The Four Percent Rule for Retirement

There is a "rule" often referred to as the 4 percent retirement rule that is popular among retirement savers. It gives you a guideline for how much you can spend in your retirement. However, the 4 percent retirement rule falls far short of working perfectly – after all, it is only a rule of thumb.

4%

People like the 4 percent rule because of it is simple and easy. How much you can afford to withdraw from your retirement savings? just multiply your total retirement savings by 4 percent. That is how much you can spend of the principle of your retirement fund. If you have $200,000 saved, you can spend $8,000 of it each year.

There is another rule of thumb useful feature of the four percent rule. You can use it to reverse-engineer how much you need to save to be able to retire comfortably. If you expect to need $50,000 per year, subtract from $50,000 what you will receive in Social Security, and then divide that number by .04. If your Social Security is expected to be $20,000 per year, then save $750,000, because $50,000 - $20,000 = $30,000. 4 percent of $750,000 is $30,000.

Is that useful? Yes. And the 4 percent rule actually has a reasonable analytic background. But it also has serious flaws that are inevitable with any simplistic system. It does not take the very uncertain future into consideration. A downward market fluctuation at the wrong time can destroy the backwards-looking long-term reasoning underlying the 4 percent rule. A serious downturn in the market could easily cause you to pull out more than 4%. A financial emergency could do the same. And then there is the problem that the 4 percent rule plans on enough money for 30 years of retirement. But what if you live longer? What is inflation raises the cost of living? The 4 percent rule is a conservative rule designed to deal with the worst-case scenario, but it is far from perfect.

So a natural question comes to mind, "Is there something better than the 4 percent rule? The answer is "no" unless you are willing to add complexity to the rule, and the complexity is based on very uncertain elements of life. And, of course, adding complexity destroys that useful simplicity of a well-thought out rule. The factors you need to consider in altering the 4% you can pull out annually are:

1. Your life expectancy. No one knows that time God will call us home. If your family history and your personal health suggest you may live into your 90s, you may want to reduce that 4% to something lower.
2. The market. In good years, you may be able to withdraw more than 4% and it bad years, less. Unfortunately, in very bad years that could mean a lot less.
3. Market timing. If the market does well in your early retirement years, you may be able to take out more than 4% for many years. On the other hand, a bad market dip early in your retirement could turn the 4% rule into a 2 or 3 percent rule.

4. Your expenses will change based upon your age. You will likely travel more in your 60s and 70 and less in your 80s and after. To offset against that, your medical expenses and needs will likely increase as you age.

If you are struggling with your finances, give The Idlewild Foundation a call at 813-264-8713, we would love to help.

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