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Consider All Individual Circumstances Before Suggesting 4% Retirement Income Withdrawal

An individual's investment allocation is a big factor to consider when deciding a proper optimal withdrawal rate of savings in retirement, but there are many other factors to consider as well.

By *Rebecca Moore*



Art by Katherine Streeter

Individuals approaching retirement would like to be able to determine the largest steady withdrawal they can possibly take during retirement.

As a video from Compass Point Retirement Planning points out, if a retiree takes too much retirement income each year, he risks running out of money, and if a retiree takes too little each year, he risks missing out on perhaps a better lifestyle.

A common rule of thumb used for decades is called the "4% rule." It says a retiree can take 4% of his starting savings balance at retirement, adjust each year only for inflation, and his savings should last for 30 years. However, this assumes a specific investment mix and, according to Michael LaBrie, president of Compass Point Retirement Planning in Wakefield, Massachusetts, while it accounts for inflation, it doesn't address real-world costs.

One problem, LaBrie says, is a retiree's savings balance is not static. If he takes 4% of his balance the first year at a time when the market is high and the market then falls, the withdrawal rate will show itself to have been too high, and vice versa.

LaBrie spent six years researching, developing and testing a mathematically engineered, patent-pending methodology called "[The TRU Method](#)." Analyzing more than two centuries of historical economic data to test how the 4% Rule would actually have performed over all 30-year periods from 1801 through 2017 using realistic cost assumptions, LaBrie's research showed two different high percentage failure modes. First was a high frequency of premature depletion of the retirement portfolio when 4% proved to be too high a withdrawal rate. Second was an even higher frequency where retirees could have safely afforded a rate higher than 8%. LaBrie then ran the same data using the TRU Method, which showed zero instances of retirees running out early and significant increases in total lifetime income safely taken on average.

LaBrie says his method corrects for what he calls the ValueGap—the difference between the fluctuating performance over time of an equity index or investment and its mean value when expressed as real total return. "The mean is a much better basis in determining purchasing power," he says. "It shows the purchasing power of \$1 over time. The Value Gap shows how misaligned current values are at any given time above or below the mean value." His mathematical method aims to quantify and eliminate the Value Gap.

He further explains that the 4% rule used one portfolio—70% stocks/30% bonds. If a retiree's portfolio tends to earn more, he would be able to take more, if it tends to earn less, he would be able to take less. The larger the volatility of asset classes results in smaller withdrawal percentages, and historical performance will inform the withdrawal percentage, he further explains.

Not only is the 4% rule not necessarily right for every person, it may not be right for every point in time, LaBrie says. "If there are two people with similar circumstances, one may retire at a time when 4% of his balance is maximized and sustainable, while the other may retire at a time when, because of the market, 4% could be far too high or too low.

David Blanchett, head of retirement research for Morningstar Investment Management LLC in Chicago, agrees that 4% has been considered a "safe" withdrawal rate looking at historical returns. However, he points out that there is a large consensus that [returns on average will be lower in the future](#). Blanchett has done [his own research](#) and found that changing the returns projection method from historical to projected (i.e., using lower returns) had a significant, negative impact on the safe initial withdrawal rate.

Blanchett's research also suggested that if a retiree wants to preserve his funded ratio—savings balance—throughout retirement, a static withdrawal amount would result in failure, implying a need for dynamic withdrawal rates. If the portfolio experienced a negative (or poor) return, the funded ratio would decrease, and to get the funded ratio back to its target, the portfolio withdrawal amount would need to decrease.

Other Variables

Blanchett says there are many variables that go into target savings and target withdrawal rates. "Four percent may be a good starting point, but in reality, it will not work for someone who is 80-years-old or someone who retires at 40."

In [his research](#), "Estimating the True Cost of Retirement," he found that the actual income replacement rate needed by retirees is likely to vary considerably by retiree household, from less than 54% to more than 87%. This is because retiree expenditures do not, on average, increase each year by inflation or by some otherwise static percentage.

Other research has shown that retiree spending in retirement is low—either out of an [abundance of caution in preserving their assets](#) or because [discretionary expenses decrease](#) the longer a person is retired.

Blanchett says there is overwhelming evidence that retirees don't increase spending with inflation but actually spend less, in today's dollars, over time, "even if you look at those with tons of money." However, he points out that [health care costs are growing](#)—meaning an 80-year may expect increased expenses, but on the other hand, retirees can decrease discretionary spending if they want.

In addition, in "The Impact of Guaranteed Income and Dynamic Withdrawals on Safe Initial Withdrawal Rates," Blanchett found that varying levels of guaranteed income shifted the safe initial withdrawal rate approximately 4 percentage points on average (from approximately 6% when 95% of wealth was in guaranteed income, versus approximately 2% when only 5% of wealth was in guaranteed income). This has implications for assumptions about Social Security, pension benefits and individually owned annuities.

[Research from Global Atlantic Financial Group](#) also finds retirees with a guaranteed income stream are able to spend more.

Blanchett's research also points out that typical models used to determine a safe withdrawal rate in retirement use a fixed retirement period (e.g., 30 years); however, some mortality tables show there is a 43% chance that at least one member of a couple (or both) will survive 30 years in retirement, a 16% probability of surviving 35 years, and a 3% probability of surviving 40 years. Withdrawal rates would have to be adjusted for longer expected retirements.

How to Figure It Out

Unfortunately, figuring out a safe or optimal withdrawal rate in retirement is not an exact science. Financial advisers and online calculators can be useful, Blanchett says. However, he cautions that there are many assumptions to use, it's a complicated decision and different advisers and calculators may yield different results.

According to Blanchett, Morningstar is seeing an increase in the availability of retirement savings projection tools on recordkeeper websites, and there are online advice tools available from Morningstar, Financial Engines and robo advisers. "Plan sponsors and advisers should provide tools for employees," he says.

"One thing I'm convinced of," he adds, "is that these tools may provide different answers, but participants who engage with these tools save more, and most are not saving enough. Any tool to get participants engaged is saving is good and gives them a way to start planning for the future."

LaBrie concludes, "Being able to get the maximum retirement income without running out of money is the Holy Grail of all this. People don't want to miss out in their retirement years, and they need good answers."

Tagged: Retirement Income