Forget the 4% withdrawal rule

Big idea: The most important retirement rule has changed

Almost every asset you can invest your nest egg in now looks expensive by historical standards. What's more, argues Wade Pfau, this has big implications for how you draw down from your savings the money you need to live on. If he's right, it throws one of the best-known retirement guidelines right out the window.

When Pfau, a professor of retirement income at the American College for Financial Services, says both stocks and bonds are expensive, he isn't predicting an imminent crash -- the Ph.D. economist is a number cruncher, not a tea-leaf-reading market forecaster. But he argues that basic math suggests asset prices have less room to rise, meaning the long-run outlook is for lower returns ahead.

Based on studies of stock and bond returns since 1926, financial planners had settled on a benchmark for how much a retiree could spend each year without fear of running out of cash. It turned out that a person who invested half in stocks and half in bonds could spend 4% of his or her wealth in the first year, adjust that dollar amount for inflation in subsequent years, and still have money 30 years later. That worked in every historical 30-year period, as well as in most computer simulations based on the historical rate of return. Even drawing a hefty 5% worked more often than not.

But without strong stock and bond returns to help refresh your nest egg as you spend from it, those old numbers can't be relied on, argues Pfau.

"The probability that a 4% withdrawal rate will work in the future is much lower," he says. His new safe starting point: a 3% drawdown. That means that if you've saved $1 million, you're living on $30,000 a year before Social Security and any other sources of income you might have, not $40,000. Ouch.

You may be relieved to hear that Pfau's idea is controversial. Michael Kitces, partner and director of research, Pinnacle Advisory, who has worked with Pfau on other research (more on that later), is one of many experts who think that the long historical record is still a decent guide to the future.

Yet William Bengen, the planner who in 1994 came up with the 4% rule, says some rethinking may be in order. "I think Pfau has done a great job of looking at the issues," he says. "Market valuations are important, and he may be right."

Here's the story the numbers tell, according to Pfau: The 10-year Treasury recently yielded only 2.6%, compared with its 3.5% historical average. Current 10-year yields generally tell you the total return you can expect over the next decade. (Even if yields go up from here, today's owners of bonds will suffer a loss of capital, since bond prices fall when yields rise.)

As for stocks, large companies listed on the S&P 500 index are priced at 25 times their averaged earnings over the past decade, according to measurements by Yale economist Robert Shiller. This gauge stands significantly above its average of 16. When Shiller's price/earnings ratio is high, lower returns typically follow over the next 10 years.