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WHAT IS A SUSTAINABLE WITHDRAWAL RATE FOR RETIREES?

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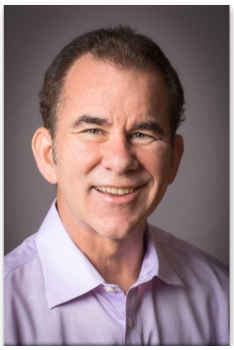
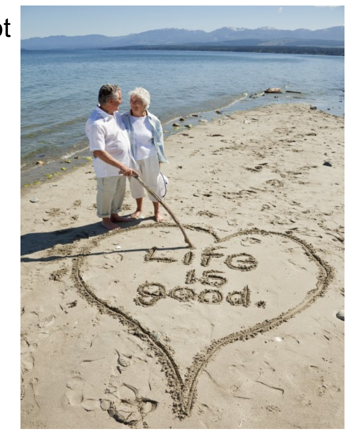


STEVE McCARTHY
CPA, CFP®,
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com

"Factoring in the steps we take in managing portfolios, along with the recommendations provided in the article, we still feel 4% is a sustainable withdrawal rate for portfolios despite future stock and bond returns being lower than their historical

McCarthy Asset Management, Inc. is an independent, fee-only investment advisory firm that has been helping people invest wisely for over fifteen years. Our mission is to help you better understand and improve your financial situation. We specialize in Retirement Planning, Portfolio Management and Tax Planning.



A "*sustainable withdrawal rate*" is a very important concept in retirement planning. It is *the percentage of your invested assets that you can spend each year without running out of money before reaching the end of your life*. The safe withdrawal rate method is a constructive approach that tries to balance having enough money to live comfortably without depleting retirement savings prematurely.

The "4% sustainable withdrawal rule" was first introduced in a 1994 study by William P. Bengen, in which he stated that for a portfolio comprised of 50% stocks and 50% intermediate-term treasuries, a 4% annual withdrawal rate is sustainable for a minimum of 30 years. The rule states:

> *Withdrawing 4% of your portfolio in the first year of retirement and then withdrawing the same amount adjusted for inflation each year thereafter will result in a high probability of your retirement savings lasting 30 years or more.*

This finding was later confirmed and expanded upon in studies by other academics to account for different asset allocations, time horizons and historical periods. Since then, the 4% rule has become one of the most widely used "rules of thumb" in retirement planning. For example, an investor who has accumulated a portfolio worth $1 million, and who is faced with 3% annual inflation, should be able to withdraw $40,000 the first year of retirement, $41,200 the second (i.e. $40,000 increased by 3%), $42,436 the third and so on, without fear of depleting her assets.

I last wrote about sustainable withdrawal rates in our September 2013 Monthly Commentary ("The Sustainable Withdrawal Rate- Is the 4% Rule Still a Good Estimate?"). Since writing that article, the stock market has appreciated substantially and bond yields have fallen. These are both negatives that suggest future returns for a stock/bond portfolio will be muted relative to historical averages. This is consistent with our outlook, as well as Vanguard's. As discussed in our October 2017 Monthly Commentary, Vanguard's 10-year outlook is for bonds to return 2.5% annually and stocks between 5% and 7% annually. Given this tempered outlook, is it still realistic for a retiree to withdraw 4% annually from his/her invested assets and not run out of money? In particular, here are two of the risks to the rule:

- **Low-Yield Environment and Above-Average Stock Values:** Most research done on sustainable withdrawal rates uses historical data and assumes the same expected return on each asset class year-after-year. This is a reasonable assumption when the stock market is fairly valued and bond yields are at or above their long-term averages. This is not a realistic assumption in today's environment of low bond yields and high stock market valuations. When factoring in the aging population and the slow economic growth, and the 4% rule begins to look too aggressive for the current environment.

- **Sequence of Returns Matter:** Intuitively, most people understand that if they retired in late 2000 or 2007, right before the onset of a major bear market, the withdrawals during those early bear market years had a much bigger negative impact on the overall health of their portfolio. This concept is known as sequence risk.

Devising a Sustainable Withdrawal Program—there is no one simple solution to sustaining portfolio withdrawals during retirement, but rather an array of steps that you can take. Here are some of them:

- **Create a 3-Year Bucket**: For clients who are receiving periodic distributions from their portfolios, we typically set aside 3 years' worth of withdrawals in a conservative bond fund. As long as stock prices are not depressed, we replenish this conservative fund at least every six months when we reposition portfolios. The benefit of using this technique is that when a bear market starts and stock prices drop precipitously, we do not need to sell any equities for at least three years to cover portfolio withdrawals. Given that the duration of the average bear market since the Great Depression has been 18 months, we should have enough held in the conservative bond fund to allow the rest of the portfolio to recover as the market correction runs its course.

- **Be Flexible**: Recall that the first few years of retirement are critical to the overall success of the sustainable withdrawal program. Reducing expenses during a market downturn will allow you to temporarily reduce distributions from your portfolio(s).

- **Adjust Your Expectations**:

    1. **Reduce the Certainty**: Certainties do not exist in the world of financial planning. As much as we would like to have a 100% certainty plan, many financial planners suggest that 80% probability is an acceptable level of success for a financial plan. Furthermore, a significant downside with a 100% certainty plan is that the retiree is living on less than they could safely withdraw. Unless leaving a large estate is a very important goal, the retiree would be foregoing expenditures that are affordable. In these cases, it may make sense to spend more if it results in a higher quality of life while still minimizing the risk of running out of money.

2. **Retire Later**: If the probability of success (i.e. the likelihood of not outliving your assets) is lower than what you are comfortable with, consider working longer or saving more.

3. **Assume Shorter Length of Retirement:** A 30-year withdrawal time horizon may be longer than is likely for many who retire at 65. Consider your family history of longevity and your health when making your plan.

- **Diversify Your Portfolio**: Most of the research that has been done on sustainable withdrawal rates has been based on a portfolio made up of just stocks and bonds. Adding alternative assets to a portfolio can improve the risk-adjusted returns, and therefore increase the sustainable withdrawal rate. Bengen's initial study used only two asset classes (large-company U.S. stocks and intermediate–term U.S. government bonds). When Bengen added a third asset class, small-company U.S. stocks, he raised the acceptable withdrawal rate to 4.5%.

- **International stocks and international bonds** add diversification to a portfolio. In addition, alternative assets, such as rental real estate can add diversification without sacrificing return.

- **Add More Equities, Especially Dividend-Paying Stocks:** As people age and their life expectancies become shorter, it makes sense to be more conservative with their retirement portfolios. For those with a 15-year or longer life expectancy, however, portfolio growth is critical so that future-year distributions can be increased for inflation. Particularly in the early phase of retirement, a portfolio should be more heavily weighted toward equities and less toward bonds. Dividend-paying equities can play a particularly important role here.

In Summary: Factoring in the steps we take in managing portfolios, along with the recommendations above, we still feel 4% is a sustainable withdrawal rate despite future stock and bond returns being lower than their historical averages.