IS 4% A SAFE PORTFOLIO WITHDRAWAL RATE?

As you pursue your retirement goals, you may have to factor in other considerations

"How much can I safely withdraw from my portfolio?" This is one of the biggest, if not the biggest, of the financial concerns faced by most retired people. This seemingly simple question is prompted by a core financial goal – how to maintain a retirement lifestyle free from worry about your financial security.

There can be a great deal of anxiety around this topic. The uneasiness becomes magnified upon retirement because your paradigm shifts when thinking about your investment portfolio. You have to look at your investments from a distribution viewpoint, rather than an accumulation perspective. This may be the first time that you have thought about taking funds out of your portfolio, rather than putting more into it.

A great deal of analysis has been done on what is commonly referred to as a "safe withdrawal rate" and articles about the topic regularly appear in the popular press. In an effort to simplify the answer to this important and complicated question, many of the fundamental assumptions and limitations get lost. And the conclusions often differ, creating confusion which can be compounded by the dynamic nature of each individual's specific retirement circumstances.

FACTORS TO CONSIDER

While 4% is often presented as a rule-of-thumb safe withdrawal rate, several factors can make applying this single rate to a broad range of individual circumstances over periods of changing economic conditions an over-simplification. These factors are broadly classified as:

- Time horizon
- Initial portfolio amount
- Ongoing portfolio considerations
- Withdrawal strategy

Let's briefly look at each of these factors and how they affect estimating a safe withdrawal rate.

Time horizon

The good news is that people are living longer. That's challenging news for a portfolio that may now be required to sustain your lifestyle over a longer time horizon. To put that in perspective, consider that a 30-year retirement may be as long as some people's working careers. In other words, you may be retired as long, or longer than, you worked!

A lengthy retirement is a recent phenomenon, having developed over the last 40 years or so as longevity has increased. In generations past, the retirement time horizon was relatively short, maybe 10 years or less. With such a short time frame, it wasn't nearly as important to be so cautious with withdrawal rates, portfolio asset allocations or any of the other safe withdrawal rate factors.

When considering retirement scenarios, it's important to be aware of the time period. If the time horizon is longer or shorter than the 30-year period that is typically modeled, you may have a lower or higher safe withdrawal rate, respectively. This may seem intuitive, but it is very often overlooked, especially when considering very long retirement time frames, which may accompany an earlier retirement.

Initial portfolio amount

The size of your initial retirement portfolio is another factor. The safe withdrawal rate as a percentage of the portfolio may be constant, but the dollar value of the withdrawal rate is directly related to the initial value of the investment portfolio. This may be an obvious observation, but it's an important one that bears repeating.

How much you withdraw periodically is typically one of the most significant factors affecting your retirement portfolio, and how much you withdraw is determined by how much you need to maintain your desired lifestyle. If a safe withdrawal rate applied against the initial portfolio amount does not equate to the dollar amount needed to support your lifestyle, adjustments will be required if the retirement portfolio is expected to last your lifetime. Additionally, the rules of thumb regarding safe withdrawal rates that are often cited in the popular press frequently focus only on how much one can spend on lifestyle, forgetting that this really should be an "all in" expense number that includes taxes and fees. When considering how much you can withdraw from your portfolio and ultimately devote to funding your lifestyle, remember that some of those funds will need to be "spent" on taxes and fees. This situation is especially true if the funding is coming from a tax deferred account (IRA, 401(k), 403(b), etc.).

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Ongoing portfolio considerations

You should also be mindful of inflation. High rates of inflation, especially early in retirement, may restrict purchasing power throughout the remainder of the retirement years. Hedging against high inflation is an important element of retirement portfolio construction. Fortunately, in recent years, asset classes and products that provide some inflation protection have become much more accessible to individual investors.

Beware, however, of thinking of your portfolio on a product-by-product basis. Allocating assets efficiently and effectively from a risk and return – or risk and risk control – basis is one of the most important aspects of building and preserving your retirement portfolio. Asset allocation has become easier to implement for retirement portfolios in recent years because of innovation in the financial products fields.

Another major factor in portfolio efficiency is asset location. Asset allocation pertains to your overall wealth picture, and may include assets beyond your retirement portfolio. Asset location is part of the implementation of an overall asset allocation, and pertains to the income taxation efficiency of a portfolio. Very broadly speaking, by locating the tax inefficient assets in a tax deferred account and placing tax efficient assets in taxable accounts, you can help reduce the wealth accumulation friction of taxes. Asset location is an aspect of portfolio construction that is sometimes not considered in the analysis reported in the media. Each circumstance is unique and it is important to consider the assumptions and approach taken when any common rule of thumb is applied to one's individual situation.

Withdrawal strategy

The withdrawal strategy may be the most important and misunderstood aspect of the safe withdrawal rate concept. Many of the early retirement studies concluded that starting with a withdrawal rate of about 4% of the initial portfolio in the first year of retirement and then increasing the amount withdrawn (not the percentage taken out) with inflation over the years was a "safe" withdrawal rate. However, the reality experienced by retirees in recent years has not been as easy as relying on a simple default rate.

The retirement studies that initially produced the 4% rule often assumed an investor who took a mechanical approach to withdrawals. The investor is assumed to always withdraw the formulaically calculated amount without regard to changes in personal circumstances or market conditions. Anecdotally, this is not how real world retirees act. In down markets retirees tend to adjust their spending patterns. They will often cut back on discretionary spending as a preemptive action to guard against running down their portfolio before the end of their life expectancy.

To accommodate the behavioral finance aspects of retirees, the next wave of studies assumed some "guard rails" around the perfunctory nature of the 4% approach. Often limits were placed on annual increases and decreases to the withdrawal amounts. This approach was an attempt to inject some actual retiree behavior into the analysis. However, it did not allow for adjustments to account for the longevity of the retiree and the investment performance of the portfolio.

Another withdrawal strategy that certain retirees use is to apply the required minimum distribution (RMD) calculation as a default portfolio withdrawal method. The RMD is the legally required minimum that must be taken out of tax deferred accounts when a retiree reaches a certain age (usually tied to age 70½). The RMD generally is an annually increasing percentage of the tax deferred portfolio and, because these accounts are intended to be spent during retirement rather than used as wealth accumulation vehicles, this methodology is designed to assure that the assets for that tax deferred account are distributed and taxed to the account owner over the account owner's lifetime. For many clients, the amount of the annual RMD is more than they need, or want, to fund their retirement lifestyles. In this case, the RMD should be taken out, some of it spent, and the remainder saved into a taxable account. Unfortunately, some retirees assume the RMD is a safe withdrawal rate and spend the entire amount distributed from the tax-deferred account, without taking into consideration that the RMD methodology is driven by public policy and based on statistics, neither of which are necessarily relevant to their own personal situation.

Estimating a safe withdrawal rate from your retirement portfolio is an important and complex set of decisions.

YOUR INDIVIDUAL APPROACH

Relying on a 4% rule of thumb for withdrawals during retirement may have had a certain level of appeal and validity at a time when retirement was for a shorter period relative to one's working years. In the present day, it is an oversimplification. Estimating a safe withdrawal rate from your retirement portfolio is an important and complex set of decisions that is often laden with emotion and complicated by dynamically changing investment and economic environments. Having regular and ongoing discussions with your portfolio manager and financial planner to assist you in planning for withdrawals that meet the needs of you and your family can be of great benefit and help you to navigate these important decisions and have peace of mind that your retirement funds are positioned to accomplish the goals you have for them.

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