



Safe Withdrawal Rates

Most of you at one time or another heard us discuss the safe withdrawal rate. Much research has been done over the last few years to determine how much someone can safely take out of a portfolio annually and still be relatively sure that the portfolio will last for 30 years or more with a very low probability of depletion during your lifetime.

The simple answer is to limit withdrawals to 4.2-4.5% annually, with the withdrawals adjusted for inflation. For example, if your portfolio is worth \$1 Million when you retire, you may expect to withdraw \$42-45,000 at the start of your retirement. Some have questioned this and suggested that this withdrawal rate might be too low in many circumstances. In fact, it is low if you are NOT concerned with a repeat of the horrendous bear market that lasted from 1966 to almost 1981 or the constant volatility of the equity markets. A safe withdrawal rate without that bear market or volatility might be as high as 5.7% annually. The 1.5% difference between the two rates, 5.7% and 4.2%, is the cost of "insurance" to safeguard against the risk of a prolonged bear market and the inherent volatility of capital markets. Some people now believe that your safe withdrawal rate can be partially determined by considering how the market is "valued" when you retire. Some of this new thinking is the result of the paradox described in the paragraph below.

The paradox is as follows: Couple "A" retires with \$1,000,000 in their portfolio and adheres to the safe withdrawal rate of 4.5% taking \$45,000 out of their portfolio in the first year. If the market was also down 15% in the first year their portfolio will be worth around \$800,000. Continuing to adhere to the rule and with inflation assumed to be 3% their second year their withdrawal will be \$46,350 even though their portfolio did decline to \$800,000 (that's what that the "insurance" was for right?)

Things seem to make sense but now the paradox develops when Couple "B" who come us in year two with \$800,000 are told that their safe withdrawal rate is \$32,000! How can we reconcile this with couple "A's" circumstance? Some guidance is provided by considering the history of the markets in conjunction with safe withdrawal rates. When this history is considered we might reassess how much couple 'B' can safely withdraw.

This is where the new thinking begins. One way to determine what is a safe withdrawal rate is to analyze what amount someone could safely withdraw from their portfolio if they retired in a given year. For example if you retired in 1975 your safe withdrawal rate would have been nearly 8% (because you were on the tail end of a terrible bear market and stocks recovered strongly in the next couple of years). If you retired in 1966, the withdrawal rate was just over 4% (because of the secular bear market that lasted from 1966 to 1981). Secular bull or bear markets are markets with strong long-term trends. A secular bull (or bear) market may show strong positive (negative) trends but may have several short-term bull and bear markets embedded within them.

Looking at the safe withdrawal rate for many different years based on the year of retirement shows that the rate tends to swing between those two extremes. These figures are all for a portfolio that is 60% equity and 40% bonds. The safe withdrawal rate is strongly correlated (not surprisingly) with what happens to the stock market over the next few years after someone retires. If a person retired just before a secular bear market, the safe withdrawal rate would be on the low end of the scale, and if one retired before a bull market, the rate would be close to 8%. Some indication of the direction of the market can be provided by the average price to earnings ratio for the last few years (P/E). If the P/E ratio is low (under 15) we are more likely to experience a secular bull market with high returns for stocks over the next few years, thus allowing for a higher withdrawal rate.

We have found this study on safe withdrawal rates interesting and useful, but we believe that some of the assumptions might be flawed:

- The studies only work with 30 year periods. We have not yet seen a study that considers someone who might be retired for 40 years, which is something that might happen to someone who retires at 55 or 60. Statistically there is a 50% chance today that one spouse may live to be at least 90. With continuing advances in medical technology, longevity will only increase.
- Equity markets seem to always break some accepted “rule”. What happens if P/E ratios are at 11 and the supposed rally one might expect based on that valuation and past history never occurs?
- What happens if health care expenses cause your lifestyle needs to grow faster than inflation?

These studies of safe withdrawal rates do provide us with rules of thumb. However, as all rules of thumb tend to gloss over details and make “one-size-fits-all” assumptions. Ultimately a detailed retirement analysis that actually programs a person's projected expenses without assuming the expenses are the same every year (with only adjustments for inflation) is critical. To do otherwise is an oversimplification of reality. Performing such an analysis every few years will account for someone’s circumstances improving greatly or deteriorating if their invested assets are performing differently than originally predicted or their actual spending has been other than projected.

Using the safe withdrawal rate rule is a way to quickly determine what you might expect in income when you retire. We believe that a 4.5-5% withdrawal rate is appropriate as a rule of thumb based on our own research, but we’ll always want to thoroughly analyze and model your specific situation.