Canaccord Genuity Wealth Management

Financial Focus

Becker Orr Wealth Management

How Much Can I Spend in Retirement?

October 2021

By Clinton Orr

How much can I spend in retirement? This is a common question. We want to enjoy retirement, but not run out of money. Frequently, as a rough guide, 4% is used. In fact, 4% has been a rule of thumb in the financial planning world for many years. The idea is that you take out 4% of your portfolio in the first year of retirement, then every year afterwards you adjust that amount by inflation. So, if you have a $500,000 investment portfolio, you withdraw $20,000 in the first year, if inflation is 2%, the next year you withdraw $20,400. You follow that pattern, adjusting your withdrawals for inflation for future years. Following the 4% rule you are unlikely to run out of money.

Where did the 4% rule come from and how useful is it?

The 4% rule is taken from a research piece by William Bengen entitled Determining Withdrawal Rates Using Historical Data published in the Journal of Financial Planning in 1994. Bengen assumed a portfolio constructed of 50% stocks and 50% bonds and then used historical data to determine a safe rate of withdrawal. At the time of the research the worst-case scenario would have been someone retiring in October 1968. The stock market peaked, a significant bear market followed, as well there was runaway inflation in the 70s. If someone in 68, had a 50/50 portfolio and withdrew 4% of their portfolio in the first year of retirement, and adjusted withdrawals to inflation for the years that followed, their portfolio would have lasted 33 years. So, if someone was retiring at the age of 60 or 65, a 4% rate of withdrawal would make some sense. According to historical data the worst-case scenario is that their portfolio would last 33 years. Bengen did not mention the 4% rule in his research, readers of his work dubbed it the 4% rule, and the name stuck.

Other takeaways from the research, Bengen said the "absolutely safe" withdrawal rate was 3%. Based on the historical data the portfolio with a 3% rate of withdrawal lasted at least 50 years. The worst-case scenario for a 4.25% withdrawal rate was 28 years. The average safe withdrawal rate, based on historical data was 7%, and if someone was lucky enough to retire just before a period of low inflation and a stock market rally, the safe withdrawal rate was as high as 13%.

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Bengen also looked at portfolio allocation and determined that having too much stock in the portfolio was risky, as was having too little. The optimal range, based on historical data, seemed to be 50-75% of the portfolio allocated to stocks. Having read the research paper, I do not believe the “4% rule” is the main takeaway. In my view the 2 big items are: 1) to have some allocation to the stock market, of course adjusted to the client’s risk tolerance. Since most folks will be retired for a few decades, over that time period, stocks are still the best vehicle for growth. 2)Use a withdrawal rate that meets the clients needs, but given historical data, could also stand up to the worst-case scenario. We don’t want to plan for sunshine and rainbows then have our retirement knocked off course when it rains. We want to ensure our plan can withstand a rough patch and if things unfold better than expected, we will have surplus.

Also, important to remember that this research was published in 1994, lots has changed since then! For starters William Bengen himself has now retired and he is not following the 4% rule! In a recent interview with MarketWatch Begnen said not only is he not sticking to 4%, he says that number was always treated too simplistically. It was not intended to be a one size fits all. In a recent podcast with Michael Kitces, Bengen said today he would probably be recommending 5.25% or 5.5%.

Rules of thumb and rough guides make for quick calculations and easy planning, but, in my view, are not too useful. For example, all of the research mentioned above assumes a fixed withdrawal rate, that the retirees will spend the same amount in every year. Data shows that is not the case. There is no one size fits all when it comes to retirement planning. A proper financial plan should address the unique aspects of your situation.

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