Does the 4% safe withdraw rate still make any sense?

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A simple question without any simple answers…

Does the 4% safe withdrawal rate still make any sense?

To answer this question, I reached out to Certified Financial Planner (CFP®) Steve Bridge, from Vancouver. Steve works as an advice-only financial planner with Money Coaches Canada.

As a CFP® who helps clients directly with retirement and pension planning, I figured Steve would be an excellent subject matter expert to offer his take on this subject.

Steve, welcome to the site!

Thanks Mark! Happy to be talking with you. Love the work you do, and I know we're on the same page with helping Canadians get advice that is actually in their best interests.

You bet Steve. I enjoy running the blog and interacting with folks about personal finance and investing. Before we get the heart of the 4% safe withdrawal rate discussion, I was wondering if we could recap what this "rule" actually says and what it is based on for readers?

Sure Mark.

In general terms, the "4% rule" says that you can withdraw 4% of your savings each year from the time you retire and have a very high probability you'll never run out of money. I think this "rule" has gained so much traction over the years because it gave people comfort that if they followed this rule, they would never run out of money. We both know there are risks with this logic!

This 'rule' originated from a paper written in the 1990s by a financial planner in the USA who looked at rolling 30-year periods of a 50% equity/50% fixed income asset allocation.

Steve: For Mark's readers, here is another way of looking at it, since I know you aspire to own a $1 million portfolio for semi-retirement:

- If you grew your portfolio value to your goal, $1,000,000, then you could reasonably withdraw 4% of that or $40,000 per year almost without fail until death. (We will see why later on there some assumptions with the 4% rule to be mindful of!)
- Depending upon your lifestyle, say you needed $60,000 per year in retirement or semi-retirement, then according to the 4% rule you would need $60,000/4% = $1,500,000 in portfolio value.

Great stuff Steve.

As I approach (rather strive for) semi-retirement in the coming years, I've been doing more thinking about the 4% rule. Based on demographic shifts that I wrote about here in my top dividend ETFs post, I'm wondering if the 4% still makes any sense?

I'll be honest, I've been preparing retirement plans for people for almost five years and I have never used the 4% rule or even mentioned it to any of my clients.There are just too many factors to consider when it comes to retirement planning to rely on just one rule or aspect. I think introducing this 'rule' could potentially confuse people, as they could maybe walk away thinking, "All we have to do is withdraw 4% of our money per year and we'll be fine".There are just so many other factors to add into an overall plan that using one idea isn't advisable.

For example, you need to take into account:

- *How much Canada Pension Plan (CPP) and Old Age Security (OAS) will you receive?*
- *Timing of taking CPP and OAS (Hint: later is almost always better)*
- *Will you (or your spouse) have a defined benefit pension plan?*
- *Do you expect to receive an inheritance?*
- *Will you downsize your home?*
- *Do you have a shortened life expectancy or health issues that should be considered?*

Mark: here is a post on this very subject!

When to take your CPP benefit.

If you think about a somewhat extreme example, a couple with two defined benefit pension plans who are expected to receive 100% CPP and OAS and want to spend $70,000 per year in retirement could stop working with literally zero dollars in the bank and never have a worry. The 4% rule doesn't come into play whatsoever! For most people the rule, in my opinion, is only moderately useful at best – there are just too many other factors to consider when it comes to putting together a complete retirement plan and drawdown strategy.

I can say this because you just had that case study on your site! (Mark: read on if $1.2 million is enough???)

Mark: here is a post on downsizing and those benefits (including financial ones):

Why should you consider downsizing.

Well put Steve. So, what about our low-yield interest rate environment Steve? Thoughts?

This is a really tough one. Some people are adding more equities, some like dividend stocks and others preferred shares. For me, I think that having a balanced portfolio that allows you to sleep well at night and not having too many eggs in one basket is the way to go. What the future holds with regard to returns for stocks and bonds is anybody's guess.

I think your readers should be reminded that most research done on sustainable withdrawal rate, including the 4% rule, used historical data and, that research assumes there is an expected return on each asset class going-forward. Those are big assumptions.

What about another risk to the 4% rule – sequence of return risk. Can you explain to readers what the sequence of return risk *really means* and what harm that can cause to an investor's portfolio?

Sequence of return risk means that a stock market correction, crash or widespread economic recession in the first few years of your retirement will reduce your savings and therefore reduce the amount you can spend each year going-forward. Put another way, without adjusting downward your annual spending, you could run out of money.

Mark: I like to think of sequence of returns risk like dollar cost averaging in reverse. In my asset accumulation years, with dollar cost averaging, you invest regularly and buy more shares when investments are down.This means during these years, a negative sequence of returns works to your benefit – as you buy more shares, cheaper. When you're in retirement, selling regularly, you need to have a plan in place to make sure you aren't forced to sell too many shares when investments are down in a major way.

OK Steve, even though we haven't seen another major correction, *yet*, how might investors combat a prolonged series of bad market returns in retirement Steve? What do you advise clients?

*Ah yes, the next correction. It's definitely coming (the next correction is **always** coming), but as you and I know, there is no one who can tell us when that will be or how bad it will be!*

To protect yourself in advance of a prolonged downturn, one option that I like is to set aside a total of four year's worth of lifestyle spending in cash and GICs. For example, if someone wants to spend $50,000 per year in retirement, I would advise having the current year of spending in cash (i.e. $50,000), as well as $50,000 in each of a one, two and three-year GIC each. This would allow you to wait out most market corrections, crashes, and recessions and sleep well through the whole thing.

I recall you're going to put about a year or so of expenses away in cash as well, as part of your cash wedge. (Mark: I am!)

Another consideration is that if you have a defined benefit pension plan (I think you do Mark?), you could reduce your annual savings by that amount. So, in our example above, if someone had a $30,000 per year defined benefit pension plan they would only need to keep $20,000 in cash (instead of $50,000) and purchase the GICs for $20,000 ($20,000 + $30,000 = $50,000).

I would advise your readership that retirement planning isn't just about getting the best return bottom-line, it's also about being worry and stress free and mitigating risks.

To provide your readership with some actionable ideas, here are my solutions for clients:

1. *Have a cash cushion and GIC ladder*
2. *Know what your retirement needs are, so that you could adjust spending in a time of a severe prolonged downturn*
3. *Never sell in a downturn. Have confidence that the markets will do what they have always done – recover! Preparing mentally for this will help you avoid panicking and doing something they will regret later, i.e. crystallizing losses.*

Steve, most of the research that has been done on sustainable withdrawal rates including Bengen's 4% rule has been based on an equal mix of stocks and bonds (specifically just large-company U.S. stocks and intermediate–term U.S. government bonds). When Bengen added a third asset class, small-company U.S. stocks, I recall he actually raised the acceptable withdrawal rate to 4.5%. What are some of your thoughts adding more equities to your portfolio as you get older and/or using dividend-paying stocks in a retirement portfolio?

Great questions and observations Mark. Like we discussed above, every investor has a different set of goals and objectives. It's vital to understand and clarify those before simply adding more equities as you get older.

I think international stocks can provide diversification to an investor's portfolio. Meaning, diversification can reduce the volatility of a portfolio without sacrificing returns.

There is a lot of discussion these days around what an ideal asset allocation is during retirement. I've read some very convincing articles (with numbers and stats to back them up) that show a higher equity allocation post-retirement reduces the odds of running out of money. Again, numbers and math are one thing, but being able to sleep at night is also important. Having 80, 90 or 100% of your retirement savings in equities takes a very strong stomach and is definitely not for everyone. We talked about the volatility above. The tough part would be not selling when the market drops, because that's when the real damage is done to your future.

Final questions Steve, what are the biggest challenges you see and coach clients on these days? With that question in mind, what could all investors get better at to help them with their safe withdrawal plans?

The first challenge, which I mentioned above is, knowing how much you need or want to spend annually. Look at what you're spending now and then figuring out what will be different in retirement. Forget the '70% of pre-retirement spending' rule – look at your specific situation. I have seen cases where 50% of pre-retirement income is enough and others where they were going to spend more than they currently were! Without knowing how much you want (or need) to spend, you don't have a starting point and can't plan. You're kind of 'flying blind' and hoping things will work out and not taking out too much and risking running out of money!

Another challenge is getting advice that is actually in their best interests. There is a lot of information out there, it's more accessible than ever, and it may not be applicable or best for you.

For example, many people don't touch RRSPs until they're forced to at age 72 (when the RRSP account has to be converted to a RRIF) because either they didn't know they could or were told by someone (who may have a *vested interest) not to touch it. Investors/Retirees can save a lot of money in tax by withdrawing from RRSPs and similar accounts in their 60s.*

Finally, putting together a drawdown plan that looks at all of your accounts (including your spouse's) as a whole, as well as pensions and tax brackets will help you get money out and pay the least amount of tax possible (and therefore the most money in your pocket).

So, suffice to say there are a lot of challenges and pitfalls when it comes to planning for retirement. Be careful what advice you take, who's giving it and whether that advice is appropriate for your specific situation.

What a closing comment and some great insights from Steve.

I want to thank Steve Bridge, a CFP from Vancouver for his detailed thoughts on the 4% rule. Steve works as an advice-only financial planner with Money Coaches Canada (no affiliation with *My Own Advisor*). You can find him on that site for his services and you can follow him often on Twitter like I do at @SteveMoneyCoach.

I hope to have Steve back on the site for more investing discussions in the future! Thanks Steve!

Mark