TRI-STAR TRUST BANK

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TIPS FROM YOUR Financial Coach

Is a 4% withdrawal rate still relevant?

Many people, especially those near or approaching retirement, have heard that withdrawing 4% of your total investment value each year is a safe and successful long-term financial strategy. However, how many of us know the math behind the number?

The initial research supporting the 4% withdrawal rate was published by financial planner, William Bengen, in the Journal of Financial Planning twenty-two years ago in 1994. The outcome of his probability-based “safe” withdrawal recommendation was based on the following:

- A $1-million-dollar retirement portfolio
- A balanced investment strategy of 50% stocks (S&P 500 benchmark and 50% bonds (Intermediate Government Bond benchmark)
- An inflation-adjusted withdrawal amount based on the Consumer Price Index (CPI)
- Returns based on 30-year overlapping historical market performance beginning in 1926
- Withdrawals that begin in any year between 1926 and 1976
- A 100% probability of success

Goal: Determine the maximum inflation-adjusted withdrawal percentage of a 50/50 portfolio that can be taken each year assuming historical market returns that would result in the retirement portfolio lasting at least 30 years 100% of the time.

Result: Withdrawing 4.15% adjusted each year for inflation from a $1-million-dollar balanced portfolio would last at least 30 years given all overlapping 30-year historic returns. Hence, the recommendation to limit withdrawals to $40,000 per year given a $1-million-dollar value. This $40,000 is inclusive of all fees and taxes.

Reasons why the 4% rule may still be relevant.

1) Historically, the average return of a 50/50 portfolio has exceeded 7% from 1926 through 2015, therefore withdrawing 4% does not seem unreasonable.
2) Portfolios that are well-diversified amongst all asset sub-classes historically have experienced higher returns than the asset mix Belgen used in his research. In fact, when he added small cap equity exposure into the portfolio, the recommended withdrawal rate increased to 4.5%.
3) Striving for a 100% probability of success may encourage cautionary spending during retirement that is unwarranted.
4) Many people may not need their retirement assets to last for 30 years. They may intend to work well into their 70s or 80s, may have a shorter life expectancy, or they may have income resources like pensions that minimize withdrawal needs from investments.

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Reasons why the 4% rule may no longer be relevant.

1) Current 10-year Treasury yields are much lower today at 1.8% than historic averages.
2) We haven't experienced significant inflation in the past several years. Consecutive periods of high inflation would unravel this strategy. Moreover, healthcare expenses inflate more rapidly than the CPI, and these health-related costs typically make up a large portion of a retiree's spending.
3) Withdrawal needs are not likely to remain constant, and will fluctuate from year to year. You may need more or less than the inflation-adjusted 4% amount.
4) Consecutive negative market years, especially at the beginning of retirement, may be too devastating for your portfolio to overcome.
5) This research does not factor in asset allocation changes over time.
6) People are living well into their 90s nowadays, and your retirement may be longer than 30 years.
7) The effectiveness of this approach is dependent on the investor maintaining a buy and hold investment strategy. You would have to follow this strategy without being influenced by all the market and economic noise you will undoubtedly hear throughout your retirement years.

Recommendation

Retirement goals are unique to each individual. One person will have a different vision and will take a different path to get to their retirement destination than another. Additionally, a person in their 40s may have different priorities than a person in their 50s or 60s. It wouldn't be practical to tie the success of an ever-changing retirement landscape exclusively to a study based upon a variety of constants.

Withdrawing 4% of your portfolio each year is a reasonable guideline or starting point, but it does not guarantee that your portfolio will last throughout your retirement. There are too many unknowns and too many assumptions built into this static approach.

At Tri-Star, we encourage our clients to go through the comprehensive financial planning process for 5 primary reasons.

1) To identify and quantify your goals.
2) To determine a baseline of retirement success given income, expense, asset, liability, tax, inflation, longevity, and market return expectations.
3) To develop and implement strategies to improve the probability that you will accomplish your goals and your investments will last your lifetime.
4) To utilize your plan as a foundation for making financial decisions after analyzing the impact of various what-if scenarios.
5) To monitor and update your plan every 3 years, or when you experience a life change that will affect your financial future.

The one thing we know for certain is that change is constant, and this is why we create a financial plan as a living document, changing as life changes. Please contact your Tri-Star advisor if you are interested in our financial planning services.