Is Bengen's Four Percent Rule Still Relevant?

How much should retirees safely withdraw each year?

By Guy Baker

Key Takeaways:

- The calculus of retirement planning has changed as people live longer in an era of extended low interest yields, inadequate nest egg accumulation, market volatility and high medical costs.
- SAFEMAX refers to the highest sustainable withdrawal rate for the worst-case retirement scenario in a retiree's lifespan.
- Sequence risk refers to the danger of receiving lower (or negative) returns, which substantially deplete assets, in the early stages of one's retirement.

Some of you may remember William Bengen, the trailblazing advisor who in 1994 first proposed the concept of a "levelized" withdrawal (SAFEMAX) from an investment account. His research was predicated on the 1992 Ibbotson Associates' Stocks, Bonds, Bills and Inflation Yearbook. This data was used to determine whether a portfolio invested in stocks and bonds could sustain a four percent withdrawal rate over an extended life expectancy. His conclusion was that retirees could withdraw 4.2 percent of their nest egg every year with confidence that their money would last for 30 years. Is this still valid today?

Financial advisors are helping clients cope with the reality of retirement. This reality includes living longer, extended low interest yields, inadequate retirement accumulation and market volatility, not to mention the impact of inflation and high medical costs. The question of "Where should I invest my money?" is being asked more and more frequently.

So is Bengen's recommended withdrawal rate still valid today? Since his inaugural quest, many academics have attempted to modify his four percent analysis to include "Monte Carlo" simulation, more sophisticated asset class allocations and strategies to protect capital from sequence risk. The conclusions are varied, with estimates the SAFEMAX rate could be as high as 5 percent or as low as 2.5 percent.

Sequence Risk

The issue for many clients and their advisors is sequence risk. Over the past 90 years, the stock market has returned, on average, 10 percent (with dividends reinvested). But again, that's the ***average***. It is the down years—which we potentially face in any given year--that can impact the risk of running out of money. So it is important for retirees to protect themselves against a protracted down market. Based on the data, the market has never been down for five consecutive years, even during the Great Depression. A possible solution would be for clients to split their money into two funds. One is their income fund and the other is their growth fund. Set aside five years of income in the income fund and then invest the rest in the growth fund.

By doing this, they can drain the income fund without negatively impacting their growth fund. In those years when their growth fund increases, they can refill their income fund. By using this strategy, it prevents you from having to liquidate in a down market. Of course, there are no guarantees.

Other options include annuities or a laddered bond approach using inflation adjusted bonds. A pension income secures a guaranteed benefit for life. But it all depends on the amount of capital someone has

accumulated. Don't forget how powerful Social Security can be for many retirees. If retirees can push back their normal retirement date until age 70, their benefit will grow eight percent every year until they start taking their income. Also, since Social Security has an inflation boost each year, it is a way for retirees to keep pace with purchasing power pressure.

Conclusion

The question remains: What is the SAFEMAX rate? Despite all of the studies that have been done, no one knows for sure. Markets are unpredictable. But one thing is for certain; the coming influx of retirees (including those who have already retired) is going to have to navigate these troubled waters. So, advisors who can help clients find a safe harbor for a reasonable time frame and then invest the rest will provide a meaningful benefit to those clients.

About the Author

Guy Baker, MBA, MSFS, CFP® *and a candidate for a PhD in Retirement Planning and Investments. He is a financial advisor to business owners, helping them find ways to reorganize their wealth planning to achieve tax-efficient solutions to their succession, retirement and estate planning problems. Guy is a 36-year member of Top of the Table and was recognized by Worth magazine as one of the top 250 financial advisors. For more information, you can contact him at guy@wealth-teams.com or through www.bmiconsulting.com* *This paper is ©2016 Guy Baker; All Rights Reserved.*