Proper Use of the Four Percent Withdrawal Rate Guideline

Four percent has become a popular guideline for sustainable annual withdrawals from investments. However, this guideline is frequently misunderstood and misapplied. Following is an explanation of the proper use of this guideline.

Setting an initial before-tax withdrawal rate of four percent of investment assets and adjusting that withdrawal rate annually for inflation will have a greater than 80 percent probability of maintaining the inflation adjusted withdrawals for 30 years or more if historical capital market data is a reasonable basis on which to form expectations about the future. This statement makes numerous assumptions (including using a sensible investment strategy) and could be argued either way. However, most financial planners would agree that it is in the ball park.

As an example, retiree with $2 million in investment assets who wished to follow this strategy would take before-tax withdrawals of $80,000 in the first year and increase the withdrawals annually for inflation regardless of actual investment results. Following this system beginning at age 60 or older would result in a high probability of maintaining that withdrawal rate on an inflation-adjusted basis beyond age 90.

This withdrawal rate is recommended to minimize (not eliminate) the risk that a retiree may have to reduce spending in the future even through bad markets. Therefore, following this guideline does not require adjusting the withdrawal rate for actual investment results. In the above example, if the retiree experienced a loss in the first year and had only $1.5 million in investment assets at the beginning of the second year, he would nonetheless increase his withdrawal by inflation even though that would create a withdrawal rate in excess of four percent for the second year.

This creates a logical paradox since a new retiree in the second year beginning with $1.5 million would be told that a sustainable withdrawal rate is $60,000 (four percent of $1.5 million) while the retiree who retired the previous year would be told it is affordable to spend $80,000 plus inflation. How can two retirees with exactly the same wealth have different affordable withdrawal rates? The answer is that they cannot.

This is the first misuse of the guideline. It is not intended as a means by which to manage or adjust spending. It is intended as a reasonableness benchmark for making financial decisions. In the first year the first retiree made the decision to retire and established a budget based on the belief that a four percent withdrawal rate was safe. After withdrawing four percent and experiencing a 21 percent investment loss, he now has 25 percent less wealth. He was unlucky and his retirement plan got off to a bad start. He cannot continue to spend $80,000 plus inflation if he still wants an 80 percent chance of maintaining a constant inflation-adjusted withdrawal rate.

The four percent guideline is reasonably safe but not 100 percent safe. Actual events must be considered and future spending must adapt. The paradox of the two retirees is not really a paradox, it is a misunderstanding of the meaning of the four percent guideline.

The second misuse of the four percent guideline is assuming that spending will remain constant forever. A beginning withdrawal rate of six percent, might be okay if it includes expenses that will stop at some point like a mortgage that is almost paid-off or if it is temporarily high until social security or pension begins. A higher withdrawal rate may also be reasonable if the retiree has substantial discretionary spending and is willing to live with adjusting spending with ups and downs in the portfolio (see The Six-Three Solution℠).

Alternatively, beginning retirement with an annual withdrawal of only three percent is not necessarily safe. A low initial withdrawal rate could still be risky if it is only temporarily low due to an income stream that will stop at some point like deferred compensation or part time work or if the investment strategy is excessively conservative or expensive. In addition, a retiree with a chronic health condition who has high medical expenses that are not covered by insurance, might need to allow for a higher inflation rate and might need to begin with a lower withdrawal rate.

Finally, the four percent withdrawal rate guideline is based on the assumption that no other withdrawals are ever made from the portfolio other than the four percent annual withdrawals. This is often an unrealistic assumption. Most retirees will make other withdrawals from their portfolios at some point during retirement for major expenses such as car purchases, home repairs or to help a struggling child.

The four percent guideline is not a substitute for retirement planning. It is a benchmark against which to evaluate the reasonableness of more detailed planning. Individual circumstances must be considered and actual results must be evaluated. A financial or retirement plan is a dynamic living process. Guidelines and rules of thumb are useful benchmarks and checkpoints, but they should not be the driving force in the construction of a plan.