal rate developed as a basic rule of thumb for retirement income planning.

Naturally, as this is a rule of thumb, it does not necessarily mean that 4 percent is an appropriate withdrawal rate for every new retiree. Here are 10 reasons (some of which suggest lower withdrawal rates, while others suggest higher withdrawal rates) why advisors and their clients should think more deeply about whether 4 percent is the appropriate solution.

“What matters for sustainable withdrawal rates is the interaction of portfolio returns and volatility.”

ONE

The U.S. historical experience is not sufficiently representative to provide a clear idea about the safe withdrawal rate. The 4 percent rule has not worked as well in other countries, and new retirees today experience a market environment that has very little precedence in the U.S. historical record. This is because bond yields are so low at the same time the stock markets are significantly overvalued, according to Robert Shiller's cyclically adjusted price earnings ratio. This represents a clear challenge to the continued sustainability and viability of the 4 percent rule for recent retirees.

TWO

The 4 percent rule is based on an assumption that investors earn the underlying indexed market returns with annual rebalancing. Investors who pay fees or otherwise underperform the indices, because of either poor timing or asset selection decisions, cannot rely on 4 percent.

THREE

The 4 percent rule is based on a tax-deferred portfolio. For those withdrawing from a taxable portfolio, taxes will play a bigger role than one may expect. Not only are taxes paid on withdrawals, but taxes must also be paid on reinvested dividends, interest and capital gains when they accrue and even if they are not withdrawn. This limits the chance for the portfolio to earn compound growth on those removed tax payments.

FOUR

The 4 percent rule assumes a retiree has no desire to leave a bequest or to build in a safety margin. In the worst-case scenario, wealth depletion can be expected. This causes the retiree to play a game of chicken as wealth plummets toward zero. Building in an additional safety margin further reduces the sustainable withdrawal rate.

FIVE

The 4 percent rule is based on a planning horizon of 30 years. Those with other planning horizons must adjust

their withdrawal rate accordingly, as increasing planning horizons will cause a further decline in the sustainable withdrawal rate.

SIX

The 4 percent rule assumes only a few asset classes. What matters for sustainable withdrawal rates is the interaction of portfolio returns and volatility. Including more asset classes can allow for different portfolio characteristics, and, potentially, a portfolio with better return/volatility characteristics can be found. Advisors who implement strategies that reduce some of the downside volatility for client portfolios through the use of financial derivatives or other strategies can also find justification supporting a higher withdrawal rate.

SEVEN

The 4 percent rule assumes constant spending in inflation-adjusted terms throughout the retirement period. Two questionable aspects about this may or may not be related. First, actual retirees tend to reduce some of their discretionary expenditures as they age

and spend more time at home. On the other hand, health expenses tend to rise with age. Different assumptions about how spending evolves with age have an impact on sustainable withdrawal rates. Second, because survival probabilities decrease with age, it is somewhat natural to plan for a reduced spending pattern over time. Otherwise, one sacrifices too much by cutting spending in early retirement to allow for the same spending much later on when the probability of survival is quite low. One would need to be extremely inflexible with regard to their spending decisions or extremely averse to outliving their wealth to prefer a strategy of constant spending over retirement. And with such inflexibility, it would be odd to try to manage all of this longevity and market risk on one's own without branching out to consider various strategies that incorporate guarantees.

EIGHT

The 4 percent rule assumes withdrawals are taken from a portfolio invested with a total returns perspective. But there are many other options available to retirees building income strategies, such as fixed and inflation-adjusted immediate annuities, variable annuities (with and without guarantee riders) and bond ladders. Retirees may seek to build an income floor to make sure their basic needs will be met. A time-varying strategy of withdrawing more before age 70 and less after may be appropriate, as it is often beneficial to delay claiming Social Security. A complete strategy will involve a process that seeks to combine different income tools to best balance between one's goals and risks to those goals.



NINE

Optimal retirement income strategies involve changing one's spending in response to evolving market returns and their impact on wealth. The constant inflation-adjusted withdrawal strategy from a volatile portfolio without guarantees is inferior to other strategies, no matter the types of evaluation measures or retiree circumstances.

TEN

The 4 percent rule is based on an evaluation measure that seeks only to minimize the probability that financial wealth will be depleted at some point before death. It ignores the potential magnitude of failure (that is, how much time at the end of retirement will be spent without wealth), and it ignores other resources that may be available to the retiree in the event of wealth depletion. A more complete picture of retirement income resources may suggest, in some circumstances, that retirees can

be more tolerant about later financial wealth depletion as it will allow them to enjoy a more satisfactory early retirement period. This more complete picture would also account for when, precisely, financial wealth is depleted.

The 4 percent rule and the probability of running out of financial wealth are just one piece of a much larger puzzle that needs to be solved to help clients fully enjoy their retirement. Retirement income planning is quite distinct from pre-retirement wealth accumulation, as clients must determine how to disburse their assets to maximize their spending potential without running out of income before running out of time. New designations, such as the Retirement Income Certified Professional® (RICP®) designation from The American College, are now available to help advisors strengthen their understanding and to better implement the strategies needed to help their clients enjoy a successful retirement. ■■