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PERSONAL FINANCE

The 4% Retirement Rule Is in Doubt. Will Your Nest Egg Last?

A well-established strategy for funding our golden years is no longer foolproof. Retirees need to get creative.

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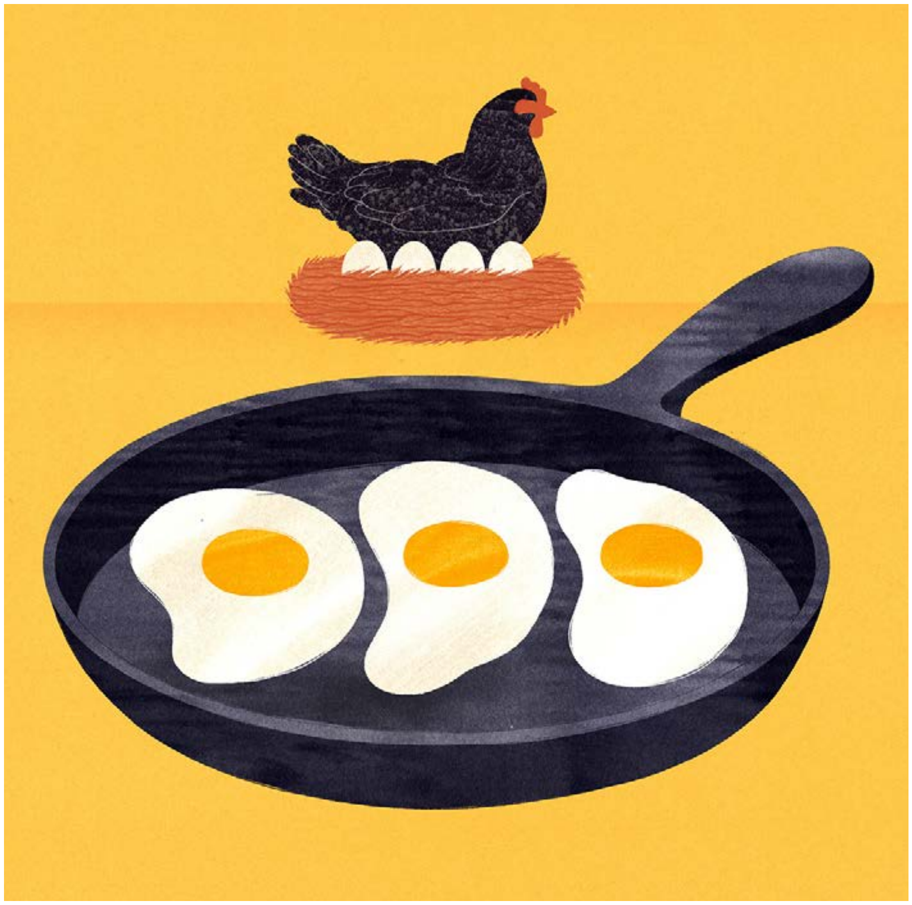

ALEX NABAUM

A longstanding rule of retirement spending is getting a pay cut. But there are ways to ensure the income you receive in your golden years doesn't take a big hit—if you're willing to be flexible.

Conventional wisdom recommends spending no more than 4% of savings in the first year of retirement and adjusting that amount annually to keep pace with inflation. The math behind that rule is changing as market forecasters predict lower returns ahead, potentially shifting the way that millions save and spend for their later years.

People retiring now who want a high degree of certainty their money will last should spend no more than 3.3% of their savings in the first year of a three-decade retirement, and adjust for inflation after that, according to a report released Thursday by investment research firm Morningstar Inc. So someone with a $1 million portfolio would spend $33,000 in the first year of retirement. Assuming 4% inflation, the investor would increase annual income to $34,320 in year two and $35,690 in year three, regardless of the market's performance.

The 4% rule emerged as the wealth-management industry's standard in the 1990s. In the subsequent decades, millions of Americans came to rely on that figure to guide their retirement spending, and with good reason. The 4% strategy would have enabled investors holding 50% in stocks and 50% in bonds to make their money last over the vast majority of 30-year retirements from 1926 to 2020.

That, however, is no longer as likely because future returns are expected to be lower following an extended period of above-average gains. Morningstar researchers simulated future returns over a 30-year period and found that in a quarter of the simulations a half-stock, half-bond portfolio would run out of money if withdrawals stayed at 4%.

One indication the current market may be overvalued is the S&P 500's price/earnings ratio, which measures the price investors pay for a dollar of corporate earnings. It is 23.88 when calculated using recently reported earnings, according to FactSet. That is significantly higher than the 17.35 average over the past 20 years.

"It's counterintuitive, but when the stock market and stock valuations are high, it's the worst time to retire," said Morningstar personal finance director Christine Benz, a co-author of the firm's report.

Morningstar isn't the only corner of the wealth-management universe counseling an adjustment to the 4% rule. Some other researchers agree

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returns are likely to fall, complicating withdrawals. If inflation, which is at a 30-year high, remains at or near today's level for an extended period, even a reduction to 3.3% could prove optimistic.

There are ways retirees can still spend more than 3.3%, if they are willing to be flexible. They can opt to work longer, reducing the number of years in which they'll have to rely on their nest eggs. They can also delay the year they start taking Social Security; the longer they wait, the higher the monthly check when benefits begin. That, in turn, will reduce the amount they need to withdraw from retirement portfolios.

Some advisers also recommend varying your portfolio withdrawals in response to market moves—taking more when the market is up and less in down periods. How retirees pull that off depends on their tolerance for complexity, how much they wish to leave for heirs and their ability to cut spending.

The simplest version of this plan is to forgo inflation adjustments in any year after which your portfolio incurs losses. The advantage of that tactic, aside from its simplicity, is that it allows for a higher starting spending rate than 3.3%. Assuming you hold 50% in stocks and 50% in bonds, you can withdraw 3.76% at the outset of retirement and still have a 90% chance of not running out of money over 30 years, according to Morningstar.

The method produces a more predictable income stream and leaves more for heirs than most other variable strategies. But there is a downside: While your nominal income may remain steady, your inflation-adjusted income is likely to decline over time—a more painful prospect when inflation is high.

A more complicated approach is to spend more at the outset of your retirement, pull back when markets do badly and raise your withdrawal amount when stocks rise. This so-called "guardrails" strategy allows someone with a 50% stock and 50% bond portfolio to withdraw 4.72% at the outset of retirement and still have a 90% chance of making their nest egg last 30 years, according to Morningstar. The strategy was devised by financial planner Jonathan Guyton and software developer and educator William Klinger.

There are risks, though. Some cutbacks could be large, and a higher starting rate means less money is likely to remain for heirs.

Here's how it could work: Say you retire with $1 million and withdraw 4.72%, or $47,200, in year one. If your portfolio declines from $1 million to $750,000, your $47,200 withdrawal—plus an annual adjustment for inflation—now represents more than 6% of your new $750,000 balance.

Any time your withdrawal rate rises to 5.7% or higher, the guardrails strategy imposes a 10% pay cut for the next year. So after adjusting the $47,200 initial withdrawal for inflation—to $49,088, assuming a 4% inflation rate—this method cuts income by 10%, or $4,908. You would take a $44,180 withdrawal in year two—which could mean forgoing a vacation or putting off a car purchase.

You can give yourself a 10% raise following years in which your withdrawal rate falls by 20% from the initial 4.7% level, to 3.8% or below. Any spending cuts would be suspended in the final 15 years of a 30-year retirement, Ms. Benz said.

In years in which your withdrawal rate is between 3.8% and 5.7%, adjust your most recent withdrawal to keep up with inflation. (Skip the inflation adjustment following a year in which your portfolio sustains a loss.)

"Many of today's retirees will have to be more resourceful to support their income needs," Morningstar said in its report.

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