Retirement Hacks

The 4% rule is being debated — again — but here's what you should do

Last Updated: Nov. 16, 2021 at 11:19 a.m. ET
First Published: Nov. 15, 2021 at 1:04 p.m. ET

By Alessandra Malito Follow

This retirement savings withdrawal rule was meant just as a guideline, but some experts say it is outdated

Withdrawal rates are crucial to protecting retirement savings throughout one's lifetime, but not all experts agree on how much someone should take out of their accounts each year.
GETTY IMAGES

The 4% rule — which suggests retirees withdraw 4% of their retirement savings every year for living expenses — may be too high, according to the latest analysis of the popular strategy.

Retirement Tip of the Week: Don't just assume you need to withdraw 4% in retirement because it's been a general rule of thumb for so long. Assess your income needs for retirement first, and adjust your withdrawal rate as needed.

With the 4% rule, retirees would withdraw no more than 4% of their retirement assets, adjusting each year thereafter for inflation. It's a strategy for retirees to avoid outspending their retirement savings before they die.

See: The FIRE movement confronts the 4% rule

But a new analysis from investment research firm Morningstar suggests the withdrawal rate may be off. In fact, researchers suggest the rate should be as low as 3.3% for people who want to ensure their retirement savings last their lifetimes. The 3.3% figure assumes a balanced portfolio and fixed withdrawals over the span of 30 years, an estimated length of retirement years, which leads to a 90% probability of not running out of money in retirement.

"Given current conditions, retirees will likely have to reconsider at least some aspects of how they define their 'safe' withdrawal rate to make their assets last," the research note said. "Our research finds that retirees can take a higher starting withdrawal rate and higher lifetime withdrawals by being willing to adjust some of these variables — tolerating a lower success rate or forgoing complete inflation adjustments, for example."

Take for example adjusting expectations for successfully outlasting their retirement savings — retirees who are willing to accept an 85% success rate could bump their withdrawal rate to 3.7%, and those with an 80% probability could use a 3.9% withdrawal rate. Of course, whether lower rates of withdrawal are feasible also depends on how much money has been saved, if it's invested appropriately and what the retirees' budget and income needs will be — immediately upon retiring, as well as in their older ages.

This is not the first time the 4% rule has been contested. Even the guideline's creator, Bill Bengen, said it was used too simplistically, and meant as a way for retirees to protect their nest eggs in a "worst-case scenario," such as October 1968 when the stock market soared and inflation had gotten out of hand. A newly retired person would have had their money last if they maintained a 4% withdrawal rate, he said when he created this rule of thumb in 1994.

Bengen's updated suggestion is in a direction opposite the Morningstar researchers. He said retirees' withdrawal rates should be no more than 5%. One reason: persistently low inflation rates. Inflation was what was most dangerous for retirees in the 1970s, he noted.

Other analysts agree the safe withdrawal rate would be around 3% — or lower. "I think it is far too aggressive today and other advisers agree," Allan Roth, founder of Wealth Logic, wrote on Barron's.

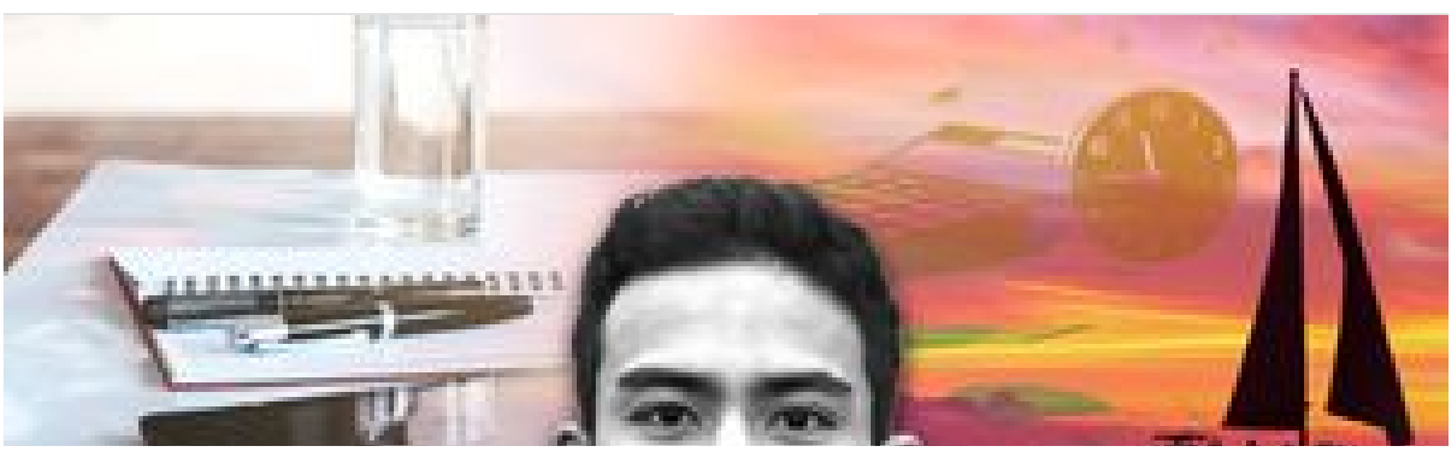
After modeling these rates, Roth said a 3% withdrawal rate would be good for 25 years, so a couple at the age of 65 who retired should try to aim for 2-2.5% if their budget is mostly non-discretionary. This rate also depends on the age at retirement — someone younger would need to spend less whereas someone older could have a higher rate.

Have a question about your own retirement concerns? Check out MarketWatch's column "Help Me Retire"

The three keys to maximizing this safe rate, according to Roth, are: staying flexible, especially when the market has a downturn; delaying Social Security, which would increase a guaranteed source of income; and investing "responsibly," which includes minimizing investment fees and taxes, maintaining a diversified portfolio and acting with discipline when the market is volatile.

What was a safe withdrawal rate 40 years ago may not be safe today, and what is an appropriate withdrawal rate today may not work in the future. As such, retirees need to look at the bigger picture when choosing their withdrawal rate. Today's economic environment includes low bond yields, high stock valuations and low inflation, which means historic rates no longer apply to new retirees.

"A starting safe withdrawal percentage in the low-3% range might seem demoralizing for new retirees, but a countervailing force is that most retirement savers' balances are appreciably higher than they were a decade ago," the researchers said in their note. An expansive bull market over the last 10 years certainly helped those investors.



I'm 36 with $435,000 and want to retire early — 'the earlier the better' — but without a frugal lifestyle

Alessandra Malito

Alessandra Malito is a retirement reporter based in New York. She is also a Chartered Financial Consultant. You can follow her on Twitter @malito_ali