

Should You Withdraw 4% or Even More Each Year?

# Planning for Retirement Income

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As financial planners we field questions on a wide variety of topics, including financing college education for children or grandchildren, buying a home, starting a business, saving for retirement or giving back, to name just a few. But the most common concern is the ability to retire in comfort. As clients approach retirement, they want to ensure that their money lasts as long as they do and perhaps have some left over for the next generation.

Our crystal ball is just as cloudy as anyone’s. The future is unknowable and you can’t achieve this goal with absolute certainty. But that doesn’t mean you can’t put yourself in position to have a great chance for financial security in your golden years.

The list of uncertainties that face each of us in retirement can seem daunting. How long is each of us going to live? How healthy will we be? Might we move to be closer to our children or grandchildren? How will stock markets perform and how will interest, inflation and tax rates change during our retirement years?

When Alex started in financial planning more than 40 years ago, the retirement income picture for most clients was somewhat simpler than it is today. Many people had pensions that provided reliable lifetime income, health care costs were lower and life expectancies were shorter. Social Security income appeared to be somewhat secure.

Today, most people don’t have pensions and must rely on Social Security and their savings to provide retirement income. Although it appears that Social Security income will survive, it may meet less of your typical retirement expense than originally projected, particularly for younger people. Sadly, many don’t save enough, choosing instead to spend now rather than save for a future that seems so far away.

## The Search for a Magic Formula

Nearly 30 years ago Bill Bengen, a Massachusetts Institute of Technology graduate and financial planner in Southern California, attempted to come up with a formula that would provide the amount a retiree could safely draw from a portfolio without running out of money. He ran an analysis in which he studied retirement peri-

ods of 30 years’ duration, beginning in 1926. He discovered that withdrawing 4% and adjusting the amount annually for inflation from a balanced (60% stocks/40% bonds) portfolio enabled someone to survive for every one of these periods, even starting at the worst possible time, just before the Depression. He later raised his recommended withdrawal rate to 4.5% by using a more diversified portfolio.

One valid criticism was that this testing was for a worst-case scenario and, therefore, was too conservative. In Bengen’s studies, this worst-case scenario only occurred once during a 70-year period. Financial planning expert Michael Kitces refined Bengen’s research and illustrated that for most historical periods you could have ratcheted your spending higher than 4% as the majority of historical market periods were far more rosy than the Great Depression.

In most scenarios, adhering to the 4% rule resulted in the retiree ending out with a significant excess of unspent wealth. The average initial withdrawal rate could have safely been 6%, or even higher, in many periods. The prob-



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lem is how are you able to predict which period you’ll spend your retirement in?

About 15 years ago, Jonathan Guyton, a financial planner from Minnesota, came up with the concept of dynamic spending strategies as opposed to just using a “safe” autopilot program that’s never adjusted.

Guyton said that spending should be cut if withdrawals rose to be a dangerously high percentage of the then-current portfolio (because spending growth was outpacing portfolio growth). The “prosperity” rule allowed spending to be increased if the portfolio had done well.

In some ways this provides proof of what may seem like common sense — you should reduce spending if



your retirement funds aren't doing well and allow yourself to spend a little more if they are doing well. During the 2008-2009 stock market debacle, we saw most of our clients, whether retired or not, reduce their expenses during this difficult period as well as postpone any unnecessary purchases.

Bengen and Kitces have also explored the idea of varying your withdrawal rate, based on the valuation of the stock market, and the current level of inflation. In late 2020, Bengen showed that historically, your annual withdrawal rate could have ranged between 4.5% and 13% (admittedly an extreme outlier), based on stock market valuation and inflation at the time of retirement.

Nearly 30 years after Bill Bengen tried to put a firm number in place, the debate continues. But we think 4% is important to keep in mind. If you're drawing less than 4% per year, you may be missing some opportunities that you could afford without jeopardizing your long-term plan. Likewise, a withdrawal rate significantly higher than 4% may indicate you need the markets and inflation to break just right, in order to make it through retirement.

### The Bucket Approach

Many advisers approach the problem from a different angle, using what is commonly called the "bucket" approach. This approach recommends you segment your portfolio based on when you expect you'll need your money.

First you (or your planner) estimate your expenses for the first two years of retirement. From there, subtract your fixed sources of income, such as Social Security and pension income, and then set aside the remaining amount in a "two years expense bucket" holding cash and short-term bonds.

From there you will fill in two other "buckets." The first is more conservative, invested in intermediate bonds, and the second, longer-term bucket will hold stocks. The amount

in each bucket depends on your age and risk tolerance.

As the first bucket is spent down on living expenses, it must be replenished. This can be accomplished in two ways. First, you have the interest and dividend income from buckets two and three paid into the first bucket. More commonly, you will rebalance the portfolio each year.

The third bucket, which contains the growth-oriented investments, will likely grow faster than buckets one and two over time. To keep the appropriate balance, you sell some from buckets two and three each year, and use the proceeds to replenish bucket one.

Thus your portfolio would remain in balance and you will have expenses covered for two years at any given time. This enables you not to worry so much about the impact of market fluctuations on the rest of your investments.

### Three Phases of Retirement

Although it's nice to think there might be a "safe" annual withdrawal rate, whether it's 4% or 6%, the fact is people don't spend money in a linear fashion. A flat withdrawal rate doesn't take into account personal changes in health or lifestyle that occur with age. Over the years, we've found that spending patterns in retirement can be divided into three phases of about 10 years each. These are sometimes referred to as the "go-go," "slow-go" and "no-go" retirement years.

During the first, most active phase, people tend to make more one-time purchases that they may have postponed when they were too busy. Now that they have more free time, they might renovate their home, buy a vacation home or take that long-dreamed-of trip overseas.

As they shift to the next phase, big-ticket expenses settle down but day-to-day life remains relatively active. During the final phase, more money is spent on health care. In May 2021, Fidelity estimated that the average 65-year-old couple may

need \$300,000 to cover medical expenses in their lifetimes.

### Our Advice to Retirees

While we agree that there's no "one size fits all," many planners including ourselves start the conversation with a withdrawal rate of 4% to 6% and then adjust as necessary based on the client's specific situation.

For some, simply spending down 5% each year will be enough. Others may prefer the structure of the bucket approach, to better segment their investments and define their budget.

Either way, real life tends to intervene. We must acknowledge that there's no magic formula. Rules of thumb are just that — general benchmarks that are a good start point for a deeper consideration of your personal situation. Simply owning a portfolio of investments is not a retirement plan. Properly balancing your spending with your portfolio, in the service of your lifestyle and goals, is where true financial planning begins. **B**

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