How to Draw Down Your Nest Egg: 3 Alternatives to the 4% Rule

The presumed safe withdrawal rate of 4% has been a disaster for new retirees the last dozen years. Here's a better way.

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The 4% safe withdrawal rate has come under fire for good reason: It is based on a relatively small sample of historical market data and does not hold up when a retiree suffers big losses the first few years out of the gate.

In today's lasting low-return environment—and with the U.S. economy possibly taking a back seat to other parts of the world for decades to come—more recent studies suggest the safe withdrawal rate is more like 2.5%. Still, the 4% rule is deeply ingrained, and financial planners say it remains a valuable rule of thumb.

The rule states that each year you can withdraw 4% of a portfolio's value, raising the annual withdrawal amount by 3% to account for inflation, and be confidant that your money will last through 30 years of retirement. This rule, based on a mix of 60% stocks and 40% bonds, was popularized in the 1990s when markets were roaring. It was back tested through modern U.S. market history.

The investment firm T. Rowe Price gave the 4% rule another look, beginning with a retirement date of Jan. 1, 2000. It found that the Internet bust and financial crisis would have laid waste to the finances of anyone practicing the 4% rule since that date. If you had retired on that date with a portfolio of 55% stocks and 45% bonds and begun withdrawing 4% a year (plus inflation), your portfolio would have fallen by a third over 10 years. You would have only a 29% chance of your money lasting 30 years.

So it turns out 4% has been anything but a safe withdrawal rate for new retirees in these recent tough years. That doesn't mean it won't work going forward; it's just not the sure thing you may have come to believe. The real benefit of this rule is that it has got millions of retirees imposing some level of discipline on their spending. For that reason, 4% is still a worthwhile benchmark. But think of it as an upper limit to hit only when your portfolio has had an outstanding run.

If you think it's time to give up on the 4% rule, the *Wall Street Journal* – in a piece worth reading here – cites three alternative strategies for drawing down your assets in retirement:

- **Stocks plus annuities** You may be able to generate annual income equal to 4% of your portfolio with a 50-50 mix of dividend paying stocks and a single-premium immediate annuity. In today's low-rate environment annuities may seem expensive. But the income is guaranteed for life. You still have stocks to sell if you get socked with an unexpected expense.

- **Life expectancy** Draw down your assets based on how many years you are expected to live. Use actuarial tables that the Internal Revenue Service publishes to determine minimum IRA distributions. Say you have $1 million and are expected to live 20 more years. Divide $1 million by 20 and you get $50,000 a year. Do this calculation once a year, but err on the conservative side just in case you outlive the average of your age peers.
- **Stock valuations** This approach gives you a withdrawal rate based on stock values relative to their earnings, as measured by the S&P 500 price-earnings ratio. The idea is that when stock P-Es are high it means returns will be low going forward and you should withdraw less. When stock P-Es are low you can withdraw more because returns should be higher going forward. This analysis assumes a portfolio of 60% stocks and 40% bonds. The withdrawal range given is 4.5% to 5.5%. But that seems high. You might consider using the same approach with a range of 3.5% to 4.5%. Incidentally, stock P-Es are at the high end currently, suggesting withdrawal rates should be at the low end.